The Other Side September 12, 2013

Economists and the Exchange Rate

After the new Governor's statement and press conference a week back, the rupee has strengthened sharply. The stock market also has given its vote of confidence to the new Governor. Does this mean that the problem is solved? I wish I had the confidence to give an affirmative answer. However, one thing is clear: our central bank considers the exchange rate to be volatile only when the rupee falls sharply, not when it rises!

In the previous few weeks, we have seen a number of articles from academic economists, many of them from outside India, writing articles on the subject in our newspapers. Devesh Kapur and Arvind Subramanian, respectively of the University of Pennsylvania and Peterson Institute for International Economics, argued in Business Standard (August 24) that, "*India today has not pegged its currency, avoiding the over-valuation problem."* (First question: if the rupee is not overvalued in real terms, why the huge increase in external deficits, lower savings and investments, and a slowing economy?) In a subsequent article (August 28th) they advocate "*exchange rate depreciation, the classic demand-switching policy*" (Second question: if the exchange rate is not overvalued, why does it need depreciation, creating a risk of re-kindling inflationary pressures?) Another academic, Vivek Dehejia of the Carleton University, quoting Milton Friedman, argued in Business Standard (September 3) that a flexible exchange rate provided "insulation" to an economy, ….. allowing the real rate to stay close to its equilibrium level. In a subsequent article (September 8th) Dr. Dehejia seems to deny any middle course other than either a pegged exchange rate or a floating one, the latter leaving the central bank "*free to pursue a monetary policy which stabilises domestic inflation.*" One suspects that, in his focus on the "corner solutions" he omits to consider a managed floating rate policy, something which the Indian central bank followed very successfully for almost a decade and a half. As for Milton Friedman, in his Essays in Positive Economics (1953), he argued that "*speculation can be destabilizing in general only if speculators on the average sell when the currency is low in price and* *buy when it is high"* The reality on the ground is that they do exactly that: "momentum play" is a very successful trading/speculating strategy, carrying the price further away from the equilibrium level.

In its *Free Exchange,* The Economist (August 31), referred to a recent paper by Helene Rey of the London Business School, in which she has argued that "*free capital flows may inevitably mean a loss of monetary-policy independence*"; that the Impossible Trinity has been reduced to an "irreconcilable duo" because "*prices of risky assets, such as equities and corporate bonds, move in lockstep across the global economy, regardless of what exchange-rate regime is in place. She links these moves to swings in the VIX—an index of market volatility derived from S&P 500 stock-options prices—which is also correlated with capital flows and credit growth*" (quotes from The Economist). There is no reference to the impact of capital flows on exchange rate, on competitiveness, on output and employment! The currently fashionable economic view seems to be that the dog of the real economy must wag to its tail, the financial economy – as if all of us can grow rich by devising and marketing ever more complex derivatives!

Bhaskar Dutta of the University of Warwick takes a much more balanced view of the recent volatility in the currency market. In an article in the Indian Express (September 5), he argues that, "*the global unrest has only been a catalyst. We would not have witnessed this turmoil in our foreign exchange market if the fundamentals of the domestic economy were stronger, and if the government and the RBI had not been so complacent in their management of the economy…. Why should foreign investors take the plunge? They are well aware that the Indian growth miracle is a thing of the past."*

Tushar Poddar, Managing Director, Goldman Sachs India (Indian Express, September 6), has argued that, "*There is no evidence of currency depreciation helping reduce the current account."* Others argue differently. Mihir Sharma (Business Standard, August 6) quotes a World Bank study of 92 episodes: *"significant increases in manufacturing export growth that lasted at least seven years… followed a massive currency depreciation, which caused a reallocation of resources to exporting sectors. …. The*

Harvard economist Dani Rodrik argues that such depreciations can even overcome failures of markets or governance in sectors that produce tradable goods." To quote from a December 2012 article by Nouriel Roubini, "*To maintain growth, over-spending countries need nominal and real depreciation to improve trade balances, while surplus countries need to boost domestic demand, especially consumption.*" As Samuel Brittan confessed (Financial Times, November 4, 2011) "*those of us who were brought up to think of international economics in terms of costs, prices and exchange rates are made to feel like dinosaurs.*" Are we?

In a 1999 paper *"The Twin Crises: The Causes of Banking and Balance of Payments Crises"* Carmen Reinhart and Vincent Kaminsky concluded that, in many cases, both came after a long economic boom that was *"fueled by credit, capital inflows, and accompanied by an overvalued currency."* Are we heading in that direction? This time may not be different.

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