

Exchange Rate Policy - II

The subheading given by the paper to my last week's article has perhaps created an impression that it discusses my expectations of what the official policy "could possibly look like". In fact, the article is, as stated in the first paragraph, my articulation of what the policy **should** be. I continue.

As argued, an overvalued exchange rate encourages consumption, particularly of imported goods, and is a deflationary factor as far as the domestic economy is concerned; on the other hand, an undervalued exchange rate reduces consumption below the level the productive capacity of the economy can afford, thus militating against the basic objective of growth which is to increase consumption. Both these conclusions assume that there is a "correct" value of the exchange rate which would balance the needs of growth and consumption. In many ways, a carefully constructed and based real effective exchange rate is a reasonable measure of the direction of movement of an exchange rate, and also of its deviation from fair value. (The REER index has some weaknesses but so do all indices used for policy making – the WPI, the CPI, the IIP, etc.) The second measure of the deviation from fair value is the resultant imbalance between the economy's current external earnings and expenditure.

Believers in market efficiency would argue that market prices are self-correcting and that, therefore, the central bank should leave the rate to the market, an argument that is rarely made in relation to the domestic value of money. (No modern democracy however can afford to take such market fundamentalist approach to the value of money.) Arguably, the exchange rate would be self-correcting if the foreign exchange market were to consist primarily of current account transactions: an overvalued domestic currency would make imports cheaper and exports uneconomic, increasing the demand for imports and dollars to pay for them, even as the supply of dollars falls because of the lower export earnings. The resultant demand supply change in the foreign exchange market would itself correct the exchange rate. The fact is, however,

that too often flows other than current account transactions, dominate today's foreign exchange markets. Globally, the volume of exchange transactions is something like 30 times the trade flows. Even in the domestic market, the gross amount of transactions is around 14 times the current account transactions.

Capital account flows are often cyclical: for example, capital inflows in the equity market would tend to appreciate both share prices and the exchange rate which, in turn, attract more investors thus continuing the cycle, carrying the exchange rate significantly away from fair value. Opening the capital account for outflows by residents cannot really compensate as, if returns in the domestic market are perceived to be attractive, residents too will prefer to keep the money at home. Many emerging markets have witnessed the cyclicity of capital flows in the reverse direction also, by both residents and non-residents. Given the well known herd instinct of investors, the only counter cyclical force can be the central bank.

*It is well accepted that an independent monetary policy, a managed exchange rate and a liberal capital account cannot co-exist ("the impossible trinity"). In practice, however, it is possible to manage the exchange rate even in a relatively liberal capital account regime, by intervention in the exchange market and sterilization of the impact on money supply through open market operations or changes in the reserve ratio of the banking system. It is sometimes argued that sterilization of the excess money supply can lead to increase in domestic interest rates, which would be detrimental to growth. This argument, however, has limitations. For one thing, if the currency is allowed to appreciate to avoid intervention and sterilization, this too is a deflationary factor for the economy. Second, **so long as sterilization is limited to the money created through intervention, it should leave the market liquidity, and therefore interest rates, unchanged.***

*It cannot however be gainsaid that, if domestic interest rates are higher than the earnings on reserves, sterilization through open market operations entails a measurable money cost. On the other hand, if sterilization is done through increasing the cash reserve requirement, there are no costs to the central bank – or **even to the banking***

system since the central bank is impounding only the money it had created through intervention.

But coming back to the impossible trinity, if capital flows continue to surge as many analysts and indeed the IMF are expecting, in an extreme situation, one of the three may have to be given up, it should be the liberal capital account – in other words, resorting to capital controls particularly on portfolio inflows. This is the least costly measure in terms of growth and investment as there is no empirical evidence suggesting that a liberal capital account helps growth. Nobel Laureate Andrew Michael Spence said as much during his recent visit to India: “You need to have capital controls and exchange rate management so that you have some control over the volatility of the prices that determine the way you interact with the rest of the world.”

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