INDIA NEEDS A FREE MARKET EXCHANGE RATE

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The Achilles heel of the Indian Economy at the moment is the artificial and unrealistic exchange rate. The official exchange rate is the same today as it was in 1955. In the interim, prices within India have risen some 30 to 40 per cent; whereas prices in the US, UK, Germany have risen far less, at most by 10 per cent. If the rupee was worth 21 cents in 1955, it clearly is not worth 21 cents today. And even in 1955, India was experiencing difficulty in balancing its payments. It was even then engaged in extensive foreign exchange control, import restrictions, and export subsidies.

The attempt to maintain an over-valued rupee has had very far-reaching effects. The rise in internal prices without a change in the official price of foreign currency has made foreign goods seem cheap relative to domestic goods and so encouraged attempts to increase imports; it has also made domestic goods seem expensive to foreign purchasers and so discouraged exports. This is the basic reason why India's exports have risen so much less than world trade. It is also the basic reason why India's foreign exchange reserves were so rapidly exhausted despite the very large amount of foreign exchange made available to India through aid from the US and other countries, loans by the International Bank, and the like.

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The pressure on the balance of payments has been officially met in three ways: first, by using up foreign exchange reserves; second, by getting additional assistance and loans from abroad; third, by extending direct control over imports and subsidising exports. There has been a fourth unofficial way, namely, black market transactions in exchange and the smuggling of goods. Though no records exist on this fourth way, there is little doubt that it has expanded greatly as the official exchange rate has become more and more unrealistic and that it increasingly renders official statistics unreliable as measures of India's foreign trade transactions.

The first of these resources is exhausted. The second may still be of some avail though it seems hardly likely that present assistance will be expanded very much. In any event, so long as the exchange rate is as far as it currently is from a realistic rate, foreign assistance will simply be poured down a bottomless well. The third recourse, direct controls, is the one on which most reliance will have to be placed, if the present official exchange rate is to be maintained. It is, therefore, worth examining in some detail what its effects have been and what the prospects are that it will be able to resolve the present difficulties.

Exchange control has not in fact been able to stimulate exports. They have stagnated or fallen. It has operated almost entirely by preventing individuals from importing as much as they would like at the controlled exchange rate. In doing so, it has done immense harm to the Indian economic and political structure. There is no satisfactory criterion available to the planning authorities to determine what items and how much of each should be permitted to be imported. There is much talk of restricting "unessential" imports and permitting only "essential" ones. But this is just talk unless there is some way of determining what is and what is not essential. In the absence of a market test, there is in fact no satisfactory way to do so. When a family must reduce its expenditure, it does not cut out whole categories of goods; it cuts its expenditure a little here and a little there, balancing the loss from spending a rupee less on toothpaste with that from spending a rupee less on movies and so on in infinite variety. The same principle applies in restricting imports to available exchange. But how can planners at the Centre have the necessary information about each of the tens of thousands of items imported? How can they know how much a little cut here will reduce exports of a hundred other items? How costly will it be to provide domestic substitutes, directly and indirectly? How much the consumers of the ultimate products would be willing to sacrifice in other directions for a little more of a particular import item?

The fact is that the planners cannot possibly know what they would have to know to ration exchange intelligently. Instead, they resort to the blunt axe of cutting out whole categories of imports; to the dead hand of the past, in allocating certain percentage of imports in some base years; and to submission to influence, political and economic, which is brought to bear on them. And they have no alternative, since there is no sensible way they can do what they set out to do.

On the economic front, the result has been waste, inefficiency, and misdirection of resources. India has become a protected economy in which items are produced domestically at a multiple of the cost at which they could be obtained from abroad. And at the same time, foreign exchange is wasted in purchasing goods abroad for which it would be more economical to use domestic substitutes. Once an import licence is granted, the recipient gets foreign exchange at the official rate: he gets a dollar for 4.7 rupees. Hence he uses this rate in judging whether to use the imported goods rather than domestic products. But this is a false basis for calculation from the national point of view since the official rate is so far below the rate that would prevail in a free market. A dollar should be spent abroad only if domestic substitutes for the item purchased would cost something like 7 or 8 rupees; but the recipient of an import licence figures that it is worth spending it abroad if one can save thereby more than 4.7 rupees. Hence the very large demand for import licences and the waste of foreign exchange by the lucky recipients.

To some extent this deficiency is offset by the black market that has sprung up in import licences. The original recipient of the import licence may never use it but resell it to someone else for a premium. The effect is to raise the cost of foreign exchange to the ultimate user and force him to use a more appropriate rate in making his calculations. But this gain is purchased at a high social and political cost. It promotes corruption and the exercise of influence, in obtaining import licences, produces windfall profits to persons lucky enough or influential enough to get the licences, widens the inequality of income and wealth, and undermines public trust in Government.

It is one of the great vices of centralised control that, as in this instance, it both stimulates conduct that on a private level is reprehensible and unethical and makes such conduct useful. The black-marketeer, the purchaser and seller of import licences, and so on are flouting the law and behaving in a way that most of us find highly objectionable. Yet they are also reducing the harm that is done by direct controls over exchange transactions.

Despite the extensive network of direct controls, it will be impossible to maintain the present exchange rate indefinitely. The only thing that has made it possible to do so up to now has been the large sums of foreign exchange that the Government has acquired from foreign aid and loans. Unless these are stepped up drastically, the pressure on the present rate will become unbearable. Experience of many other countries, such as the United Kingdom, France, Israel and so on has shown that an artificial exchange rate can be maintained by direct controls only if the deviation from the market exchange rate is minor. Once it gets as wide as one-third to one-half of the official rate—which is probably roughly the present discrepancy in India—a change in the rate becomes inevitable.

What is probable is that sometime within the next year or so India will devalue, moving to an exchange rate of something like 7 rupees to the dollar or 20 rupees to the pound. This will be preceded by a very sudden and rapid worsening of the exchange situation as people inside and outside the country come to expect devaluation and try to convert rupee assets into foreign exchange assets.

While this is the probable course of events, it is not the most desirable. The new fixed rate of exchange may be satisfactory for a while but sooner or later similar difficulties are likely to arise.

A much better resolution would be for the Government of India to cease trying to peg the foreign exchange value of the rupee. Let the exchange rate float and be determined from day to day in the market by private transactions. A floating rate would provide an automatic adjustment mechanism. It would render impossible exchange crises.

It would be best of all if a floating rate were accompanied by the complete elimination of import quotas, export subsidies, and other interference with international trade. But even if this is not feasible, it would be far better to discriminate among imports by tariffs than by quotas, and to do so in the presence of a floating rate to provide an automatic adjustment mechanism to balance payments.

The effect of setting the exchange rate free would be to increase the foreign trade of India. Exports would be stimulated and the funds available to spend on imports increased. Attempted imports would be reduced, but actual imports increased. To illustrate by hypothetical figures: At the official rate, people would like to import, say 200 units, but foreign aid and export provide foreign exchange for only 100, the difference being eliminated by direct controls. At a free market rate, people would seek to import less, say 130, and would be able to import this much because the stimulus to exports would make 130 units available.

A free market rate would make everyone throughout the country aware of the true cost of foreign exchange and of the true gain from selling abroad. It would thus enlist the interests of tens of millions of people in their everyday lives in economising on imports and in promoting exports to precisely the extent that is in the social interests. The activities of these tens of millions of people, each drawing on his little store of specialised knowledge, would provide a far more subtle and efficient adjustment than blunt measures of a few central planners, who, however knowledgeable individually, do not begin to match collectively the aggregate of knowledge of the population as a whole.

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