The Original Sin

In a recent main page article (Business Standard, August 23) Mihir Sharma argued that "*India is, even at the best of times, an inward-looking place*". I should plead guilty to the charge and do not believe that "*the reason for the recent sell-off in bond, equity and currency markets is that the United States Federal Reserve is on the point of withdrawing its massive quantitative easing programme*". The much commented Federal Reserve statement was perhaps little more than the event which focused media attention, and headlines, on the exchange rate and its vulnerability to what Ben Bernanke says and does, and how a few score fund managers in Singapore and Hong-Kong react to these comments in terms of their investment/disinvestment decisions.

The seeds of the current situation were perhaps sown in 2009 when the Group of Twenty expressed concern about global imbalances, a euphemism for Chinese surpluses, and emphasized market-determined exchange rates. The call was aimed at China, the expectation being that the yuan would appreciate if allowed to float, and help reduce Chinese external surpluses; these have come down since, despite China continuing to manage its exchange rate, engineering a gradual appreciation and significant wage increases in coastal provinces where much of export manufacturing is located.

Our policy-makers, perhaps out of a colonial mindset of looking to the west for approval; or perhaps out of a conviction that a market-determined exchange rate would help us grow even faster (since markets are supposed to produce prices reflecting all fundamentals, and allocate capital efficiently); or a combination of both; responded by allowing the rate to be determined by the market. True, the public rhetoric has remained unchanged: that we do not target a level; that the central bank intervenes only to curb volatility; etc – but there is enough empirical evidence to suggest that the policy on the ground has changed dramatically, since 2009. And, unlike in the case of interest rate policy and growth, there do not seem to be any differences between Delhi and Mumbai, on this issue!

While the rupee was technically floated in 1993, for a decade and a half, the central bank was actively intervening in the market to manage the nominal exchange rate against the dollar in such a way as to keep the "real", i.e. inflation adjusted, exchange rate reasonably steady in terms of the currencies of our major trading partners. Whatever the weaknesses of the index used – and there are several -- this helped keep the current account deficit within $ 10 bn over most of the period: in fact, we recorded surpluses for a few years. Over the last four years of floating, the deficit has gone up year after year, thanks to appreciation of the exchange rate in real terms, and growth has slowed down. So much for the virtues of a floating rate.

The Anglo Saxon countries are past masters in propagating myths, both political and economic. As for the former, just recall the "weapons of mass destruction" in Iraq and, more recently, about Iran's nuclear program (for the truth about Iran, read *A Dangerous Delusion* by Peter Oborne and David Morrison). As for the latter, opium exports to China and grain imports from an Ireland facing a severe famine, were justified in the name of free trade. In recent decades, the west and its hand-maiden, the IMF, have been propagating the virtues of liberal capital flows and market determined exchange rates although the IMF's own research does not suggest that they promote growth. On the contrary, "capital flows appreciate the real exchange rate and hurt growth through reduced investment incentives in manufactures" (Dani Rodrik 2008). As for the G20 call, China's global imbalance has come down with a managed exchange rate, while ours has gone up 10 times with a floating exchange rate! In fact, if anything, exchange rates need to be managed to bring down global imbalances!

This columnist has consistently argued in favor of the central bank managing the external value of the currency, just as it manages the domestic value (i.e. inflation). While I am aware that consistency is a virtue of fools, on first principles, what I can never understand is how floating, unpredictable, exchange rates benefit the real economy which produces growth and jobs. Yes, volatility is the source of profit for the currency trader, but clearly it increases the risks of investment in the tradeables sector, particularly when it consists primarily of non-differentiated goods and services, as in India.

In our case, exports and imports (goods and services) today aggregate to 42 % of GDP! Besides, many domestically produced goods are priced at import parity: in short, the pricing and competitiveness of a huge proportion of the domestic economic activity is determined by the exchange rate. After March 2009, it appreciated more than 10% by April 2011, even as the domestic inflation was much higher than in our trading partners. No wonder, the tradeables sector has become uncompetitive, and the external deficit so high. Even more crucially, net negative exports of USD 90 bn in 2012-13 alone mean a corresponding loss of output and millions of jobs. To be sure, environmental regulation, land acquisition policies, court orders, etc. have also contributed to the slowdown – but so has the exchange rate policy. The deficit is not merely a problem to be financed! It has serious implications for growth and employment.

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