Exchange rate and the current account

Given the real appreciation of the currencies of many emerging markets, commentators have been referring to the so-called Balassa Samuelson hypothesis (1964): "*an increase in the* ***productivity*** *of* ***tradables*** *relative to* ***nontradables****, if larger than in other countries, will cause an* ***appreciation*** *of the* ***real exchange rate****.*" Recently, an article in the Financial Times (February 28) referred to the hypothesis while suggesting that investors can gain from investing in emerging market currencies. One wonders of course to what extent the hypothesis is relevant in today's world, when capital account transactions rather than trade have become the largest single mover of the exchange rate, as in the case of India: in other words, it would be unrealistic to attribute the real appreciation of the rupee over the last couple of years as reflecting the increased productivity of India's tradables sector, notwithstanding the sharp rise in exports in the last couple of months. The very fact that the merchandise trade deficit has gone up from less than 1% of GDP a few years back to perhaps 7% plus of GDP in the current fiscal year indicates the lack of competitiveness of the India's manufacturing economy, at the present exchange rate. While on the subject, I am reminded of a recent article by T.N.Srinivasan, professor of economics at Yale University and Vani Archana of ICRIER, titled "Determinants of Export Decision of Firms" (Economic & Political Weekly, February 12, 2011). I was disappointed that it did not consider the exchange rate while regressing 11 other variables. Being closely involved with firms in the real economy, I have long felt that the economics of exports, on which the exchange rate is a major influence, is often the single biggest influence on export decisions.

While on the subject, I cannot help commenting on another article by a U.S. academic, "How India Can Cope With Plenty?" by Eswar Prasad, professor of economics at Cornell University. (The Wall Street Journal, January7, 2011). The focus is on capital inflows, and some of the points Prof. Prasad makes are, to say the least, curious:

⇒ Talking about the current account, he argues that "*Reducing the deficit beyond a certain point would require forcing Indians to forego some of the tangible benefits of development."* What should be the priorities? Consumption of Pratchi chocolates, costing Rs. 3600 a kilo, Guchhi handbags and shoes, the pleasure of seeing Pamela Anderson on reality shows on Indian TV? Or creation of reasonably paid employment for the millions who have problems in getting two square meals a day? And, it is exports which create jobs (as President Obama himself acknowledged in his visit to India saying that the orders signed then would create 50,000 jobs in the U.S. for the next several years); substitution of domestic output of all kinds of goods from electrical accessories, to furniture, to toys, to Ganapati idols, to power plants, to …, by imports, destroys them. And, the galloping merchandise trade deficit, particularly with China, exhibits the latter phenomenon. Sorry, Prof. Prasad, we do need to bring the deficit down; and a more competitive, managed exchange rate, is a necessary condition for this.

⇒ *"Policy makers must focus on how that deficit is financed*". Many of our policy makers, to my regret, are following Prof. Prasad's advice and are complacent about the exchange rate and the deficit it is leading to, given the level of reserves and the belief that capital inflows will continue indefinitely. Too many emerging market economies have done the same mistake and suffered crises during the last couple of decades. The "music" of capital flows leading to currency appreciation, deficits on the current account, ever greater need for more capital inflows, unfortunately does stop playing some time – the song lasts somewhat longer if your currency happens to be the global reserve currency, an "exorbitant privilege" which India does not enjoy.

⇒ "*As for portfolio inflows, India must do a better job welcoming foreign investors who see India as a country with long-term growth potential rather than just as an opportunity to make a quick buck.*" One is not at all clear how exactly one should distinguish between the two at the point of entry, particularly as, according to Prof. Prasad, "*policy makers must strongly resist an urge to impose capital controls to discourage short-term capital flows."*

Prof. Prasad is of course right in arguing that "*policy makers should focus on opening new pathways,… for foreign direct investment*". In the last Monday's budget, our Finance Minister has overlooked this issue, even as he seems to continue to accept the other points made by Prof. Prasad, as also other Anglo Saxon economists.

I am equally puzzled by the contents of the communiqué issued after the recent G20 Finance Ministers' meeting in Paris. On the issue of "Global Imbalances", the G20 merely asked the IMF to monitor "*the trade balance and net investment income flows and transfers"*. Services were omitted (why?) but transfers, which are no reflection of a recipient country's policy, are included! Strange are the ways of the G20!!!

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