The Other Side September 26, 2013

Financial and Real Economies

Since the 2008 financial crisis I have been working, albeit desultorily, on a book on global finance. The argument is that, over last few decades of financial liberalisation, finance capital has become the master, rather than remaining the servant, of the real economy. One manifestation of this is the argument made by the last Governor of our central bank on several occasions, that the solution to the appreciating rupee and a consequent loss in competitiveness, is for industry to increase productivity: the reality is that productivity growth can come only gradually say – 1.5 or 2% p.a. The exchange rate can change that much in 24 hours!

One wonders whether our policy-makers still retain faith in the rational expectations of financial market participants, of financial markets being efficient producing prices which reflect all fundamentals, etc. The hollowness of the argument struck me recently in the sharp contrast between the behavior of the domestic and external values of the rupee. The latter has changed by 10% or more in a matter of days (and in opposite directions), twice in recent months, in reaction to monetary policy statements. In contrast, it took the former Governor three years, thirteen interest rate hikes, and umpteen statements, to reduce the rate of fall of the rupee's domestic value from 9.6% to a little under 6% in terms of the wholesale price index. (The rate has gone up since.) Why does the domestic value change remain so sticky? One reason could be, as a recent paper by a former Governor of the Bank of Japan, quoted by John Dizard in Financial Times (September 15), finds, that population growth and inflation have a strong positive correlation: is our inflation purely a monetary phenomenon, as per the Milton Friedman theory, or because of our demographics, as Japan's deflation is?

Even assuming that inflation is purely a monetary phenomenon, are ¼% changes really effective in changing expectations? As for money supply, the reality on the ground, as distinct from theory, is best captured by a confession in Sir Geoffrey Howe's memoirs

Conflict of Loyalty. (Sir Geoffrey was the first Chancellor of the Exchequer under Mrs.Thatcher and thus the chief implementer of her monetarist stance.) To quote, "*We… were already beginning to detect real difficulty in setting, sometimes even reading, the monetary compasses by which we were aiming to steer"*. The 'M's move in different direction and as, Samual Brittan recently wrote in the Financial Times May 4, 2013, "*Even if one has decided how to measure both the quantity of money and the price level, there is no stable ratio between the two.*"

In many ways, prices of goods and services in the real economy (on which the WPI depends) are far more dependent on fundamentals like demand and supply, which cannot be changed easily. As for the external value, it is not so much fundamentals as the perceptions of managers of finance capital, that determine it. And these are often shaped by "animal spirits"; by the herd instinct; by behavioral economics and game theory, by *rationalized*, rather than rational, expectations. And hence a few press statements are enough to change them!

Coming back to financial and real economies, even as we talk of further liberalizing the former, we are putting more and more fetters on the latter, that too at a time when 15 mn new job aspirants are entering the market every year: on the ground, corporate India is bleeding jobs in both manufacturing and services, white collar and blue collar (Indian Express, September 16), to stay afloat. The land law now adds to the hurdles and costs particularly of labour–intensive of manufacturing industry, over and above the constraints of environmental regulations, superstitions of Adivasis, retrospective changes, years of delays in getting procedural approvals even for oil exploration and gold mining. And agricultural is hobbled by our very slow response to introduction of GM seeds. Capital gains of in finance capital which adds little to output and employment (only appreciates the currency) are tax free: the earnings of investment capital (DFI) are taxable, sometimes with retrospective effect!

In a Project Syndicate column (obviously written before he became Governor, Mint, September 12th), Dr. Raghuram Rajan made the point that, that despite all governance

and maco-economic weaknesses, India was earlier growing at 9%; that then India “could do no wrong”. What has changed during the last four years? To my mind,
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⇒ the exchange rate policy which has led to a huge external deficit, which gobbles up domestic output;

⇒ The quality of fiscal deficits with expenditure, not investment, driving it;

⇒ Ever greater deterioration in the quality of governance: too many bureaucrats and politicians with the power to deny, to delay, to reverse earlier agreements, and nobody with the power and responsibility to override them!

Admittedly, Dr. Rajan has no control over the latter two; but surely he can do something about the first? Starting with a far more realistic index model for the real exchange rate? In an article on the then incoming Governor, The Economist (September 7th) complemented “*the pragmatism typical of Indian policy makers*” for “*letting the rupee find its own level*”. So the test of the wisdom of policymakers is in allowing the exchange rate to go where it will; those who crib about halving of the growth rate, about lack of job creation, are obviously foolish!

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