The Other Side February 27, 2014

International Monetary Co-operation

Mr. P. Chidambaram has expressed satisfaction at the outcome of the last week-end meeting of the Group of Twenty in Sydney, at the finance minister/central bank governor level: he believed that the meeting addressed India's concerns. Earlier, Governor Rajan, as quoted in Bloomberg, had expressed concerns that "*International monetary cooperation has broken down*". The reference obviously was to the much publicized "tapering" by the US Federal Reserve, of the increase in money supply: in two steps it has come down from $ 85 bn a month to $ 65 bn a month. The taper has created volatility in the exchange rates of several emerging economies (including India's, when the first announcement was made six months back, though not recently.)

The G20 communique had the following to say on the subject: "*All our central banks maintain their commitment that monetary policy settings will continue to be carefully calibrated and clearly communicated,… being mindful of impacts on the global economy."* Whatever the articulation, the reality is that monetary policy will continue to be conducted in the interest of domestic objectives, whether inflation or employment creation; that international co-operation depends on the needs of Washington, not India's desires. To quote a few examples, Washington wanted the dollar's exchange rate, which had appreciated very significantly against the major currencies in the 1980s, to fall sharply, and the result was achieved through the now famous Plaza Agreement of 1985. More recently, when the financial markets stopped functioning after the mortgage crisis in the US and UK, the Group of Twenty was activated at the Summit level. With crisis abated, US monetary policy would continue to cater primarily to its domestic priorities: though this does not stop the US to simultaneously ask Germany to use its financial strength to help other euro zone economies! Meanwhile, the US Congress has blocked the implementation of higher IMF quotas and voting power for the emerging economies as agreed to in an earlier G20 Summit.

The lesson we need to learn is that it is dangerous to allow our external imbalance to grow to levels where we are at the mercy of international creditors and portfolio investors. (Blaming others does not mitigate the problem: to be sure, we have a long history, dating back to the first Mrs. Gandhi, of blaming the "foreign hand" for our weaknesses; the Finance Minister, while presenting the interim budget, also blamed the global economy for the sharp drop in our growth rate.) And, a reasonably balanced external account needs a managed exchange rate to ensure that the deficit does not exceed say 1.5% of GDP and is zero over an economic cycle. If oil or gold prices go up, the solution is to make their domestic prices costlier through the exchange rate, which also helps the tradeables sector to be more competitive. The recent steadiness in the exchange rate, and the sharp fall in the current account deficit in Q2, should not blind us to the need to manage the exchange rate. Even a 3% deficit means a huge loss in output and employment.

The IMF in its recent report on the Indian economy has projected some fall in the current account deficit over the next five years (3.3% of GDP in 2013-14 to 2.7% of GDP by 2018-19). This implies that over this period, we would need to have additional external liabilities of the order of $ 200/250 bn – **over and above the present net external liabilities of $ 300 bn!** How long will foreign lenders/investors continue to finance them? Remember, we do not have the exorbitant privilege of the rupee being the world's sole reserve currency!

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Dr. Manmohan Singh could be nearing the end of an illustrious career from academic economist, to civil servant, to Governor of the central bank, to finance minister, to head of government (at least *de jure*!): hence a couple of personal reminiscences.

The first comes from the 1970s, when George Fernandes was a cabinet minister in the post-emergency government. Talking later to me, he said that the most impressive civil servant he came across was Dr. Singh. George took some time to realize this as Singh would rarely open his mouth *suo moto*, sitting in meetings with an inscrutable face: but once when George asked him a specific question, he found Singh far more knowledgeable and studied than all the more voluble participants! After that, he made it a point to ask Singh for his views first!

Another memory: elections had been announced and a caretaker government was holding charge in 1996. I used to write a weekly column titled *World Money* in Business Standard those days. I had written a couple of articles criticizing the then interest rate policies. A friend of Dr Singh since his IMF/RBI days wrote to him about the articles, arguing how my analysis seemed more logical than the central bank's: that money was extremely tight because of reversal of "leads and lags", and not "overheating"; that RBI needs to supply liquidity rather than allow market rates to go haywire. I received a gracious letter from Dr. Singh (then Finance Minister) also mentioning that he has been reading the column. In a couple of subsequent one-to-one meetings, I found him extremely candid.

Dr Singh's simplicity and unassuming nature are still remembered by old-timers in RBI – even as Governor, he would stand in the queue to see the in-house doctor!

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