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The CEAs and the exchange rate

Dr. Raghuram Rajan has recently taken over as the CEA. He comes at a critical juncture in the Indian economy, with the twin deficits (fiscal and current account) worryingly high, and a dysfunctional government. His wisdom, knowledge and advice will surely be found very useful by policy makers.

My memories of Dr. Rajan go back to the second half of 1980s when I was teaching a course on international finance at the post-graduate program of the Indian Institute of Management, Ahmedabad, where he was a student. (He was wise enough not to opt for my course, despite its popularity amongst the students!) He was the youngest chief economist of the IMF and the first to predict the possibility of a financial crisis in the U.S. mortgage market: he did this in 2005 at the annual Jackson Hole gathering of economists. The main theme of that year's speeches was to praise Alan Greenspan as being the best central banker in history. (After the crisis erupted, in Congressional Testimony, Dr. Greenspan confessed to trusting private markets too much, and conceded lapses in regulation.). It took a lot of courage of conviction to make that kind of lonely prediction before an august gathering. Nouriel Roubini predicted the possibility later, but probably got more publicity for the prediction than Dr. Rajan.

Over the years, I have been reading Dr. Rajan's articles and books. I particularly liked a recent article ("What money can buy") published in Mint on 9th August. The article is about the increasing financialisation of modern economies, and reaches to philosophical levels: perhaps no wonder, because it comments on a recent book by a Harvard philosopher. I should confess, however that I did not quite follow the logic of sovereign debt, government myopia, and the financial sector, co-authorised by him. The issue is important in a different context in India with "Financial Repression" in the form of the huge reserve requirements for the banking system.

Coming to the exchange rate, the Reserve Bank's recent Annual Report cautions that external imbalance: "*It is important not only to focus on financing of CAD, but also on compressing CAD to lower manageable levels*." To my mind, this would mean a more active management of the exchange rate, abandoning the policy of the last few years, with the objective of keeping the tradeables sector of the domestic economy competitive enough to bring the external imbalance to say 1/1.5% of GDP, over the next, say, 3 years.

In this context, I recently came across a curious paper titled "The Art of Currency Manipulation", 26th June 2012, by Dr. Kaushik Basu, Dr. Rajan's predecessor. From what I could make out, Dr. Basu (now appointed as the chief economist at the World Bank) blames the "currency manipulator", whoever he may be, for the volatility of the rupee's exchange rate, also taking a swipe at the Reserve Bank (*The central bank and regulator, …. have very little notion of how the currency manipulator works and so have dealt with this problem very inadequately.*) Evidently in his view, the volatility has little nothing to do with the ever widening deficits on current account; the slowing growth, the slippage in competitiveness, the tax uncertainties etc., making India less attractive to foreign investors; etc. Dr.Basu's perspective reminded me of how Dr.Mahathir Mohamad, the Prime Minister of Malaysia, blamed hedge funds for the East Asian currency crisis in 1997-98.

But coming back to Dr.Rajan, one does not know whether his views on the real exchange rate have changed since 2009.The report of the Committee on Financial Sector Reforms, which he them chaired, while accepting that the real exchange rate is the key factor determining India's competitiveness, also argues that "*it is influenced by factors such as productivity growth and demand imbalances that are not changed by central bank intervention against the dollar.*" The fact is that, in the absence of central bank intervention, the real rate can appreciate even as competitiveness declines, (as evidenced by the widening deficit on the current account), because of high capital inflows – as has been the case in India in recent years. The problem with ever widening deficits is that the music of capital flows stops playing some day, and a crisis results. On the subject of exchange rates, we probably need to learn more from Beijing than from Chicago, which has become a synonym for market fundamentalism.

Although he teaches in Chicago Dr. Rajan did his Ph.D. in MIT, which is much more open to Keynesian influence. It may therefore be useful to remind ourselves of what Keynes said on the exchange rate policy, *“We are determined that, in future, the external value of sterling shall conform to its internal value as set by our own domestic policies, and without interference from the ebb and flow of international capital movements or flights of hot money. Thirdly… we will not accept deflation at the dictate of influences from outside. In other words, we abjure the…….the increase of unemployment as a means of forcing our domestic economy into line with external factors.”*

A.V.Rajwade
Email: avrajwade@gmail.com