The Other Side May 26, 2016

Second term for Dr. Rajan? -- II

In the last article, I had referred to the fact that the CPI targeting approach has led to double digit interest rates for the business sector, given that the WPI is a better index of inflation in that sector. Real interest rates are all the more important for the health of capital intensive businesses and, arguably, the very high real rates have contributed to the sharp rise in the non-performing assets of the banking industry, a matter of serious concern to both the banking supervisor and the owner of 70% of Indian banking. And, with the latest CPI number, there are few prospects of lower rates in the near future. One also believes that given its composition, the CPI is far more influenced by the international commodity prices and, in India, the rain Gods, than by monetary policy. The demographic profile of an economy is also important: Japan and Europe, with their aging populations, are finding it difficult to meet inflation targets, despite years of effort.

Turning now to the other price of money, namely the exchange rate, in a speech in Singapore last month Dr. Rajan emphasised that, "*depreciation in the rupee essentially matches inflation differentials and therefore anybody who invests at rupee rates gets appropriate returns to match the kind of depreciation risk that they have taken*": in other words, the exchange rate for the Indian rupee is determined by the good old purchasing power parity theory of exchange rates. I have some major reservations on the argument made:

⇒ Empirical evidence does not support that inflation differential is the sole, or even the primary, determinant of the exchange rates, even on a year to year basis;

⇒ The REER index prepared by the IMF (and used by Dr Rajan in his Ramnath Goenka Lecture in March) evidences a rupee appreciation of 20% from September 2013 to January 2016, clearly not what PPP needs;

⇒ The very fact that the FPI quota in the bond market was not fully used recently as prospects of a rate cut have dimmed, suggests that the FPI's primary objective is not so much the yield or inflation differential as capital gains through interest rate movements. In fact, the popularity of "carry trades" in currency markets, and also with Indian corporates with foreign currency debt, suggests that in the era of a liberal capital account, exchange rate levels, on their own, do not move to reflect inflation/interest rate differentials, even over years.

In a recent Project Syndicate article, Dr. Rajan has ridiculed critics of the exchange rate policy by saying that *"interpretation is in the eye of the beholder"*. While each analyst of the economy has his/her own beliefs, and tends to give more importance to data supporting them ("confirmation bias" in the jargon of behavioural economics), surely this is equally true of policymakers? One example: in the same article, he argues that "*over the past year, as goods exports have slowed, the real effective exchange rate has been rather flat."* The slowdown, net of POL exports, is marginal. On the other hand, the merchandise trade deficit has remained at around $ 140/150 bn for 3 years, despite the sharp fall in oil prices from June 2014, which should have reduced it significantly. This apart, the output loss on the external account, measured as current account net of secondary income, particularly private remittances (which are not the domestic economy's earnings), is as high as 6% of GDP. And, the net external liabilities have jumped seven times in seven years to $ 350 bn plus, despite the record level of reserves. Of the external liabilities, $ 80 bn represent short term trade credits. And, $220 bn of portfolio investments are potentially short term. How long can our excess consumption continue?

In the article, he also spells out his idea of an ideal exchange rate, "*It is the 'Goldilocks rate' produced by market forces, with RBI focusing on attracting long-term capital inflows and intervening only to maintain orderly movement of the rupee versus other currencies."* Is this a realistic proposition?

To come back to another term for Dr. Rajan, the recent intemperate letter from Dr. Subramanian Swamy and the cult status he seems to have assumed amongst business leaders, would probably ensure that Government offers him one. If he decides to accept the offer, will he undertake a zero-based review of both the monetary and exchange rate policies, before the ever-increasing NPAs and net external liabilities overwhelm us?

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