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Dear Students,

Here is a very interesting article on the recent visit of Professor Kenneth Rogoff, the chief economist of the IMF (the guy who actually is responsible for dealing w/ currency crises prevention in the world) on the booming forex reserves in India. He addresses several very important concepts, that we have either covered in class, or came across.

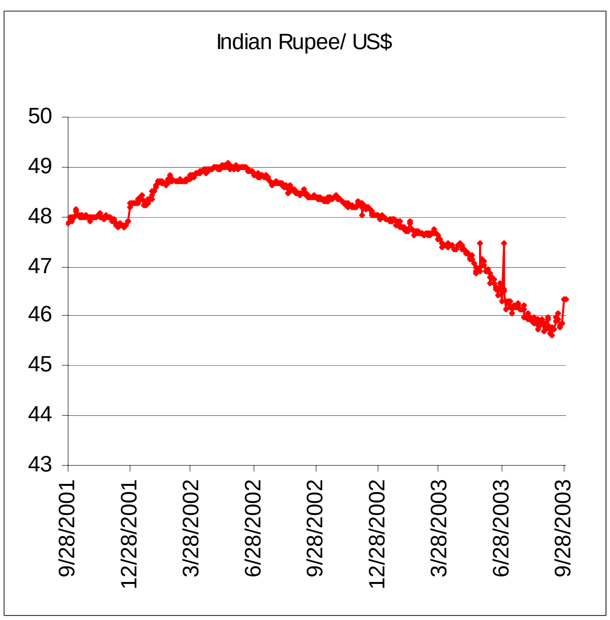
So, when you read the article, try to answer the following questions:

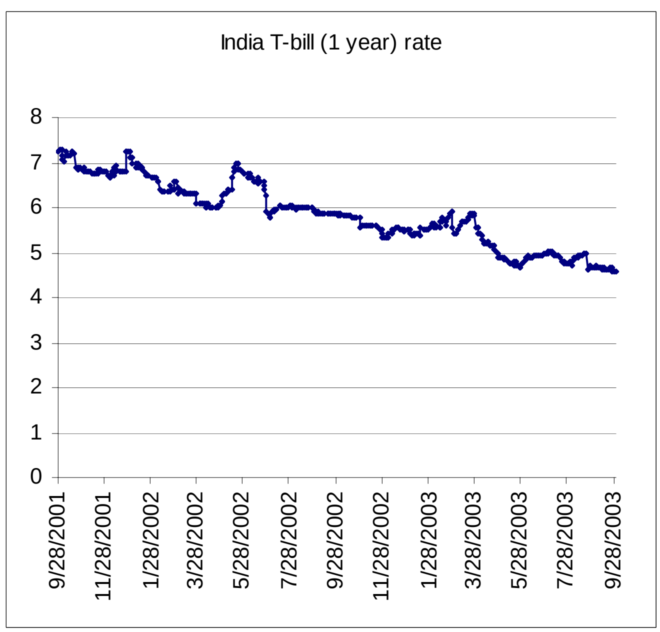
1. Why did Rogoff suggest that reserves are costly? What is the “costly” all about?

2. What does it mean that government’s fiscal deficit will crowd out private investment? (<u>Note</u>: to crowd out means to substitute, i.e. replace. So think about it, if you have the government stepping in the capital & money market and selling their bonds, what would be the effect on private investment? Hint: every investor has to choose where to place her money – of course she will choose the one with the highest return – and if the government offers good return, guess what happens with the private investors looking for stock market funds)

3. Why did Rogoff refer to the liberalization of the capital account as only secondary to the liberalization of the international trade? What could happen (as in the case of the Asian crisis) if you have no free trade, but have free capital flows?

Here are some macro-financial indicators help you answer the questions above.





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Reserves are costly: Rogoff

P Vaidyanathan Iyer in Dubai
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Holding foreign exchange reserves was India's choice, but it was difficult to understand the phenomenal accretion since 2002 end, said Kenneth Rogoff, chief economist, International Monetary Fund.

India's foreign exchange reserves rose 25 per cent since January 2003 to touch $ 88 billion now.

"Till the end of 2002, we could understand what happened. India and other Asian countries said the reserves accumulation was for insurance, which was a reasonable explanation," he told ***Business Standard***.

But since the beginning of 2003, it was more than just insurance; there had been dramatic savings and holding such huge foreign exchange reserves was expensive, Rogoff said.

"How to allocate the reserves is another issue that crops up," he said.

This, according to him, has both political and economic risks. While economics would recommend diversification, effecting any perceptible change in the composition of reserves was political choice, Rogoff noted.

According to Rogoff, the combined Centre-state fiscal deficit of over 10 per cent of the gross domestic product would create long-term problems for growth. "It is not an immediate problem," he said.

The overhang of government deficits would affect interest rates and servicing such a huge debt would crowd out private investment, he added.

If India could grow at 10 per cent a year, the high fiscal deficits could be sustained, Rogoff said.

"As an economic counsellor, I and my successor Raghuram Rajan feel that the IMF's word of caution to India on its high fiscal deficit is not unreasonable," he said.

Given these constraints, the IMF has projected the GDP growth at 5.6 per cent for this year and 5.9 per cent for 2004, he added.

Rogoff said that 8-10 per cent growth was completely achievable for India. "In sectors like information technology and biotechnology, sky is the limit for India. I do not think it takes super-human effort to achieve 10 per cent growth," he said.

India should lose its nervousness about globalisation, Rogoff pointed. "East Asia liberalised its capital account without opening up trade," he said, adding, there was a fear that India was learning the wrong lessons.

"India should open up trade and then improve its financial market supervision. After these, it can go ahead liberalising its capital account. This pays off big," Rogoff said.

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