The impossible trinity and the exchange rate policy

It is widely accepted that the trinity of free or liberal capital flows, an independent monetary policy and a managed exchange rate cannot co-exist, at least in extreme situations. In the 1920s, the accepted wisdom in the then leading economies (U.S., U.K., Germany and France) was to give up an independent monetary policy. The result in U.K. and Germany was huge unemployment, and both had to change policies. Germany adopted exchange controls, and Britain suffered a huge devaluation in the early 1930s, only after inflicting enormous pain on the poor. The U.S. and France did not follow the 1920s accepted theology very faithfully, and emerged from the 1920s as the two strongest economies. It is difficult to argue that the global depression of the 1930s did not have anything to do with the policies of the 1920s.

Over the last 30 years the fashion propagated by the Anglo-Saxon ideology and the IMF has been to give up the managed exchange rate. Over the initial decade and a half of economic reforms, Indian policy makers did not adopt extreme policies: the capital account was gradually liberalized, but broadly speaking, the exchange rate was so managed as to keep the rupee reasonably stable in real effective terms. Despite the need for reform of the index, which I have argued in earlier columns, the policy worked reasonably well: the gap between external earnings and expenditure was just $ 7.5 bn in 2003-04, even as domestic savings and investments grew rapidly. India built up reserves of the order of $ 200 bn by the end of fiscal 2006-07, as the central bank continued to absorb surplus capital inflows. In the first few months of 2007-08, it seems that the exchange rate was deliberately allowed to appreciate, but then held steady for the rest of the year through intervention (reserves $ 300 bn. by March 2008). 2008-09 was the year of the financial crisis, a huge amount of capital went out, the central bank sold almost $ 50 bn, even as the currency fell sharply. There was hardly any net intervention in 2009-10 and none since December 2009, thus completing the dramatic change from a reasonably managed exchange rate to a fully market determined one. The income expenditure gap went up to $ 90 bn in 2009-10.

The result is a dramatic increase in the net external liabilities of the country, from a reasonably stable level of around $ 47bn at the end of 2003-04, to more than $ 158 bn at the end of March 2010, and perhaps to $ 200+ bn by March 2011. Surely this is a large enough number in relation to GDP, for policymakers to think about, particularly in the context of the fact that an ever increasing proportion of the total liabilities now consists of (potentially quick to reverse) portfolio investments and short term credit aggregating $186 bn on 31-3-2010! Overall, while external deficits have so far been easily financed through capital inflows, the quality, as distinct from quantity, of the capital inflows, has continued to deteriorate.

To come back to market determined exchange rates, Finance and Development, March 2011 issue, carried an article titled “Gyrations in Financial Markets” by three IMF economists. While correctly arguing that “*gyrations in financial markets have greatly influenced real activity around the world*” it refers to real estate, credit and equity markets, carefully avoiding any reference to the exchange market: no wonder of course! The virtuousness of a market determined exchange rate is an integral part of the IMF theology. Interestingly, the same issue carried a report on an interview with Nobel Laureate, Robert Solo. He argues that, “*in the modern world, it is impossible to pursue macroeconomics without taking account of finance; and second, financial markets are not necessarily stable or self-correcting.”* Market determined exchange rates are necessarily more volatile, increasing risks in cross-border trade, and making investment in the tradables sector less attractive, affecting manufacturing growth, a point I will come back to next week.

I have earlier expressed my apprehension that the unannounced, undebated change in exchange rate policy during the last few years seems to be aimed at pleasing the Americans in the G20 forum. It is strange that we still have faith in Anglo-Saxon wisdom in understanding financial markets. In 2006, the Icelandic banks got a resounding certificate of their soundness from a soon-to-be Governor of the Federal Reserve, Frederic Mishkin! Iceland had followed the script: a fully convertible currency, market determined exchange rate, etc. It was perhaps thought incidental that the banks’ assets had bloated to 50 times GDP! What happened to the Icelandic banks and the economy just two years later is now too well known. And, the mortgage crisis itself was the result of policy-makers’ faith in the wisdom of market participants in managing risk, in pricing assets, in efficient markets generally. The end result, lest we forget, was that the world suffered the deepest recession since the 1930s. (Only a return to Keynesian measures avoided a worse fate.)

A.V.Rajwade
Email: avrajwade@gmail.com