

The Rafale Deal Turbulence

– A Discussion on India's Monetary Policy and Its Impact

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Abstract: Starting from a discussion of the current turbulence surrounding the India-France Rafale Deal, this paper delves into the historically contextualized evolution of the Indian Rupee, tracing its trajectories of significant exchange rate volatility, primarily in the post-independence era. It examines the rupee's journey from its peg to the British pound to its current status, underpinned by momentous economic reforms and global economic crises. The focal point of the paper is the period surrounding the Rafale defense deal negotiations (2012-2016), during which the rupee faced exacerbated volatility spurred by a confluence of regulatory, economic, and political factors, including the implementation of GST, RERA, and a controversial demonetization initiative. The paper further articulates the ramifications of unregulated monetary policies, emphasizing their effect on inflationary dynamics via the mechanisms of money supply and demand responses to changing interest rates. An in-depth analysis of India's monetary policy reveals a complex interplay with inflation and bank credit, with implications for economic growth and inflation control. Additionally, fiscal policy coordination challenges at state and central levels are critiqued, particularly regarding their alignment with the Reserve Bank of India's monetary stance. In relation to sovereign debt management, the paper explores India's public debt and the Reserve Bank of India's strategies in managing debt-related risks amid economic and policy flux.

Keywords: Indian Rupee, Rafale Deal, India-France Relation.

1. Introduction

Narendra Modi and François Hollande in a joint press conference on 10 April 2015 where Modi announced the intention to acquire 36 Rafales. On 31 January 2012, the Indian Ministry of Defense announced that Dassault Rafale had won the MMRC competition to supply the Indian Air Force with 126 aircraft, along with an option for 63 additional aircraft. In February 2014, defense minister A. K. Antony said that the procedure of calculation of life-cycle cost was being re-examined and the contract could not be signed in the fiscal year 2013-14 due to budgetary constraints [1]. In May 2016, Modi and Hollande arrived at a figure of €7.87 billion (₹58,891 crore) for the agreement, compared to €11.8 billion quoted in April 2015 and €8.6 billion quoted in January 2016. Unnamed government officials quoted by Press Trust of India said that the decrease in price was due to a change in escalation formula from a fixed 3.9% to a floating rate linked to European inflation indices along with a cap of 3.5%. However, India one-sidedly changed the terms in the contract. Reliance is the main France

company that provides the aircrafts to India. According to Rahul Gandhi, Reliance had obtained both contracts for a total of ₹130,000 crore and termed it as a theft. The Indian government was dissatisfied with the price Reliance provided and is continuously trying to reduce the money they have to pay to achieve more profit. The incident has reached a stalemate. Although India had already received a huge amount of the weapons, the period of the payments has been continuously postponed for the unreach agreement in terms of change of clauses and amount of deal.

Its debt to France and the monetary policies made by the president. refers to the use of government spending and tax policies to influence economic conditions, especially macroeconomic conditions. Another factor that causes conflict in the Rafale controversy is the issues caused by the fluctuations of exchange rate, particularly in the context of the Indian rupee. The quoted figures in the initial terms of the Rafale deal in euros have underwent a considerable reduction, from €11.8 billion in April 2015 to €8.6 billion in January 2016 and the ultimately settling of €7.87 billion (₹58,891 crore) in May 2016. Although the government attributed this apparent cost reduction to a change in the escalation formula, a cap on rates, and the underlying factor of exchange rate dynamics played a significant role. with a cap of 3.5%, the shift from a fixed 3.9% escalation formula to a floating rate linked to European inflation indices, directly impacted the final cost converted into Indian rupees. The complexity of exchange rate fluctuations has become a point of contention, some critics argued and state their point that such adjustments could potentially effect the deal's financial implications. At the same time, the prolonged negotiations and subsequent deadlock between the Indian government and Reliance, the unpredictable nature of exchange rates have further exacerbated the major contributor to the Rafale supply chain. As the dispute persists, the question of how these currency dynamics will influence the overall financial framework of the Rafale deal remains a critical aspect that adds an additional layer of uncertainty to an already contentious military procurement agreement. The delicate dance between political, economic, and strategic interests continues, with exchange rate fluctuations standing as a testament to the intricate web of factors shaping the outcome of this high-stakes negotiation.

2. Historical and temporal context of Indian Rupee development

The history of the Indian Rupee is rich and can be traced back to ancient times, but significant volatility in its exchange rate has been a more modern development, particularly post-independence. Initially pegged to the British pound, the Indian Rupee's value has been influenced by a variety of internal and external economic forces over the years.

The wave of economic reforms in 1991, prompted by a severe balance-of-payments crisis, marked a turning point in India's economy, leading to the devaluation of the Rupee. These measures, aimed at liberalizing the economy, while creating short-term strain, were instrumental in setting the stage for future growth. As India opened its markets and dismantled many state controls, it exposed the Rupee to the volatility of global markets, linking it closer to the fluctuations of international finance. The Rupee also felt the tremors of various global economic crises over the years. The East Asian crisis in 1997, the burst of the dot-com bubble in the early 2000s, and most significantly, the global financial meltdown in 2008, have all led to sharp capital outflows, causing the Rupee to depreciate quickly. Such events have tested the Indian economy's resilience, often resulting in the tightening of monetary policy and other corrective actions by the Reserve Bank of India to stabilize the currency.

Domestic policy decisions by the Indian government and the RBI have historically had a direct impact on the Rupee. These include efforts to control inflation, managing liquidity through interest rate policies, and interventions in the foreign exchange markets. Fiscal discipline, trade policy reform, and other economic adjustments have also been critical in shaping the trajectory of the Rupee's value over time.

During the period when negotiations for the Rafale deal were taking place, from around 2012 to 2016, the Rupee experienced considerable volatility due to a confluence of internal and international

factors. In 2013, in response to the Federal Reserve's tapering of its quantitative easing program, emerging market currencies, including the Rupee, plummeted. India faced one of its worst currency crises, with the Rupee hitting record low values against the dollar.

The period preceding the signing of the Rafale deal also saw significant reforms including the implementation of the Goods and Services Tax (GST) and the Real Estate (Regulation and Development) Act (RERA). These reforms had the long-term goal of increasing tax compliance and improving market transparency but also led to short-term economic disruptions and influenced investor sentiment. The Rupee's value was inevitably affected by such profound policy changes.

Moreover, in a move that took the nation and its economy by surprise, the Indian government in 2016 announced the demonetization of the two largest denomination currency notes, causing severe liquidity constraints in the market. The intention was to combat corruption and unaccounted wealth; however, the immediate effect was a period of significant economic uncertainty which translated into volatility for the Rupee. Compounding this was the uncertainty surrounding the costs and off-set arrangements of the Rafale deal itself, which were heavily scrutinized and debated in the public sphere. Defense deals can have wide-ranging impacts on a country's economy - the fiscal outlay can influence current account deficits, while the strategic strengthening of defense capabilities can affect long-term geopolitical stability and investor confidence. In sum, the Indian Rupee's journey has been one of remarkable transformation, mirroring the country's own economic and political shifts. The Rafale deal, with its complex interplay of defense, economics, and politics, occurred amidst a succession of influential economic changes, each leaving its imprint on the currency's value. Thus, the value of the Rupee is the result of an intricate mosaic of events that collectively shape the narratives of India's financial chronicles.

2.1. The Aggrandization of Economic Inflation by Unregulated Monetary Policy

The nature of aggrandization of economic inflation, according to Bhattacharai, is achieved by cash in advance as the rooted cause [2]. The utility of money, under the scene of oversupply of cash, may fluctuate in accordance to the growth rates of capital, output, prices, money, consumption, investment, labour supply and lifetime utilities of household [2]. The money in advance has a significant effect in causing the economic growth. From decades ago, the function of money have been as a medium of exchange and unit of standard, identify the value of a product and standard of differed payment [3]. Certain scholars see money as a public debt which can guide savings, encourage investments and lead to a higher rate of economic growth [4]. Also, it is believed that putting money in a utility function and get the result of money is neutral, it would not cause any impact and as the value of the money increase, it will only cause inflation [5]. However, there are no specific data that can show the fluctuations in macro economic variables.

2.2. The effect of the unregulated monetary policy on the money supply

One of the greatest factor that can effect the money supply is the unregulated monetary policies. There are facts that points out that the monetary market is related to the macro economy trend. Monetary policy measures employed by governments to influence economic activity, specifically by manipulating the supplies of money and credit and by altering rates of interest. The chngaes the entral bank and the gvernment each country made of monetary policy can bring a great influence to the financial markets and the mony supply in the market. One of the right of the central bank is that by lowering or raising the benchmark rates, which is similar to the interest rate, they can do in regulating the economy [5]. It is suggested that by owering deposit reserve ratio, the money supply in the stock market and the monetary market can go through a larger fluctuation, this is a significant "sign effect" [5]. Also, raising policies will impact the monetary markets more by large flucyuations.

2.3. The effect of the unregulated monetary policy on the money supply The effect of the monetary policy on the money demand

Another impact the change in the monetary policy will cause is the money demand and the output. In the 1980s, the great event “Volcker recessions” have shown how a sudden tightening of monetary policy can cause great recessions in terms of overall economic growth. However, the effect the “Contractionary” monetary policy cause in the GDP is considerably ambiguous. With data supporting the statement, the typical shock will move real GDP by up to 60% [6]. After a contractionary monetary policy shock, the GDP price deflator would not fall that much. At the same time, monetary policy shocks account for only a small fraction of the error variance in the forecast for the federal funds rate, except over periods of less than half a year, and in terms of prices.

3. The vicious circle of monetary policy in India

India is witnessing a sharp rise in the inflation rate due to the rising crude oil prices, exacerbating the challenges for monetary policy frameworks and complicating the economic landscape with increased costs for production and transportation. This situation is further pressured by the nation's heavy reliance on energy imports, amplifying the economy's sensitivity to global market fluctuations. In India, the targets and executions of the fiscal policy of different state governments are independent, lop-sided, and also distinct from the fiscal stance of the central government. Besides, the fiscal policy of the central and the state governments are not consistent with the monetary policy of the Reserve Bank of India.

The inflation rate in India wasn't that obvious before the economic crisis. Due to the report given by the headline Wholesale price Index (WPI), the average annual inflation rate was only around of 6.7% from 1950 to 2013. Also, from 2000 to 2008 the average annual inflation had even lowered to around 5.2 percent. However, headline inflation rose close 10% from 2010 to 2012. This massive increase in inflation the sudden surge in inflation and its persistence are puzzling. Due to the gradual external liberalization, it appears that there are more freedom in the Indian economic, and the global commodity prices and exchange rates plays a significant role in causing the determining inflation. Recently, India mainly depends on the product import from other countries. For example, nearly 80% of the crude oil in India are imported from other countries. Between 2009-2011, the global commodity prices had caused negative impacts on domestic inflation. The depreciation in exchange rate of Indian Rupees had reduced the positive impact the marginal decline in global community price will bring to the inflation. Due to the studies on the transmission of monetary policy in the Indian economy, it is obvious that the role of interest rates is increasingly important. Starting from May 2011, the Reserve Bank of India published the procedure of monetary policy, it clearly took the weighted average interest rate of overnight calls as the operational target of monetary policy. Due to the conclusion of the studies and the graph modified by economics, there is a 15 basis points increase in the nominal policy rate of inflation, which is found to be caused by the peak effect of a 100 basis points [6]. And others found that there would be a fell of about 2.2- 2.8% in the bank credit due to the increase in the nominal policy rate for every 100 basis points and the policy rate hike has a negative impact on inflation [5]. Substantiating these findings, research suggested that inflation within the non-food manufactured goods sector could potentially be curtailed by 25 basis points following a 100 basis point rise in the nominal policy rate [6]. These revelations point towards a nuanced and complex interplay between monetary policy levers and inflationary trends. The RBI's challenge, therefore, hinges on finely tuning these levers to strike a balance between curbing inflation and bolstering

economic growth, without exacerbating the already present vulnerabilities from a policy and global perspective.

India is currently experiencing a significant increase in its inflation rate, primarily driven by escalating crude oil prices. This rise is placing considerable stress on the nation's monetary policy frameworks. The complications arising from this situation extend to the broader economic landscape, leading to increased production and transportation costs. Moreover, the predicament is intensified due to India's substantial dependence on energy imports, which heightens the economy's vulnerability to the whims of global market fluctuations.

Furthermore, there is a notable lack of cohesion in the fiscal policies pursued by India's state governments when compared to the central government's fiscal stance. State-level fiscal targets and executions operate on an individual basis, and they are often not only independent in their approach but also tend to be lopsided and distinct from the central government's strategies. This dissonance extends to monetary policies, as the actions and plans of both the central and state governments frequently exhibit a lack of consistency with the monetary policy directives set forth by the Reserve Bank of India.

Historically, India maintained a relatively subdued inflation rate. According to the data reflected in the Wholesale Price Index (WPI), the country had an average annual inflation rate of approximately 6.7% from 1950 to 2013. The period from 2000 to 2008 saw an even lower average annual inflation rate, hovering around 5.2%. Contrastingly, from 2010 to 2012, headline inflation approached the 10% mark — a spike that was not only significant but also persistent and somewhat confounding in nature. This puzzling trend could be attributed to India's gradual shift toward external economic liberalization, allowing the Indian economy to have increased freedom but at the same time making it more reactive to global commodity price changes and exchange rate shifts, which play pivotal roles in determining the inflation rate.

In recent times, India's economy has shown a high level of dependency on imports, with crude oil being a stark example where nearly 80% is sourced from other countries. The period between 2009 and 2011 was marked by the negative impact of global commodity prices on domestic inflation. The declining value of the Indian Rupee further compounded these effects, diluting any relief that could have been experienced from a marginal global commodity price reduction on domestic inflation.

Studies focusing on the transmission of monetary policy within the Indian economy have highlighted the increasingly significant role of interest rates. From May 2011 onward, the Reserve Bank of India adopted a clear approach to its monetary policy, targeting the weighted average interest rate of overnight call money as its operational goal. Analysis of economic data has shown that a rise in the nominal policy rate by 100 basis points is likely to result in a 15 basis points increase in the inflation rate due to the peak effect of the policy change [3]. Additionally, further research indicates that for every 100 basis point uptick in the nominal policy rate, there is an anticipated decline of about 2.2-2.8% in bank credit [6]. Such an increase in the policy rate is observed to have a dampening effect on inflation. The full impact on inflation, however, is typically delayed by about three quarters, with the total duration of this effect lasting anywhere from eight to ten quarters. Reinforcing these findings, Kapur and Behera provided evidence supporting the notion that inflation within the non-food manufactured goods sector could be mitigated by approximately 25 basis points in response to a 100 basis point augmentation in the nominal policy rate [5].

4. Conclusion

In conclusion, this paper intended to estimate the terms of the Raphael contract, examine what solutions India decided to use to solve the problem of not being able to pay the money that should be paid to France for the weapons purchased. And by doing researched of the essays describing and explaining the change in the exchange rate of the Indian rupee and the reasons for this phenomenon.

I understood and explained why it was not a wise option for France to agree the request of India paying the arrears in Indian rupees. In this article, I have shown why the Indian rupee's exchange rate would have significant change in a short period of time frequently. I also showed what action and solution the Indian government had took and what economic policies it has introduced to address this issue. I also highlighted why India dared to print rupees in large quantities and why this would not have much impact on the living quality of the Indian citizens. It is also very important as I mentioned in the article, what factors leads to the great inflation in India and who controls most money and caused the phenomenon of India being lack of money.

However, there are still some limitations of this study, which could lead to further studies and recommendations for future directions. This article mainly focused on the rafale contract and the change in exchange rate of rupees and certain reasons that caused the inflation in India. It would be more interesting to extend the analysis of the other factors that plays a significant role in pushing the Indian inflation and do more research on the situation the Indian economy is facing. I believe future studies can focus on more information that are very interesting and can look at the event and the phenomenon in a brand new point of view. Also, can do some research on the solutions to reduce the Indian inflation or to stop it. With further explorations, I believe more strategies could be found in explaining the factors that caused the Indian inflation and how we can prevent it to happen to other countries.

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