The Two Values of Money

Governor Rajan continues to attract favourable comment in the western media. On February 6th, David Pilling hailed him in the Financial Times as the "inflation slayer" India needs. Earlier, the paper had editorially commented (January 27) that "*Mr Rajan's decisive move has won him plaudits from foreign investors*" but that "*India's currency is now back on a rollercoaster, after emerging markets were hit by a heavy sell-off last week*". In fact FII inflows have been very small in January and negative in the last couple of weeks; and the external value of the rupee has been quite steady, and not only in recent weeks.

And, this lower volatility is clearly due to a dramatic, and welcome, change from the not-so-benign neglect of the exchange rate by his predecessor. In contrast, Dr. Rajan has been far more interventionist: his currency swaps with oil importers did a lot to restore balance between demand and supply. But this facility ended ten weeks back, and the earlier volatility has not returned. Does it mean that all is well on the external and that Rs 62 is a sustainable rate?

Hardly. The improvement in the trade balance over the latter half of 2013 was due to:

- Gold imports (at least in the official market) having come down dramatically, thanks both to the imposition of an import duty, and a fall in the international price of the commodity; so have non-gold imports because of a slowing economy; even as
- Exports have evidenced a rise, perhaps a lagged effect of the earlier fall of the currency.

The other side is that

- Gold smuggling seems to have gone up sharply. The World Gold Council recently estimated gold imports in India in 2013 at between 900 and 1,000 tonnes, 750 tonnes officially, and 150/200 tonnes through smuggling: the latter ultimately has to be paid for in dollars which would otherwise be reflected in the official balance of payments; and
- Export growth seems to be slowing. And no wonder: a steady rupee in nominal terms implies an appreciating rupee in real terms given our high rate of inflation.

So we come back to the virtuousness of low inflation. As the FT editorial quoted above argued, "*Inflation is a significant drag on the Indian economy*". Dr. Rajan seems to agree as he said in the Bloomberg interview (see Mint, January 31, 2014), "*Today what* *is standing in the way of growth is inflation. Unless we bring inflation down, growth through lower interest rates has no hope."* The crux of the Urjit Patel's Committee Report is that RBI should adopt inflation target, that too in terms of the Consumer Price Index, something like 8% (presently close to 10%) in a year's time, and to below 6% in two years. If this is to be achieved, one apprehends further hikes in the policy rates: we should get some pointers later in the week.

Dr. Rajan has also been quoted as saying that inflation of over 6% (CPI? WPI?) hurts growth. I have seen the central bank's economic analysis on the issue which is based on the WPI, but have several questions. Is the number independent of global commodity prices, oil in particular? Is the only variable relevant to growth the inflation number? What about the demographics of the economy? What about the exchange rate in real terms? Surely, an overvalued exchange rate hurts domestic output? This apart, the ability of even the most sophisticated models to predict the future or provide reliable "forward guidance" is highly questionable. One recent example is that of the Bank of England: in August, it had argued that low interest rates would continue until unemployment came below 7%. Its own forecast was that this is unlikely to happen until 2016. As it happened, within 3 months, the unemployment rate was down to 7.1%! Perhaps, "*Moderately high British inflation may have* (made) *the difference"* (The Economist, February 11). Surely Bank of England has access to more reliable data than our own policymakers and still …..

To come back to the FT editorial referred to above, it went on to argue that "*An economy marred by high inflation is also more unequal …. It is also necessary that the government narrows its large budget deficit*". The other side is that research by the International Monetary Fund economists finds that a liberal capital account and fiscal compression lead to higher income inequalities. As for the former, in the same Bloomberg interview Dr. Rajan argued that the *"notion that let the prices move and let the markets adjust, then everything will be fine, is something you hear again and again. Fortunately the IMF (International Monetary Fund) has stopped giving this as its mantra."* The last institutional view of the IMF on the subject of a liberal capital account and floating exchange rates was published in November, 2011; it does not seem to suggest any material change in the ideology of the last quarter century.

This apart, while managing either price of money, we should not forget that for many years now, creation of reasonably paid jobs has been well below the number entering the job market. Again, too many of the jobs created seem to be in the form of low paid, casual employment in construction and households. In the focus on inflation targeting, we should not lose site of the socio-economic imperatives of this phenomenon.

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