

Intriguing (and dangerous?) Complacency

The rupee has continued to appreciate, reaching a high of Rs. 44.13 per \$ on Thursday, even as the Reserve bank remained a silent spectator. The media will of course continue to celebrate the rupee's rise with headlines like "Rupee posts its best weekly rise in nearly 9 months" – as if the rise of the rupee is an unmitigated blessing for the economy! Perhaps the headline writers forget that a rise in the rupee has the same deflationary impact as a rise in interest rates, -- not quite comparable to celebrating the rise of the stock market, although there has been strong positive correlation between the two.

In fact, the complacency of the authorities is becoming more intriguing, even as many other countries from Japan to Switzerland to Brazil to Taiwan, Indonesia and Korea have recently taken steps to stem the rise of their respective currencies. (One major difference between India and these countries: we have a yawning and increasing deficit between our external earnings and expenditure while the others are surplus and can presumably afford a rising currency better than us!) Consider some recent pronouncements by policymakers:

- ⇒ *"Exporters and others are a little worried. But the RBI is watching it and I do not think it calls for an intervention just now. The RBI will intervene as and when required."* (Pranab Mukherjee, The Economic Times, October 5, 2010)
- ⇒ *"We are clearly thinking of ways in which we can deal with it ...as long as the capital flows are in excess of the current account deficit, the pressure to appreciate will continue and it could potentially disrupt."* (Subir Gokarn, Dy. Governor, RBI, quoted in Mint, October 6, 2010)
- ⇒ *"The current account deficit is within manageable limits ... the inflow has not reached a level that demands corrective action."* (Dr. C.Rangarajan, Chairman, Economic Advisory Council to the Prime Minister, quoted in Business Standard editorial October 4, 2010)

⇒ *“the tolerable level of net capital inflows could be informally set at \$ 150 billion, up from the earlier figure of around \$ 110 billion.”* (The view of the Central Government and RBI, as reported in The Financial Express, August 14, 2010. The actual net capital inflows in fiscal 2009-10 were \$ 56.3 bn.)

The views as quoted do not seem to evidence any concern of the deflationary impact of a rising rupee on output, growth and employment, or about the health of the large segment of SMEs competing with manufacturing imports.

Many of the non-official analysts and commentators are painting an altogether different picture. Arvind Subramanian of the Peterson Institute for International Economy has described the inaction as manifesting that *“the tail of finance is again wagging the dog that is the economy.”* Sanjay Mathur of the Royal Bank of Scotland recently said in an interview (Mint, August 5, 2010) that “the external position ... is a key macro concern ... that the funding available for the current account deficit ... has been exceptionally volatile”. Even Mark Mobius, Templeton Asset Management, normally an emerging market bull, was quoted in this paper (October 7) expressing his concern about the widening trade deficit, cautioning that *“the risks are a change in the global risk appetite and a sharp rise in energy prices, as either of these could exert further pressure on the current account.”* Gerard Lyons of the Standard Chartered Bank, even while arguing that *“the best option is letting the currency be the shock absorber”*, conceded that this *“may be like waving a red rag to a bull ... further speculative inflows may be attracted.”* (The Economic Times, May 17, 2010) And, multilateral organisations are predicting a surge in capital flows to emerging markets. The latest Global Financial Stability Report of the IMF refers to a *“secular asset allocation shift from developed markets to assets in emerging economies”*. The Asian Development Bank in its Economic Monitor published in mid-July has expressed concern that *“capital flows to emerging economies could become volatile, destabilising financial markets – at least in the short term – and could hurt the real economy as well.”* Its Chief Economist, in a recent interview (The Economic Times, August 21, 2010) drew attention to *“the possibility of a sudden withdrawal of capital, which could also threaten financial stability. This will be the challenge*

for Asian countries. It is important to strengthen the financial markets and manage the macroeconomic policy better.”

Is tacit acceptance of the currency appreciation a part of the anti-inflationary stance? But the RBI's Annual Report quotes research showing that “a 10 percent change in exchange rate leads to change in final prices by about 0.6 percent in the short-run and 0.9 percent in the long run.” It also explicitly concedes that “currency appreciation worsens the trade balance significantly; the estimated coefficient shows that a one percent real appreciation would invoke almost 0.7 percent deterioration in trade balance.” And, the rupee has appreciated more than 25% in real terms against the dollar, the invoicing currency for 80% of our cross-border trade, over the last 18 months!

Any further comments are superfluous.

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