

The Two Values of Domestic Currency

The Anglo-Saxon countries are past masters in propagating myths. (In the geopolitical field, the biggest was the existence of weapons of mass destruction in Iraq). Many myths are propagated also in relation to economic policies – and these could become real weapons of mass destruction for emerging markets; indeed, these have converted financial markets from a means to satisfy the genuine needs of the real economy to an opportunity for making speculative profits.

One of the myths is that, while it is virtuous for the central bank to keep the domestic value of the currency stable – indeed this is the primary function of central banking --, the external value should be left for the market to decide. Arguably, the rationale was the original belief that a stable domestic value and money supply would automatically lead to stable exchange rates (Rudiger Dornbusch, 1976). It is by now quite clear that this concept proved to be “an empirical bust” as Kenneth Rogoff wrote 25 years later.

What has provoked these thoughts is a spate of statements by the Deputy Governor on the exchange rate policy. He has argued that there is no change in the policy; that the central bank does not have any level in mind; and that it intervenes only to smoothen volatility. While this has been the public stance of the central bank for a long time, empirical evidence suggests something else: just look at the amounts of foreign currency sold and purchased by the central bank over the years.

The Deputy Governor has been recently (December 3rd) quoted as saying that the RBI would “*not hesitate to use all available instruments if we do see the short-term risk of a downward spiral (in the rupee value) escalating*”. Is this in

response to the reality that FII inflows will not resume so long as the slide continues (assuming that they will do so then)? In H2, 2008-09, there was significant intervention to halt the sharp fall of the currency in the wake of the financial crisis: very little since April 2009 despite the sharp rupee appreciation in both nominal and real terms. This suggests to me that the central bank is more concerned about exchange rate changes when they threaten portfolio capital inflows, than about keeping the tradables sector of the economy competitive, more attractive to long term investors in the real economy? Or have we swallowed another myth propagated by the Anglo Saxons – that financial markets are efficient and produce prices reflecting all known fundamentals; that participants have “rational expectations”; and, therefore, portfolio inflows are a manifestation, a stamp of approval, of the soundness of our macro-economy?

The result of the appreciation of the rupee from April 2009 to mid-2011 has been a very sharp increase in our external deficits both on trade and current accounts. This should not be a surprise as the exchange rate is a very important element of the competitiveness of the economy in global and, indeed, domestic markets: all the more so for economies where the tradables sector consists primarily of non-differentiated goods and services. We seem to have forgotten that exports create jobs, while imports destroy them; that markets once lost, domestic or global, are very difficult to recapture.

One wonders whether our policy makers still believe that savings and investments are “given”, and therefore the deficit has nothing to do with the exchange rate. The fact is that exchange rates do influence significantly the savings side of the equation: an overvalued exchange rate encourages consumption, and therefore reduces savings in the household, corporate and government sectors, the last through slower growth. (Our household savings have fallen below 10% for the first time in many years).

It is now well accepted that free capital flows, an independent monetary policy, and a managed exchange rate (the impossible trinity) cannot co-exist. Historically speaking, in the era of the gold standard the central banks gave up an independent monetary policy; in the 30 years after the second world war, the accepted wisdom was to forego free capital movements; and in the last 30 years the myth that has been propagated is to give up a managed exchange rate, as we seem to have done over the last few years. What is the record in terms of major crises over these three periods? The following numbers taken from the Reserve Bank's Report on Currency and Finance speak for themselves:

1875-1939	109, (including the great depression)
1945-1971	17
1973-2007	399

Coming back to geopolitics, the western countries do seem to be preparing ground for attacking Iran – and the probability of that occurring has gone up in recent months. In that eventuality and with its impact on oil prices, we would surely be in a major crisis. Our policy makers need to review the wisdom of continuing with a market determined exchange rate ignoring the impact this can have on the competitiveness of the real economy, leaving it even more vulnerable to the vagaries of external capital flows – ask the Greeks and the Romans.

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