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Prices, fast and slow

The job of the government in finance is not to influence the price but to create open access systems through which everyone can express views on the market

SNAKES & LADDERS

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We often think that there is a problem when asset prices move sharply in a short time. There is a clamour for a government that will prevent these movements and "manage the volatility". However, a slow, predictable price move is often destabilising. The one thing worse than a fast price move is the same move spread out through time.

Large price movements of financial assets worry many people. We would all like to live in a low volatility world, where nothing much changes from yesterday to today. People are even more suspicious about large price moves that happen within the day. When a price changes by a lot in a few seconds, we think: "How could things change so fast?"

This leads to calls for government intervention. We want the government to get into the act, and somehow force the price to not move so fast, and thus make everyone happy. These days, we are all more sophisticated and we no longer say that we want the government to control the price. We just want the government to reduce the volatility. Government interference in the volatility is considered acceptable while government interference in the price is no longer kosher.

Suppose the world changes and a large move in the exchange rate is called for. Look back at the early 2000s, when there was new buoyancy in Indian services exports, coupled with a new level of capital flows into India. If the market had been allowed to work, there would have been a rapid currency appreciation.

The authorities decided to manage the volatility. A rapid currency appreciation was replaced by a long slow predictable appreciation.

Every rational person thought: "Ah, the rupee is going to appreciate!" People started looking for ways to profit from this coming move. This meant you should bring foreign capital into India for six months, in which time you get about 4 per cent as interest and about 2 per cent as INR appreciation, giving a low-risk 6 per cent return in dollars within six months. This was very attractive and we got a flood of capital coming in, which made life more difficult for the authorities.

Capital flooded into India, the RBI bought dollars and flooded the local market with rupees, which gave a growth rate of 35 per cent a year in bank credit. But banks in India are poorly regulated, so they took this additional capital and lent it out badly. A few years later, we realised there is a banking crisis.

A similar story was repeated in 2013. Conditions changed in the US and a large INR depreciation was required. The authorities tried to manage the volatility. A rapid large move was replaced by a long, slow predictable depreciation.

Every rational person looked for ways to sell assets in India, take the money out, wait out the depreciation, and then bring the money back. The RBI tried to fight it by doing numerous things that harmed the economy, e.g. by raising the short rate by 440 basis points. A drama that should have been finished in a few days was dragged out for a few months.

In the end, this was ineffectual, as the overall INR depreciation which took place in India was in line with what happened in other emerging markets. The only thing that was different about India was that we harmed our local economy more by trying to fight the depreciation (*https://goo.gl/KJq9na*). This time, the sharp rise in interest rates harmed the over-leveraged corporations (which had been created in the previous episode of volatility management) and exacerbated the banking crisis.

A similar story has shaped up on the long-dated government bond. Fundamental factors point to an increase in the Indian long rate. The best thing is to allow the market to work and let the long rate go up (i.e. have a decline in the price of the long bond). We are doing many things to prevent the long bond price from going down.

This has presented a one-way bet for market participants: You are better off selling the long bond, waiting out its price decline, and then profitably buying it back. Each actor who does this tends to push down the price of the long bond, making things harder for the authorities.

A financial market should have some people who think the price is low and worth buying, and some people who think the price is high and worth selling. If prices were allowed to adjust, there would always be some people who are willing to lend to the government at the prevailing market price, thus giving stability to the borrowing programme of the government. Artificial interference in the working of the market creates conditions where there is only one side to the market. This creates greater harm than the problem that we set out to solve.

It is attractive to think that in normal times the market will work, and occasionally the authorities will prevent volatility. This does not work out owing to moral hazard. If private persons are told that they are protected from large price movements, they will take larger risks. For example, too many Indian companies have borrowed abroad after 2013 as the Indian state is likely to fight large rupee depreciation. This increases the harm when large price movements do come about (as they will), and creates new kinds of political lobbying.

As with the price of cement or steel or wheat, we are better off with prices that come out of markets. There was a time when the newspapers in India pondered whether the price of cement or steel should be allowed to fluctuate, whether the government should get involved in controlling this volatility. Deregulation came, and everyone learned to live with a steel price that is no longer in the zone of public policy. The job of the government in finance is not to influence the price but to create open access systems through which everyone can express views on the market.

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