September 22, 2011

The Future of the rupee

Some perspectives

The future of the rupee depends on the conscious choices we make today in terms of whether we wish to see:

⇒ The Indian economy growing fast, focusing on employment creation particularly in better paid manufacturing jobs, a ranking member of the global community; and

⇒ The rupee used increasingly not only for our own cross border transactions, but also becoming an international currency over the next couple of decades.

If the answers to both the questions are in the affirmative, as any patriotic Indian would like them to be, then a lot is going to depend on studying what has happened in the global economy over the last three decades, and following macroeconomic, particularly exchange rate, policies needed to achieve the objectives.

Before discussing these, however, it would be useful to touch upon the ongoing sovereign debt crisis in some of the eurozone economies. To me, their basic weakness was that, in the supranational currency regime, domestic inflation was higher than in more disciplined Germany: the result was that even as Germany was earning large surpluses on the current account, their own economies were incurring increasingly large deficits on the current account. The inevitable corollary: persistent and growing dependence on capital inflows to balance the books. The crisis resulted when the costs of getting that capital, as reflected in bond yields, became unacceptably high. There are lessons for us in this on-going saga.

India's savings investment imbalance

Economics 101 teaches us that, in macroeconomic terms, this equals the current account imbalance. Also, conventional macroeconomic accounting classifies inward remittances as part of the current earnings. This probably does not matter much for most countries, where the number is not significant – buts in our case it is. For economic analysis, I prefer to look at remittances as capital inflows, albeit of an irreversible nature; they obviously are not "earnings" of the domestic economy.

Table 1 summarises the changes in the external deficit and the net external liabilities since 2004-05. In the last six years, the trade and current account deficits have gone up year after year; the mirror image of this is the rapid rise in India's net external liabilities which have gone up to almost $ 220 bn by the end of the last fiscal year, a very significant amount in relation to our GDP.

Our policymakers seem to believe that the rise in the current account deficit is the result of the higher investment needs of the economy, as compared to its savings, which they see as a positive sign for future growth; the corollary is that we need not worry about the deficits on the current account, particularly as these are easily financeable. The refrain is: where will capital go in the current state of the global economy?

Is such complacency in our long-term interest? To my mind, there are other implications of the deficits, and their impact on growth. The external value of the Indian rupee directly impacts the trade and current accounts through the competitiveness of the tradables sector. But indirectly, it also affects domestic output and savings. "Net exports" are a part of the standard calculation of economic output of a country. To the extent the number is negative, the aggregate output is correspondingly lower – and means:

1. a reduction of government revenues through both direct and indirect taxes and therefore higher government dis-savings;
2. lower household savings as the employment in the tradeables sector falls, and also through higher consumption of cheap imports; and

3. lower corporate savings as margins in the tradeables sector are squeezed.

In short, the exchange rate is perhaps the single most important influence on the current account deficit whether one looks at it as the gap between external earnings and expenditure – or between savings and investments.

The exchange rate policy

Over the initial decade and a half of economic reforms, Indian policy makers did not adopt extreme policies: the capital account was gradually liberalized, but broadly speaking, the exchange rate was so managed as to keep the rupee reasonably stable in real effective terms. Despite the weaknesses of the trade-weighted index as a measure of competitiveness, the policy worked reasonably well: the current account deficit, as conventionally calculated, was less then $ 10 bn up to 2006-07, even as India built up reserves of the order of $ 200 bn as the central bank continued to absorb surplus capital inflows.

There seem to have been major changes since then. In the first few months of 2007-08, the exchange rate was allowed to appreciate sharply, but then held steady for the rest of the year through intervention (reserves $ 300 bn. by March 2008). Since the financial crisis (and the birth of G20 at the heads of government level), there has been hardly any net intervention, thus completing the dramatic change from a reasonably managed exchange rate to a fully market determined one.

One wonders whether, on this issue, we are more anxious to be on the “right side” of the U.S. in the G20 debate on global imbalances, without giving adequate weight to what should be the prime objectives of our macroeconomic policies: growth, jobs and reduced inequalities. Can these be achieved by following Anglo-American policies giving primacy to the financial economy over the real economy? Or do we

really believe in their wisdom? Over the last 30 years the fashion propagated by the Anglo-American ideology and the IMF has been to liberalise the capital account (Prof Jagdish Bhagwati once described this as a conspiracy of Wall Street and the U.S. Treasury) and, as a corollary, give up managed exchange rates. It is strange that we still have faith in Anglo-American wisdom in understanding financial markets: the recent mortgage crisis itself was the result of policy-makers' faith in the wisdom of market participants in managing risk, in pricing assets, in efficient markets generally. The end result, lest we forget, was that the world suffered the deepest recession since the 1930s. (Only a return to Keynesian measures avoided a worse fate.)

Before we get too enamoured of getting the U.S. to praise us for our market determined exchange rate policy, it is as well to remember post-Gorbachev Russia: his successor, Boris Yeltsin, dismantled the whole structure, bred a corrupt system, in which a dozen oligarchs stole the state's extremely valuable assets at throw-away prices and life of the average Russian was far worse than under the Soviet system. The country defaulted even on its domestic debt in the Yeltsin era. Yeltsin, incidentally, was a great favourite of the U.S. and U.K.!

In this connection it is interesting to look at the exchange rate policies of large countries and the manufacturing sector's contribution to GDP. Please see Table 2. In our case, the share has remained stagnant in sharp contrast to other large Asian economies – even as the U.S. and U.K., the strongest advocates of market-determined exchange rates, have de-industrialized themselves. Is that our objective even before becoming an industrial country? No wonder Haseeb Drabu argued in this paper (May 29, 2011) "that the unambiguous signals emanating from the Indian economy are that raw material production is more valuable than finished goods."

The Future of the rupee

The future of the rupee depends on the two questions I raised at the beginning of the article. If the answer to both is positive, we need a managed exchanged rate, aimed at keeping the current account deficit, net of remittances, within +/- 1% of GDP (it is currently 6%!); an exchange rate policy aimed at a competitive tradeables sector, not the convenience of the of financial economy or the Anglo-American ideology.

This can be done through intervention and sterilization as we did for a decade and a half (but with a reformed index); one argument against this is that sterilsation incurs costs to the extent domestic interest rates are higher than those on reserve currencies. This is true. But the costs of output loss arising from external deficits, the result of an overvalued currency, are far higher; so are the translation losses on reserves. In fact, many emerging market economies are resorting to intervention in the market, directly or indirectly, to stem the appreciation of their currencies: so, indeed, has Japan – and, less successfully, even Switzerland, recently. China, of course, does so far more aggressively. And, we should not forget that our Northern neighbour is the world's most successful economy of the last three decades.

While on the subject of managing exchange rates, one also needs to take account of the "impossible trinity": that free or liberal capital flows, an independent monetary policy and a managed exchange rate cannot co-exist, at least in extreme situations. In the 1920s, the accepted wisdom in the then leading economies (U.S., U.K., Germany and France) was to give up an independent monetary policy. The period ended in global depression. In the initial 30 years of the post-war era, most counties gave up a liberal capital account, but managed exchange rates and had independent monetary policies. There were no major crises in this era. Over the last three decades, the developing world has been pressured to give up managed exchange rates in favour of a liberal capital account. The result: ask Mexico (1994-95), East Asia (1997-98), Brazil (1998) and many other countries.

In short, if managing the exchange rate requires capital controls, so be it! But let me end by quoting Keynes: "*We are determined that, in future, the external value of the*

sterling shall conform to its internal value,…. without interference from the ebb and flow of the international capital movements, or flights of hot money. Thirdly, ….we abjure increase in unemployment as a means of forcing the domestic economy into line with external factors." (Collected Works of John Maynard Keynes, Volume 27)

Table 1

					USD bn	
year	Trade deficit	Current account deficit	CA deficit net of remittances	reserves	Net investment position	
2004-05	33.7	2.5	23.3	141.5	-41.8	
2005-06	51.9	9.9	34.6	151.6	-47.9	
2006-07	61.8	9.6	39.6	199.2	-61.4	
2007-08	91.5	15.7	57.7	309.7	-51.2	
2008-09	118.7	28.7	73.5	252.0	-66.6	
2009-10	117.3	38.4	90.5	279.1	-158.4	
2010-11	130.5	44.3	97.7	304.8	-218.9	
Note:						
	No negative signs have been used for deficit figures(as it is implied).					

Table 2

Country	**1990**	**2009**
China	35	41
India*****	17	18
Indonesia	20	27
United Kingdom	23	11
Untied States	18	13
Vietnam	15	21

*****FY end.

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