Interest rates, exchange rates and inflation

In a somewhat surprising move, the Reserve Bank increased the repo and reverse repo rates by a quarter percent, in the face of continued rise in inflation, to stall “a potential possibility of heating up” (Governor, Indian Express, March 23). Such measures are expected to be important, not so much from their direct impact on price levels, as for “anchoring” inflation expectations.

Whatever the objective, IMF economists recently took the heretic step of arguing that developed countries should aim at an inflation rate of 4%, rather than the more traditional 2%, as the former would leave larger room for central banks to cut interest rates in times of need! Obviously, it does not now seem to believe that very low inflation is necessarily virtuous. (Equally heretically, it even argued in favour of capital controls recently – clearly, the financial crisis does seem to have taught the IMF of the need to look beyond the Chicago school theology.)

For students of macro-economy, Japan is an interesting case study in terms of the relationship between monetary and fiscal policy, inflation and exchange rates. Consider some numbers:

- ⇒ The Bank of Japan cut its interest rate from 8% in 1991 to 0.5% by 1995. Contrary to what most of the pundits argue, the exchange rate appreciated sharply during the period, at one time touching JPY 80.
- ⇒ Since 1995, the monetary base has gone up 115%, but the nominal GDP has fallen by 8% despite real, if halting, GDP growth in many of the years. (Clearly, the clearly the assumption of a constant rate of money circulation is not valid in this case.) The economy continues to be in deflation even today. That this should occur over a 15-year period of practically zero interest rates and an extremely loose fiscal policy (fiscal deficit 7.8% of GDP in the current year), which has taken government debt to 200% of GDP, seems to be completely contrary to what macro economic theory

suggests. (Milton Friedman of the Chicago school believed that inflation is always a monetary phenomenon.)

⇒ It could be argued that the expectation of falling prices has become so firmly ingrained in the Japanese psyche, that the consumer keeps postponing purchases and the deflationary cycle perpetuates. But this is not supported by the fact that every annual survey since 2004 evidences that the Japanese people have consistently expected prices to go up in the following 12 months! (In other words, expectations seem to have little to do with outcomes.) In fact, household savings have dropped from 16% of income to 3% over the last quarter century, partly also because of an aging population.

⇒ This year, maturing debt equivalent to only a little less than half the Japanese GDP, would need to be re-financed – yet bond yields are barely 0.15% p.a., for two years, going up to 2.1% for the 20-year bond. But even at these low rates, the debt is so high that debt servicing consumes 35% of revenues.

⇒ Despite the sharp fall of savings of the household sector and the huge negative savings of the public sector, the current account remains in surplus. The only possible conclusion is a sharp fall in private investment.

To my mind, the last point has a plausible explanation (to be sure more creative and imaginative minds than mine would have plausible rationalisations for the others as well). Perhaps the huge gyrations in the exchange rate explain the weak domestic investments – from JPY 135 in 1991 to JPY 80 in 1995, to JPY 145 in 1998 – only to appreciate to JPY 111 in a few weeks. (That the collapse of a hedge fund (Long Term Capital Management) should change the exchange rate between the currencies of the two largest economies of the world by 30% in a couple of weeks, is a telling commentary on market efficiency and the virtues of market determined exchange rates.) Which sane businessman would invest in an economy where there is such volatility in perhaps the single most important price in a globalised world – namely the exchange rate? The surplus on current account seems to be more the result of a sharp fall in domestic investments, than anything else. (Is this the case in China as well? – a point I will come back to next week). It is noteworthy that, after Sony, Toyota, et al became global brands in the last two decades, no new Japanese brand has come up.

Overall, the Japanese economy remains a riddle for the accepted tenets of macro-economic theory. Is it an exception to prove the rule, or do the tenets need review in a globalised economy?

Meanwhile, the Japanese experience should help sober us: continued, fast growth is not “given” and to make such an assumption can be dangerous. After all, Japan was the most feared and competitive economy in the 1980s, before losing its way over the next two decades. Are we being overoptimistic in taking 9% p.a. growth for granted – despite poor and worsening governance, increasing corruption, lack of infrastructure, and an uncompetitive exchange rate?

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