The G-20 Finance Ministers Communiqué

I must confess that I am puzzled by several points made in the communiqué. For example, consider the statement that the Finance Ministers will *"move towards more market determined exchange rate systems that reflect underlying economic fundamentals and refrain from competitive devaluation of currencies. Advanced economies, including those with reserve currencies, will be vigilant against excess volatility and disorderly movements in exchange rates. These actions will help mitigate the risk of excessive volatility in capital flows facing some emerging countries."*

Three points arise. First, the wording seems to suggest the Finance Ministers' belief that "market determined exchange rates … reflect underlying economic fundamentals". What is truly amazing, and indeed touching, is the faith; that, despite all that has happened in the financial markets during the last three years, the Ministers continue to believe that market determined prices of assets reflect economic fundamentals. If this were so, why did the credit crisis at all occur? Even Mr. Greenspan, the *chela* of the market fundamentalist Ayn Rand, confessed during his Congressional testimony in October 2008, after the crisis of 2007-08, his disillusionment with his earlier beliefs, saying that "*The whole intellectual edifice (of market efficiency) collapsed in the summer of last year…..there was a flaw in the model"*. And yet, the Finance Ministers, including the Chinese one (who, incidentally, tightly controls the yuan's exchange rate, and for good reasons), have signed the communiqué! Whom are they trying to fool? Or are they themselves manifestations of the phenomenon so beautifully described by Keynes, that *"Practical men, who believe themselves to be quite exempt from any intellectual influence, are usually the slaves of some defunct economist."* The ghost of Milton Friedman must be having a hearty laugh.

Second, the subsequent part of the quote contradicts the earlier part by emphasizing the need for vigilance in advanced economies against "excess volatility and disorderly movements in exchange rates". Are they, in effect, conceding that market determined prices can be excessively volatile and disorderly? If so, why the move towards more market determined exchange rate systems? And, what exactly does “vigilance” imply: watching from the sidelines – or intervention in the market?

Third, avoidance of competitive devaluations and vigilance against excess volatility and disorderly movements are supposed to mitigate the risk of volatility in capital flows to emerging markets. The logic escapes me completely.

It is difficult to avoid the impression that the Ministers have tied themselves into contradictory knots because of the varying priorities. Amongst the Big Two, the United States would love the yuan’s exchange rate to be market determined in the belief that it will then appreciate, reducing China’s competitiveness in the global economy, and helping create jobs in U.S. On the other hand, the Chinese are obviously worried about a disorderly fall of the dollar against the other reserve currencies because of the huge losses they would sustain on their reserves, and would surely prefer stability in the exchange rates between the dollar, the euro and the yen. The contradictions in the communiqué are perhaps a manifestation of the effort to satisfy both, the Americans and the Chinese.

I am equally puzzled by our Finance Minister joining Germany, Japan and China in opposing a very sensible (for once!) proposal from the U.S. government to the effect that the G-20 should agree on limits to current account balances as a percentage of GDP. What are the macro-economic similarities between the other three and us? They are hugely surplus, we have a large and growing deficit on the current account; they have low inflation, ours is still very high; the demographics are also different. Apparently, the imbalance number the Americans had in mind was 4%. To me, this itself seems very high. But is our Finance Minister aiming at an even larger deficit, say 6/7% of GDP and, therefore, does not like the limit? But more on the American proposal at a later date.

Intervention costs

The RBI Governor recently warned that “intervention in forex market to prevent appreciation entails costs”: not intervention per se, but sterilization does entail a cost if domestic interest rates are higher than reserve currency interest rates. It should not be assumed however that rupee appreciation has no cost; the RBI's Annual Report quotes research suggesting that a 1% appreciation of the rupee leads to a deterioration of the trade balance by 0.7%. This is roughly $ 1 bn, in other words a loss of output of Rs. 4,500 crores. The point is that non-intervention is not costless in an economic, i.e. non-accounting, sense. The broader issue was highlighted recently by his predecessor as follows:

"*If public policy is itself scared of the financial markets, the financial markets will know that it can pressure them against controls. If public policy is determined to manage, it can be managed better… Public policy should keep the option of imposing a Tobin Tax open. It should insist that it has the option and that itself will make the financial markets conduct (business) with a certain caution"* (Business Standard, July 13, interview). The comments are even more relevant 3 1/2 months later.

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