The Other Side April 11, 2013

Current Account and the Exchange Rate

Given the impossible trinity of liberal capital flows, a managed exchange rate and an independent monetary policy, the accepted wisdom over the last three decades, assiduously propagated by the IMF, is that it is better to give up the second of the three elements of macro-policies. This is an approach based on belief in the efficiency of markets in allocating capital and pricing assets to reflect all fundamentals; by now, the efficient market hypothesis has been widely discredited by both empirical evidence and researches in behavioural economics. The surprise is that the G20 seems to have bought the argument, though hardly anybody amongst the G20 Summiteers is a market fundamentalist. One admires IMF's ability to persuade policymakers to its view, notwithstanding the sharp increase in financial crises during the last 2/3 decades, as compared to the earlier three decades of the Bretton Woods system.

One of the principal items on the agenda of the G20 has been "global imbalances", a euphemism for Chinese surpluses. The assumption is that these arise because China deliberately undervalues ("manipulates") its exchange rate; the solution therefore is market-determined exchange rates. As for manipulated exchange rates, Joseph E. Gagnon argued in a paper *Combating Widespread Currency Manipulation* (Peterson institute for International Economics, July 2012) that "*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".* He then goes on to define sustainability of the exchange rate on follows:

"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.

Sustainability generally implies ***a small value of the current account balance**, **but fast-growing economies can maintain moderate current account deficits as long as the associated liabilities do not grow faster than their economic output*****".** While China, at whom the G20 policy prescription was aimed, continues to manage/manipulate its exchange rate, our policy makers have been faithfully adhering to the G20 call, abandoning the policy which we had followed for the previous 15 years, and which had worked quite well.

How do our current account balance and exchange rate compare with the sustainability criteria specified by Gagnon? At 6.7% of GDP in Q3 of fiscal 2012-13, the number can hardly be described as "moderate". Policymakers have claimed that the deficit would come down to a little over 5% for the year as a whole; my back-of-the-envelope calculations suggest that, given the deficit of 5.4% of GDP for the first 9 months, it would need to come down to 3.8% in Q4 (from 6.7% in Q3) if this hope is to be fulfilled. One does not know how many takers there are for this number: and, even 5% is hardly "moderate"!

What about the associated external liabilities? They have grown from about $ 50 bn 5 years back to perhaps 6 times that number; clearly these have grown much faster than the economic output. On both counts our exchange rate and the external account seem less and less sustainable with each passing quarter.

Late last year, the Governor gave a speech on the topic of "G20 and India". He argued that *"The post-crisis debate on global imbalances has three interrelated facets. The first is the role of exchange rates in global rebalancing…. Global rebalancing will require deficit economies to save more and consume less. They need to depend for growth more on external demand which calls for a real depreciation of their currencies……"* He then goes on to argue that *"export competitiveness… should come from improved productivity rather than an artificially calibrated exchange rate".* Howsoever laudable the objective, the fact is that improved productivity takes years to be achieved; that, in the meantime, markets are lost and are difficult to regain. One should also not overlook the possibility of a crisis before improved productivity results into export competitiveness. Another questionable proposition he argues is that *"As a developing economy, we run a large current account deficit (CAD)".* The fact is that most developing countries in Asia have consistently recorded current account surpluses for many years. The real problem is the fact that in recent times our tradables sector has been rendered increasingly uncompetitive (from power plants to the colors we used in the Holi festival) thanks to the real appreciation of the rupee; imports have grown much faster than exports, and hence the galloping deficits. And the quality of capital inflows which finance them continues to deteriorate.

12-country data from a 2002 study titled IMF Supported Programs in Capital Account Crises are interesting.

Table: Selected macroeconomic Indicators for Capital Account Crisis Countries

	t-3	t-2	t-1	t	t+1
Real GDP (growth, in percentage per year)	6.0	5.4	3.8	-5.5	5.1
Current Account (as percentage of GDP)	-3.7	-4.2	-3.7	3.5	2.6

("t" is the year of the crisis)

Any comments are superfluous!

Are we playing with fire in continuing to put our faith in a market-determined exchange rate, bringing us ever near the "Minsky Moment" when some minor change in the economic environment can trigger a crisis?

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