Till the music stops…

“Chuck” Prince’s statement that “we have to keep dancing till the music stops” should go in any list of famous last words. Mr. Prince was the Chairman and CEO of Citibank when he made the point. The “music” was the market in mortgage backed securities and, as it happened, it collapsed just a few days after his statement. Mr. Prince was sacked and Citibank needed government bailout to survive. Some of the other “dancers” were wiser: J. P. Morgan stopped remaining long in the securities towards the end of 2006; Goldman Sachs went a step further and started shorting the securities through buying credit default swaps, even as it was structuring and selling more mortgage backed securities to other players.

Looking at the stock and currency markets in India, one has stated wondering when the music will stop. Our policy-makers seem to be continuing in their benign neglect of the exchange rate even as it reaches ever-higher levels. In his speech at the High-level Conference on ‘The International Monetary System’ jointly organised by the Swiss National Bank and the IMF in Zurich on May 11, 2010, the RBI Governor said that “*Last fiscal (2009/10), the rupee appreciated by 13 per cent in nominal terms but by as much as 19 per cent in real terms because of the inflation differential…”.* Considering the changes in the exchange rate and the domestic price level since then, the rupee has appreciated 25% in real terms against the dollar over the last 18 months.

No wonder the current account deficit, even as conventionally calculated (i.e. considering remittances as current account receipts), as a percentage of GDP has gone up from 1% in 2006-07 to 2.5% of GDP in 2009-10. (Incidentally, this number 2.5% used in the Governor’s speech also seems questionable. The actual amount was $ 38.4 bn.) Data released last Thursday, evidence that the deficit has tripled from $ 4.5 bn in the first quarter of 2009-10 to $ 13.7 bn in Q1 of 2010-11. At this rate, it could cross 4% of GDP in the current fiscal year. Our policy-markers seem to be willing to keep dancing so long as financing the deficit does not become a problem.

I have used the expression “as conventionally calculated” to describe the current account number. To my mind, conventional accounting fails to give a “true and fair” picture of the competitiveness of our economy. While classified as receipts under “invisibles”, remittances are not “earnings” of the domestic economy: for economic analysis, they need to be considered as capital transfers, albeit of an irreversible nature; they are a means of financing the gap between our current external earnings and expenditure. This gap was of the order of $ 90 bn last year, and may well cross $ 100 bn in the current year! Its easy financeability through remittances and capital flows should not blind us to its implications for output and jobs!

In fact, it seems that our policymakers are still looking at the current account from a balance of payments perspective. If so, it is high time that we change it. Compared to a reasonable balance between current earnings and expenditure, we are presently missing out an output of something like Rs.450,000 crores (equivalent to the gap between external earnings and expenditure). Wages represent about 30% of GDP. The output loss then translates into lost wages of something like Rs. 1,50,000 crores – far, far larger than UPA’s much trumpeted MGNREGS! Another way of looking at the number is that it represents a loss of a crore of reasonably paying jobs! Can we afford such reckless neglect of job creation in the external sector (whether in exports or in domestic industry competing with imports) when the extreme left keeps gaining strength from year to year, in district after district, and the need for employment creation should be the paramount objective of policy-makers?

Is the number of potential jobs resulting from a reasonable balance between current income and expenditure fanciful? Not really! In the debate in U.S. Congress on the bill authorising the imposition of up to 20% duties on Chinese imports would create a million jobs! If a million jobs can be created by the devaluation of the dollar against the yuan alone, which is what the 20% duty amounts to, despite the huge gap in wages between the U.S. and China, my estimate of the potential additional jobs in the tradeables sector hardly seems unrealistic. What is needed is an exchange rate aimed at the domestic economy being reasonably competitive in the global scenario.

Who are the biggest gainers from the not-so-benign neglect of the exchange rate? The FIIs and the Chinese exporters: our bilateral trade deficit which China alone could well come to around $ 40 bn in the current year. It is high time that we manage our exchange rate in the interests of optimising growth, jobs and consumption, rather than being carried away by efficiency and sanctity of markets, the possible immediate impact on stock prices, etc. Can this be done? I hope to revert next week.

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