Uncovered Interest Rate Parity vs Depreciation

What is the issue?

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- RBI recently cut the policy repo rate by 25 bps (1 percentage point is 100 bps) to 6%, as headline inflation dropped to a historic low of 1.54%.
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- It is believed that as a result of this rupee will depreciate, as the interest rate differential between INR and USD narrows.
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- On contrast, despite the rate cut, the rupee appreciated further by 0.3% that day.
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What is the reason?

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- 'Uncovered Interest rate Parity (UIP) Theory' aims to predict the spot exchange rate of a small open economy with a fully-floating currency.
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- It states that the expected change in the exchange rate between the currencies of two countries should be equal to the difference between interest rates in those countries.
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- According to the UIP, an interest rate cut makes the home country's fixed income securities less attractive and capital flows out of the country and as a result home currency will depreciate.
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- Many market participants assume that the UIP theory will hold, which turned out to be wrong this time.
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- It is wrongly believed that RBI cutting interest rates will always lead to depreciation of the Indian rupee.
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- This is not necessarily the case as depreciation also depends on the rate of

inflation, equity flows, monetary policy spills over and politics, among other factors.
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What are the flaws in the theory?

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- **Inflation Parameter -**The UIP is a relationship between real exchange rate and real interest rate differential (which takes inflation into account), not nominal rates.
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- Since inflation in India has decreased significantly over the past few months, the real interest rate has actually risen and a 25-bps rate cut is not enough to offset its impact.
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- In fact, India has the highest real interest rate in Asia of 4.5%. China is in second place at 3%.
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- Since, many tend to ignore the implication of inflation in UIP, conclusions can go wrong.
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- **Equity Flows -** The UIP model assumes that the exchange rate is driven purely by fixed income flows and completely ignores equity flows.
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- However, equity inflows have become significant, accounting for 38% of total net purchases by Foreign Institutional Investors (FIIs) in India over the last year.
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- In such an environment, a model which only looks at fixed income flows may not give a correct answer.
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- **Dollar Dominance -** The UIP ignores the fact that the international monetary system is not egalitarian but hierarchical, with the dollar as the global reserve currency.
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- US monetary policy decisions spill over to India in the form of capital flows, a factor not in the scope of the UIP.
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- Presently, US monetary policy uncertainty is one of the reasons for a weak dollar (hence appreciating rupee).
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- **Political factors -**The UIP assumes that in countries with flexible exchange

rates and no capital controls, political developments do not affect the exchange rate.
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- This is not true.
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- The relationship between politics and exchange rate has grown stronger in an era of quantitative easing.
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Source: BusinessLine

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