

International Monetary Co-operation

During his recent visit to the US, and a Project Syndicate article (Mint April 30, 2014), Dr. Raghuram Rajan has emphasized the need for the developed economies to take into account the impact of their monetary policy on the emerging/developing economies. His obvious concern is that a tightening of the ultra-easy money policies followed by the US Federal Reserve since the 2008 financial crisis, may lead to foreign finance capital in India to be repatriated, leading to volatility in the exchange market (as happened in the Indian market in September 2013).

One apprehends that his call is likely to fall on deaf ears if the past is any guide:

- When the US Federal Reserve tightened money supply in the late 1970s and early 1980s to bring down domestic inflation, USD interest rates went sky high: LIBOR had then crossed 20% p.a. This very high interest rates led to a sovereign debt crisis in many developing countries with large dollar debt: it took a decade for the crises to be resolved;
- More recently, in 2010, at a G20 Summit, there was agreement to revise the quotas and voting power of members in the International Monetary Fund, to better reflect the emerging economies' much higher share of the global output. The actual increase is still stalled by the US: the strangle-hold of the West on the two Bretton Woods institutions, and the right to nominate the chief executives, is likely to continue.
- In any case, monetary policy is aimed to serve the domestic economy, and surely every country has the sovereign right to do what is best for it.

Governor Rajan apprehends that, in the absence of greater international monetary cooperation, the emerging economies may be forced to follow a “reactive policy”. To quote from his Project Syndicate article, “*emerging economies are increasingly wary of running large deficits, and are placing a higher priority on maintaining a competitive*

exchange rate and accumulating large reserves to serve as insurance against shocks. At a time when aggregate (global) demand is sorely lacking, is this the response that source countries (i.e. the West) want to provoke?" The other side is whether such a response should necessarily be "reactive". Do large external deficits not create an output and employment gap for the economy? Is it not in a country's own interest to follow an exchange rate policy aimed at optimizing output, rather than as a reaction to what the West is doing? After all, China has done so over the last 35 years: and, its output in the current year, at purchasing power parity exchange rates, will be more than that of the US. To quote Nobel Laureate Robert Mundell from an old interview, the only "*economic function*" floating, market-determined exchange rates helped fulfill was "*stuffing gift socks of hedge funds*", at the cost of the real economy.

Our central bank has recently come out with a revised real effective exchange rate index of the Indian rupee, based on the consumer price index: the earlier index was based on the wholesale price index for India and the CPI in our trading partners. This was obviously illogical and the change in the inflation rate to CPI is a welcome reform. There is one glaring difference between the earlier and revised numbers: the WPI based index suggested that the rupee was undervalued in 2013-14, while the revised number suggests overvaluation! And the difference is not negligible – it is as high as 15%! To the extent policymakers were being guided by the old index, they were obviously getting wrong policy signals. In fact, the empirical evidence of the trade deficit growing year-after-year for the last 5/6 years surely should have led to a reform of the methodology much earlier. But policy-makers thought that gold imports were responsible and imposed a 10% duty. This has helped reduce the trade deficit, but has other implications to which I will come to a little later.

The index uses 2004-05 as the base year, when the external imbalance, as a percentage of GDP was the least. As far as the revised index model is concerned, I have some question marks about it:

- It would perhaps have been better to use the previous year, given the lag between the rate change and impact on trade;

- Bilateral trade weights, as I have argued earlier as well, do not lead to a good measure of the competitiveness of the tradables sector, although it is the “*most frequently used indicator of competitiveness across countries*”.
- Services remain excluded from the calculations.

As for gold, while the duty has clearly brought down official imports, there is enough evidence that smuggling has gone up. Because of regulatory hassles, gold jewelry manufacturing is shifting to China.. Also, gold has to be paid for in dollars, one way or another. While so far smuggling does not seem to have affected official receipts, one apprehends that this may well start in the current fiscal year. Has the impact of smuggling on official inflows been cushioned by the elections? I remember that, in an earlier era, when all gold imports were banned, the premium on the dollar in the unofficial, or *Hawala*, market would often fall in pre-election months: the then belief was that politicians bringing money kept abroad, to fight the elections, added to dollar supplies and led to the lower premium!

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