The rupee: Not too strong?

Several clients have asked me over the last few days whether I agree with Swaminathan Aiyar's argument that "*The rupee is not too strong*" (The Economic Times, December 22, 2010). My short answer is "No, I do not", partly because he looks at only one side of the current account flows: exports. What about the import growth? In fact, if the proof of the pudding is in its eating, the proof of the competitiveness of the exchange rate is in the imbalance between our current external earnings and expenditure: and this, by my estimate, could reach a horrendous figure of 7/8% of GDP in fiscal 2010/11 – representing a very significant loss of output, growth and jobs. Even the current account deficit as conventionally calculated would be 4%+ of GDP. And, this is not so much because of higher investment but, as I have argued earlier, because of the high exchange rate reducing savings compared to what they would otherwise have been.

But Mr. Aiyar has raised one pertinent question: which of the two REER indices (6 currency and 36 currency) published by RBI is more relevant as an indicator of the rupee's competitiveness? He opts for the latter. (The Reserve Bank seems to agree with him: in its policy statement of November 2nd, it said that the rupee had appreciated by 0.4% on the basis of the latter index in fiscal 2010/11 up to October 22). After talking to a large number of exporters, as part of a study I did on the question of rupee invoicing, I am increasingly coming to the view that neither really is, based as they are on bilateral trade-weighted exchange rates. Perhaps we need either a MERM (multilateral exchange rate model) which takes account of competitiveness in 3rd markets or, more readily and simply, the weights need to reflect the invoicing currencies, not bilateral trade.

The reason is simple. If imports are more competitive than prices in the domestic market, in choosing the country from which to import, the importer will ask for prices not in their domestic currencies, but in a common currency, and then make his choice, whether to import from India, Bangladesh or Vietnam. While the aggregate level of imports will be significantly influenced by domestic prices, the *source* of import will be determined by quotes in a common currency like the dollar. In other words, while the real exchange rate of a currency would influence the competitiveness of imports with domestic costs, the *source* of imports will depend on the prices in a common currency. And, hence the argument that we need to use either a MERM index or use invoicing currency weights as a proxy for MERM -- imperfect, but still better than bilateral trade weights.

This argument is particularly strong in the case of countries manufacturing "undifferentiated" goods in its tradeables sector – i.e. goods purchased primarily on price considerations as distinct from technology/brand etc. Such is the case of much of India's tradeables sector. In fact, a visit to the corner shop and a look at the electrical accessories, furniture, furnishings, toys, etc. sold there is living proof of how uncompetitive our manufacturing has become with imports. Also the fact that, as Mr. Aiyar's newspaper reported on December 22, "*Indians find it cheaper to holiday abroad now*" – and that we "import" American stars for the so-called reality shows. Not only are services like tourism and even tailoring becoming uncompetitive (it is now much cheaper to buy a made-to-measure suit in Bangkok than in Mumbai), but Philippines is becoming an increasingly strong competitor in the BPO segment – and China in IT.

It would be foolish to ignore that once you lose a market (domestic or foreign), because of an overvalued exchange rate you may not be able to regain it even if you become competitive again. "Temporary" losses in markets can become structural and permanent; the buyers get used to, and become comfortable with, other suppliers; domestic units shut down and it is difficult to revive them. One sometimes wonders whether our exchange rate policy, or lack if it, is because of our authorities pandering to financial markets, an Anglo Saxon disease -- or our need for external validation and recognition that we have "arrived". It is sad that this should be happening under a Prime Minister who, in an earlier era, was the lone voice arguing for a competitive exchange rate.

But coming back to the Reserve Bank, its statement quoted above is at best disingenuous: it glosses over what happened in the previous fiscal year. By choosing a suitable starting point (and index) one could “prove” that the rupee has actually depreciated. This apart, the last two years (as also Q1 of 2007-08) represent a dramatic and substantive shift in the country’s exchange rate policy, consistently followed since the introduction of LERMS: with no public debate or even an announcement! Let us not forget that, in financial markets, the music does not play on forever; it can suddenly stop, and that can have major consequences for financial stability.

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