1. What is the impact of exchange rate volatility on the Indian economy? In order to manage the exchange rate, what tools does the RBI use? Explain with the help of suitable examples.

Approach-

Candidates can start the answer with highlighting recent exchange of words between executive and judiciary and then write about issues and share the views on existing system.

Introduction-

Exchange rate volatility is the frequency and extent of changes in a currency's value. It is measured by calculating the dispersion of exchange rate changes around the mean, expressed in terms of daily, weekly, monthly or annual standard deviations. The larger the number, the greater the volatility over a period of time.

Body-

Impact:

- Prices of everyday goods: India is also one of the top importers of edible oils. A weaker currency will further escalate imported edible oil prices and lead to a higher food inflation.
- Importing: When the dollar strengthens against the rupee, importers will have to pay more for the same number of dollars. And since international trade is mostly in the US dollar, importers have to pay higher prices.
- A weaker rupee directly impacts India's trade balance and inflation through higher cost of imports. Costlier imports will widen the trade deficit as well as the current account deficit, which, in turn, will put pressure on the exchange rate.
- For example, Indian solar plants depend heavily on imported solar cells and modules. Project costs would rise, tariffs higher in future bids Margin compression for upcoming projects Every Re 1 fall vs Dollar leads to 2 paisa/unit increase in tariff.
- Positive impact: Weaker rupee should theoretically give a boost to India's exports, but in an environment of uncertainty and weak global demand, a fall in the external value of rupee may not translate into higher exports.
- Investments: Currency volatility can also have a devastating impact on things like investments. When a country's currency becomes weaker, this means that many people's liquid assets, such as pensions and long-term savings accounts, will now be worth less on the world stage.
- Employment: When businesses are faced with higher prices on imported goods, in order to maintain international trade relationships, they may choose to recoup those costs by making cuts to their workforce.

Role and tools with of Reserve Bank of India (RBI):

- The RBI acts as the custodian of the country's foreign exchange reserves and manages exchange control. It dominates the market as a regulator, a player and the jury.
- During high volatility in the exchange rate, RBI intervenes to prevent the exchange rate going out of control.
- For example, the RBI sells dollars when Indian rupee depreciates too much, while it purchases dollars when the Indian rupee appreciates beyond a certain level.
- RBI has also proposed the rupee settlement mechanism, under which foreign companies can make foreign payments in rupees, unlike the US dollars.
- This is expected to reduce the need for US dollars for foreign trade, stabilising its value.
- The forex market is regulated by the RBI with impregnable exchange control regulations. For example, The RBI does not permit a bank to purchase dollars from the RBI and speculate in the interbank market. Selling these dollars in the overseas cross currency market is prohibited by the central bank.

Conclusion

Under normal circumstances, rupee depreciation is good for the current account deficit because it leads to higher exports. But at present, India is already facing high inflation and continued depreciation may be making matters worse.

Q-2-India has done fairly well in terms of economic growth despite the global economic slowdown. How ?Analyse.

Approach-

In this question candidates need to write about how India manage to done fairly well in terms of economic growth despite global economic slowdown .

Introduction -

The world economy was just about poised to recover from the ravages of the corona-virus pandemic but Russian invasion of Ukraine in February put to an end all hopes of a global recovery. But India's economy done fairly well in this turmoil.

Body -

The Organisation for Economic Cooperation and Development (OECD) in its latest report projected India as one of the few growing economies in Asia amid a global slowdown triggered by a massive energy shock owing to the ongoing Russia-Ukraine conflict.

- The Paris-based intergovernmental body that focuses on economic policy reports said that India is set to be the second-fastest growing economy in the G20 in FY 2022-23 after Saudi Arabia.
- The statement comes despite decelerating global demand and the tightening of monetary policy to manage inflationary pressures.
- Most economists estimate that India will grow at around 6% during 2022-23.

Reasons why Indian economy is robust in economic slowdown of world-

- The India's "impressive progress" in recent years in extending access to financial services to a larger portion of the population, including disadvantaged socio-economic groups by leveraging the country's "competitive strength in ICT, the Unified Payments Interface (UPI) and other tools", which are easing the transition towards a cashless economy.
- The sectoral composition of the Indian economy has helped in reducing the impact of global supply-chain disruptions.
- Banks credit to industry is showing signs of sustained uptick .data on sectoral deployment of bank credit growth too industry accelerated to 8.7 percent in may 2022.
- Credit to MSME industries has shown strong growth driven by the governments emergency credit line guarantee scheme .
- With increase in capacity utilization pick up in infrastructure spending and financing of PLI schemes ,there seem to be appetite for borrowing from corporate.
- The services sector dominates the Indian economy by far, contributing over 50% of gross value added, while the manufacturing sector contributes less than 20%.
- Since disruptions of the global supply chain affect the manufacturing sector significantly more than they affect other sectors, the overall impact on the economy has been lower.
- India is particularly vulnerable to oil shocks, since it imports over three-fourths of its energy requirements. Luckily, India has been able to strike a deal with Russia and has started importing large quantities of oil from Russia at reasonable prices.
- In this case, Western sanctions on Russia have actually helped India since Russia was hard pressed to find large customers other than China. At any rate, oil imports from Russia now account for a fifth of overall Indian oil imports.
- There may be attempts from Western countries to place restrictions on these imports since a price cap has been imposed on Russian oil as part of the overall sanctions. So far, India has resisted all such attempts.

Way forward-

- There still remain considerable margins to improve efficiency, accountability, and transparency of public spending, devoting more resources to health and education and building fiscal space to enhance resilience,
- Risks remain significant. In these difficult and uncertain times, the policy has once again a crucial role to play: further tightening of monetary policy is essential to fight inflation, and fiscal policy support should become more targeted and temporary.
- Accelerating investment in the adoption and development of clean energy sources and technologies will be crucial to diversifying energy supplies and ensuring energy security.

Conclusion-

In times of global distress, partial decoupling of the Indian economy from the world economy is a blessing, since it ensures that the domestic economy is insulated from the world economy.But Renewed focus on structural policies is the need of the hour to allow policymakers to foster employment and productivity.

Q-3 What do you understand by inflation targeting ?has the adoption of inflation targeting regime served the interests of the Indian economy well? Critically examine .

Approach-

A simple straightforward question where candidates need to write about inflation targeting.In second part of answer write about is inflation targeting served the interests of the Indian economy well. Examine it critically .

Introduction -

Inflation targeting is a monetary policy strategy used by Central Banks for maintaining price level at a certain level or within a range. It indicates the primacy of price stability as the key objective of monetary policy.

Body -

In India, the Reserve Bank of India (RBI) had earlier pursued a 'multiple indicators approach', implying concern for outcomes other than inflation, including even the balance of payments.

- However, the Indian government instituted inflation targeting as the sole objective of monetary policy since 2016-17.
- Under the new statutory framework, the central government would, in consultation with the Reserve Bank of India (RBI), set an inflation target based on the consumer price index (CPI) once every five years.
- The Centre, under section 45ZA of the RBI Act, 1934, has fixed the CPI inflation target at 4% within a band of +/- 2 per cent.
- The RBI was entrusted with the responsibility of meeting this target ("accountability"), for which it would be given "independence" in the conduct of monetary policy.
- Therefore, Inflation targeting is a monetary policy framework in which a country's central bank focuses solely on keeping inflation within a certain range.
- This was hailed by the government as the adoption of the 'modern monetary policy framework' by India.

Benefits of inflation targeting -

Autonomy with Accountability-

- The RBI has been given autonomy in managing the rate of inflation within the prescribed targets set by the government. If the RBI fails to keep inflation within the target range, it would be compelled to explain the reasons for its failure. Such a clause allows the RBI to have autonomy while also allowing the government to have greater accountability over the RBI's actions.
- Inflation targeting allows monetary policy to focus on domestic considerations and respond to shocks to domestic economy which is not possible under fixed exchange rate regime.
- An increased rate of inflation reduces the buying power of currency ,reduces the rate of saving and investment ,increases unemployment and lowers overall GDP growth. it is also supplemented by larger level of fiscal and current account deficits leading to unstable macro economy hence low level inflation promote investors to invest in economy.
- Inflation targeting specifies the rate of inflation that should be targeted in a given economy. With such publicly legislated aims, there is better clarity and predictability in terms of the inflation rate and monetary policy formulation.
- A high rate of inflation diminishes the buying power of the currency and eventually lowers the overall rate of GDP growth.
- Furthermore, a high rate of inflation is accompanied by larger levels of Fiscal and Current Account Deficits, putting the country's macroeconomic stability at risk. As a result, a low or moderate amount of inflation would encourage investors to invest in the economy, promoting higher growth and development.
- An explicit numerical inflation target increases a central banks accountability and thus it is less likely that the central bank falls prey to the time inconsistency trap this accountability is especially significant because can build public support for an independent central bank .

Drawbacks of monetary policy targeting -

- There is propensity of inflation targeting to neglect output shocks by focusing solely on the price level.
- Actual year-on-year inflation in 2022 has ruled above 6% every single month from January to August. If it does so in September as well, the RBI, under section 45ZN of the same law, will have to submit a report to the Centre on "the reasons for failure to achieve the inflation target" and "remedial actions proposed to be taken by the Bank".
- Inefficiency of Monetary Policy tools-There's a simple reason for the RBI's "failure" to adhere to its inflation-targeting mandate. It has to do with food and beverage items, which have a combined 45.86% weight in the overall CPI. Inflation led by rising prices of food stuff cannot quickly or easily be contained by the mode of control which RBI uses.
- The transmission of Monetary Policy Is Inadequate in India.
- Inflation targeting is better suited to mature economies since monetary policy transmission is more efficient in these countries. However, in India, the transmission of monetary policy is inefficient, which can impair the efficiency of inflation targeting
- Diverted Focus-RBI's responsibility to regulate the financial sector may have taken a back seat after adoption of inflation targeting as the main objective.

- Disregards the RBI's multifaceted role-It is impractical for a central bank in a developing country like India to focus just on inflation without considering the greater development context. The Reserve Bank of India (RBI) must strike a balance between growth, price stability, and financial stability.

Conclusion-

Inflation targeting thus had tremendous success in controlling inflation through monetary policy. However, growth suffered due to this, thus its advisable to not look at just one indicator, rather at multiple indicators and making financial stability as the underlying theme.