**Economics of Trade and Prospects for the Exchange Rate**

The other day, our Finance Minister, perhaps concerned about the continued fall in exports month after month, and that too by significant percentages, asked exporters to produce quality products at competitive prices: to quote him, "*the world wants to buy good products, it wants to buy cheaper products and therefore you have to think ahead of the others, manufacture products which are cost and quality competitive.*" Will such exhortations and platitudes do the trick? The only help the government has given to exporters recently is an annual interest "subvention" of the order of Rs. 2500 crores. By my back-of-the-envelope calculations this works out to less than 10 paisa per dollar, and such munificence will do little to improve the economics of exports: even after the last few days fall, the rupee remains significantly overvalued and the "subvention" is unlikely to make any difference, particularly when global economic growth and demand is slow. To be sure, there is considerable scope for recapturing the domestic market for manufactured goods and commodities, from imports, but this will need a competitive exchange rate from which we are far away.

In the last week's article, I had commented on two different factors which have led to a sharp fall of the currencies of many emerging economies: fall in commodity prices have affected commodity exporters, while capital flight and reversal of carry trades seems to have affected many others. The rupee's fall last week is nowhere near the depreciation of many other emerging economies. Commenting on India's external account, *The Economist* (November 14) recently remarked that "*The current account has moved closer to balance, in part because of low oil prices but also because of the prompt action taken after concerns about capital starting to leave emerging markets sparked a mini-crisis (the so-called "taper tantrum") in 2013.*" The first reason, yes, but it is absurd to argue that prompt action to stem capital *outflows* helped reduce the current account deficit!

In fact, given the RBI's current policy stance on the exchange rate, capital outflows may well be the only way to correct the external value of the rupee. Surely the proximate cause for the recent fall of the rupee has been portfolio capital outflows of the order of $ 1.5 bn. In November. What about the future? Could such outflows continue – or even accelerate, particularly after the expected rise in USD interest rates? A few weeks back, while discussing the issue with a major fund manager I made the point that we may be more immune to capital outflows and the threat to financial stability they can pose, than many other emerging economies, already afflicted by the disease, at least partly because of the TINA (there is no alternative) factor: where else will the funds go? (Chinese market crashed 5% last Friday.) But I also cautioned that I would quantify the probability of this scenario as no higher than, say, 55: 45.

There are several reasons for the caution. First, as Geraldine Sundstrom of PIMCO, one of the largest global fund managers, recently wrote in a report, "*Foreign-currency exposure is no longer a simple numeraire that can be hedged away or ignored…Foreign-exchange considerations will weigh disproportionately on the investment and opportunities."* And, financial markets are well-known for feedback loops – capital outflows leading to currency fall leading to further outflows ….

The second reason is that, in effect, we have become a "ponzi borrower" in our external balance sheet, with liabilities far in excess of the assets. In a recent article in this paper (November 27), Daniel Gros defined "ponzi borrowers" as "*those who can service their debt only with new debt."* Given the quantity of portfolio investment outstanding, if there are significant outflows, the central bank will find it more and more difficult to support the rupee by selling dollars from the reserves, as it seems to have done last week.

The third factor that could weigh at some point of time is that our stock market is one of the most expensive ones globally in terms of the price earnings ratio and recent corporate results suggest that profitability is still under pressure. Particularly hard hit are producers of basic commodities like steel, aluminium, etc.: they have been hit by both the sharp fall in commodity prices globally, and the overvalued currency.

But surely there are better ways than capital outflows to correct the exchange rate?

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