Twitter Thread by Soham Das, CFA



Soham Das, CFA
@sohamdas



On Jan 6, 2021, the always stellar Mr @deepakshenoy tweeted, this:

https://t.co/fa3GX9VnW0

Innocuous 1 sentence, but its a full economic theory at play.
Let me break it down for you. (1/n)

> 91 day TBills at 3.03%. Interest rates are even lower than RBI has them.
>
> — Deepak Shenoy (@deepakshenoy) January 6, 2021

On September 30, 2020, I wrote an article for @CFASocietyIndia where I explained that RBI is all set to lose its ability to set interest rates if it continues to fiddle with the exchange rate (2/n)

What do I mean, "fiddle with the exchange rate"?

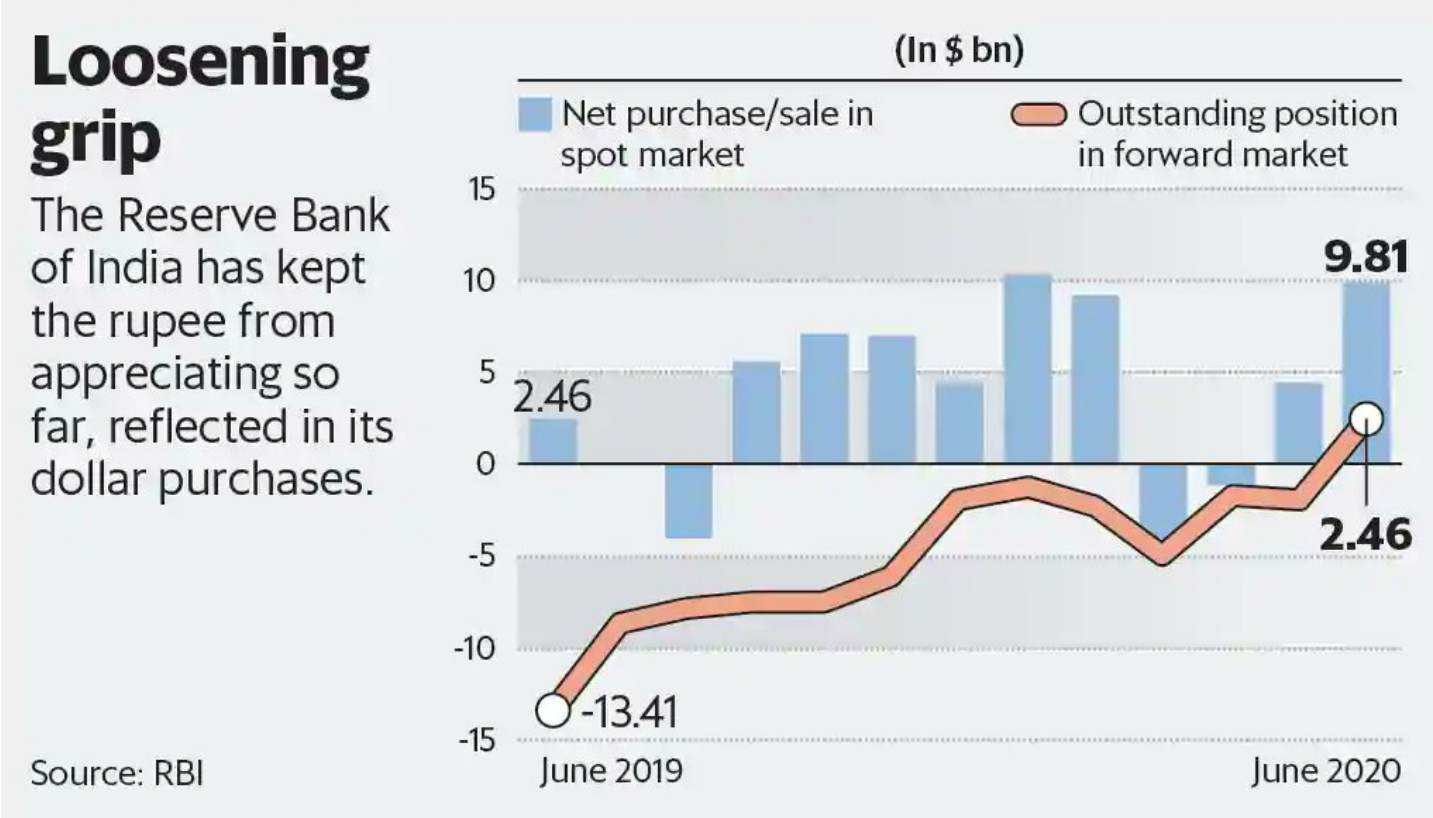
In essence, if RBI opts and continues to manage exchange rate, then that is "fiddling with the exchange rate"

RBI has done that in the past and has restarted it in 2020 - very explicitly. (3/n)

First in March 2020, it opened a Dollar/INR swap of $2B with far leg to be unwound in September 2020.

Implying INR will be bought from the open markets in order to prevent INR from falling vis a vis USD (4/n)

The Second aspect is now, that dollar inflow is happening, and the forex reserves swelled -> implying the rupee is appreciating, RBI again intervened from September, by selling INR in spot markets. (5/n)
https://t.co/9kpWP7ovyM



These interventions in the currency market to stabilize INR has a very adverse effect on the macroeconomic policy.

Which is what the subject of my Sept 2020 essay with @CFASocietyIndia was. (6/n)

What did the essay say?
This:
Consider three legs of a stool of an economy-
a. Ability of Dollar to flow in when excess in global economy
b. Fixed Exchange Rate
c. Ability to set interest rates (7/n)



This stool will always be unbalanced (unlike what I showed above).
You can choose any 2 of the 3 legs.

Choose : controlled interest rate (and hence low inflation) and fixed INR/USD rate, you cannot have an open economy.

Which India was till 1992. (8/n)

Or choose, open economy and an ability to set Interest Rates, you cannot have fixed USD/INR.

INR will fluctuate around.
Which India has adopted in the recent years. (9/n)

This theory is called Mundell-Fleming theory - or Monetary Trilemma.

Many famous currency bets were made because central banks sought to ignore this theory. (10/n)

A nice 60 second video is here: https://t.co/3qgIS5skaV
(11/n)

So what now?
Because RBI has chosen to have a 'fixed exchange rate' (or at least as fixed as markets would allow) and an open economy, it is losing its influence on setting the interest rates in the market (12/n)

And that is why, ladies and gentlemen - the cost of 90 day T-bill has inched lower than what RBI sets as polcy rate (13/13)

Thank you!

The original article is here :
https://t.co/202uXpI5Hb