Market Determined Exchange Rates - II

The last couple of weeks media debate on inflation and monetary policy have provoked one thought in me: those who articulate the maximum concern for bringing down inflation by tighter money, many of them from the financial sector, because the “poor” are supposed to suffer most from it, generally also favour free flow of cross-border capital and its corollary, market determined exchange rates: they obviously have little concern for the growth and jobs lost, or not created, because of currency appreciation and the resultant external deficit. (Economics 101 teaches us that net exports are a component of GDP.) One wonders whether the concern about inflation is not equally reflecting the need to protect the real value of the savings of the rich, for whom volatile exchange rates is an opportunity to make more money through speculation, often described as trading, and hence the advocacy of market-determined exchange rates. Why such a dramatically differing approach is advocated for the two values of the domestic currency, domestic value determined by inflation, and the external value determined by the exchange rate, that too in an increasingly globalised world economy, is difficult to understand otherwise.

As I quoted last week, even proponents of a liberal capital account and floating exchange rate have to admit that the exchange rate is an important influence on the competitiveness of the tradeables sector. Does the last four months sharp increase in exports suggest that they have not been affected by the significant real appreciation of the rupee? Frankly, I am puzzled as the phenomenon goes completely against the basic logic of competitiveness. I seem to be in good company. To quote from the Governor’s replies in the post policy question and answer session “we were also very pleasantly surprised by the increase in exports growth in last quarter of last year”. It has been claimed that the growth is the result of a diversification in the product mix and markets for our exports. But, as the Governor himself said, “it is not very clear that hypothesis stands to empirical scrutiny because some initial research done in the Reserve Bank shows that the impact of that diversification is actually quite small. So there is something else that played there and we need to investigate that.” In fact, the export growth seems as miraculous as India's overall economic growth when, *in the World Bank's "*Ease of Doing Business*" index, India ranks 134th out of 183 countries, scoring particularly badly on ease of starting a business (165th) and, above all, enforcing contracts (182nd, behind Angola but pipped by Timor-Leste for the bottom slot). Another index on "Entrepreneurship and Opportunity", produced by the Legatum Institute, a think-tank, puts India 93rd out of 110 countries.*" (The Economist April 20, 2011)

Exports apart, equally important is the competitiveness of the domestic economy with imports, in other words, trade and current account deficits. Please see the accompanying table which gives the trade and current account balances, from 2000-01 to 2010-11 (first three quarters). Some conclusions are inescapable:

⇒ The merchandise trade deficit was fairly small until 2003-04 but has gone up very sharply thereafter.

⇒ The current account deficit, as conventionally calculated, was fairly modest until 2006-07, but has galloped since then. (In my view, the current account deficit net of remittances, is a better reflection of the domestic economy's competitiveness as, for economic analysis, remittances need to be treated more as capital transfers, albeit of an irreversible nature, a way of financing the deficits between external income and expenditure, not "earnings" of the domestic economy.

⇒ Through the period, the nominal exchange rate has remained relatively stable, in other words a very sharp appreciation of the rupee in real, i.e. inflation adjusted, terms.

Are these changes merely reflective of the savings investment imbalance or of a dramatic, unannounced change in the exchange rate policy? Are savings and investments exogenous to the exchange rate? But more on this next week.

Table ($ mn)

Year	**Trade deficit**	**Current Account Deficit**	**Current Account Deficit net of remittances**

2000-01	-12460	-2666	-15520
2001-02	-11574	3400	-11998
2002-03	-10690	6345	-10042
2003-04	-13718	14083	-7525
2004-05	-33702	-2470	-22995
2005-06	-51904	-9902	-34395
2006-07	-61782	-9565	-39390
2007-08	-91626	-17034	-58739
2008-09	-119403	-27900	-71947
2009-10	-118400	-38411	-90466
2010-11*	-102100	-38900	-78400

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