The Other Side November 5, 2015

The External Account: UK and India

There are a couple of significant similarities between us and the erstwhile colonial master in terms of the external account. For one thing, both are incurring persistent deficits on the current account, clearly an indication of their overvalued exchange rates, despite the British pound being a floating currency while the rupee is classified as "*Managed floating with no predetermined path for the exchange rate*" by the IMF. To be sure, there is one major difference in the composition of the deficit: in Britain's case, the main cause is the low net income from foreign investment; in our case it is the trade deficit which has remained around $ 140/150 bn despite the sharp fall in the oil import bill. As *The Economist* commented in a recent issue (October 17, 2015), "*To finance its current account deficit Britain has sold assets to foreigners from chocolate factories to posh London homes"*; we have sold equities and bonds to foreign portfolio investors.

There are two corollaries to the external deficits:

⇒ In the case of both UK and India, the external liabilities are well in excess of the external assets; and

⇒ In our case, the deficit represents loss in potential output and employment, a point I will come back to in a later article.

As for the first, as Felix Martin, author (*"Money: an Unauthorised Biography"*) and fund manager, wrote in Financial Times (October 28), "*Britain's debt-skewed external liabilities are shorter term than its equity-heavy assets, making it vulnerable to a run…. Yet the biggest problem of all – and the root of all the rest – is simply size. Gross external assets amounted to 516% of GDP as of the second quarter this year; gross external liabilities were about 536%. …… As any fund manager or corporate treasurer knows, when gross exposure gets out of hand, even minor mismatches of risk and liquidity can generate violent swings in performance….. A devaluation might restore net investment income, and shrink the current account deficit, in a trice."*

In our case also liabilities to portfolio investors do need to be considered as short term and therefore vulnerable to outflows in event of any major domestic or international financial problem. While, in our case, the external assets ($ 529 bn) and liabilities ($ 891 bn) as a percentage of GDP are much less, the net difference, $ 362 bn, is something like 17/18% of GDP, not very different from Britain's. The assets to liability ratio in our case is much worse, 59% compared to 95% in Britain's case. The more worrying part is that the net liabilities have increased 700% in the last 7 years, thanks to the persistent deficits, clearly an evidence of continued currency over-valuation. One February 2010 IMF research department paper titled "*Capital Flows: The role of controls*", has argued that even when currency appreciation is temporary, "***damage to the tradable sector (through hysteresis) may be more permanent.***" It also concedes that "***policymakers are again reconsidering the view … that all financial flows are the result of rational investing/borrowing/lending decisions. Concerns that foreign investors may be subject to herd behavior, and suffer from excessive optimism, have grown stronger; and even when flows are fundamentally sound, it is recognized that they may contribute to collateral damage, including bubbles and asset booms and busts***."

Is our central bank *"manipulating"* the exchange rate rather than following a policy of *"managed floating"*, in pursuit of its single point agenda of inflation control? The difference between *"managing"* and *"manipulation"* was very well articulated by Joseph Gagnon in a paper *Combating Widespread Currency Manipulation,* published by the Peterson Institute: "*Currency manipulation occurs when a government buys or sells foreign currency to push the exchange rate of its currency away from its equilibrium value or to prevent the exchange rate from moving toward its equilibrium value. The equilibrium value of a currency is that which is sustainable over the long run.… An* ***exchange rate is sustainable if the current account balance is not generating an explosive path for net foreign assets relative to both domestic and foreign wealth***.*"* In terms of these criteria, our policy can surely be described as currency manipulation!

Recently, many emerging market funds have incurred significant losses and redemptions by investors. Reports suggest that there have been some outflows from India as well. Surely a more balanced external account on both flow and stock basis should be a priority?

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