WORLD MONEY April 26, 2010

Exchange Rate Policy

In a meeting in the Reserve Bank a few weeks back, my friend (and co-columnist in this paper) Ajay Shah made a point that, in the interests of transparency, the central bank needs to articulate its exchange rate policy in greater detail and clarity, just as it describes its stance on monetary policy. (In the last week's monetary policy statement, the central bank has stuck to the usual cliché, namely that it intervenes only to curb excessive volatility.) In a one-to-one meeting thereafter, Ajay asked me how I would articulate the policy. Herewith a somewhat presumptuous attempt at a policy statement:

Coming to the external sector of the economy, the merchandise trade deficit is running at a rate of $ 120 bn, or about 10% of GDP. Since a large proportion of non-oil imports and exports are of manufactured goods, the deficit is prima facie evidence that India's manufacturing sector is less than competitive in the global economy. The gap is even more glaring vis-a-vis our largest trading partner, namely China, with exports not even a third of imports.

The current account deficit is much more modest at around 2.5% of GDP, thanks to our services exports and remittances. While accounting convention classifies remittances as part of the current account, the fact is that unlike every other transaction reckoned in the current account, remittance inflows are not part of the domestic economy's external earnings. For policy purposes, they need to be regarded more as capital inflows, albeit of an irreversible nature, and a stable source of financing the deficit between the external earnings and expenditure which, thus, is of the order of 6.5% of GDP.

In many ways, in a globalised emerging economy, the exchange rate has become the single most important price as it influences the costs and realizations of a huge proportion of economic transactions. Our current account transactions alone are approximately 55% of GDP; moreover, the prices of a large variety of goods produced and sold domestically are determined by the exchange rate.

The objective of economic growth has to be to increase domestic consumption of goods and services on a sustainable basis. In many ways, an undervalued exchange rate militates against it by encouraging exports; therefore, the standard of living of the people, measured in terms of consumption, not monetary income, remains below what the productivity of the economy can afford. It also means a surplus on current account, i.e. excess of domestic savings over investments: an inevitable, if perverse, corollary for developing countries is the lending by poor countries to the rich countries by way of reserves of foreign exchange. In today's world, the Chinese economy is perhaps the most glaring example of this phenomenon. (Incidentally, during the current problems in the eurozone, Germany also is being accused of oversaving and less consumption, thereby impacting the economic activity in other eurozone countries.) An undervalued currency and current account surpluses are, in theory, supposed to be inflationary. But empirical evidence is against this: consider the inflation record of China, Germany and Japan.

On the other hand, an overvalued currency has a deflationary impact on the tradeables sector of the domestic economy, exactly like high interest rates. This reduces growth and jobs as compared to what they could be with a more balanced external account, creating a gap between the potential and actual output. It also encourages consumption, particularly of imported goods. In many ways, capital flows driven appreciation of the domestic currency benefits the financial economy at the cost of the real economy; it makes domestic industry uncompetitive against imports; and is also a potential threat to financial stability, as the quality of bank debts to the tradables sector becomes weaker.

An overvalued currency also leads to deficits on the current account, which need to be financed either by drawdown of reserves or by capital inflows. Overdependence on the latter can be risky as too many countries have found. Happily, in our case, a significant proportion of the capital inflows needed to finance the deficit is of a stable nature – in particular, remittances. And yet, the easy financeability of the deficit need not unduly influence the exchange rate policy, which has to be aimed at the national goal of growth and job creation.

Apart from the level of the exchange rate, there is also the issue of its volatility. A volatile and unpredictable exchange rate increases the risks of cross border trade and also of investments in capacity creation in the tradeables sector. There is enough empirical research suggesting that stability in the exchange rate (or a single multinational currency as in the eurozone) leads to faster growth in the cross-border exchange of goods and services. Reducing or limiting volatility is also a desirable objective of the exchange rate policy.

In short, the objective of our policy needs to be an effective exchange rate which is reasonably stable in real terms – and leads to narrowing of the gap between the economy's current earnings and expenditure to say +/ - 2% of GDP, so as to optimize consumption and growth.

(to be continued …)

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