

### Trade Policy and Exports

Recently, the Ministry of Commerce came out with a much delayed Foreign Trade Policy for the next five years. While the procedural simplifications are to be welcomed, I am intrigued by some of the numbers. In an interview (Mint, April2), the Commerce Secretary has been quoted as saying that while the Ministry has not yet worked out the current year's target, *"we have worked out the five-year target, we have worked out the merchandise service combined target of \$ 900 billion at the end of 2020....While working out the compound annual growth rate (CAGR) for the five-year target, we have worked on a CAGR of 14%."*

While the arithmetic is fine, is the assumption of 14% CAGR reasonable? Two points strike me:

- ⇒ The actual CAGR has been just 2.1 % p.a. over the last three years;
- ⇒ Is it reasonable to expect an increase to 14% p.a. for five years on past performance, whatever "sops" (media's favorite expression for benefits to exporters) "subventions", "subsidies", the (unquantifiable) benefits of procedural simplifications, etc. in the Policy?

And, while procedural simplifications do help, are the other "subventions" meaningful? The policy seems to increase the "subventions" for special economic zones by Rs. 3500 crores: the SEZs' exports amount to Rs. 450,000 crores. The former amounts to less than 0.8 % or say Rs. 0.5 per dollar. The interest subsidy comes to Rs. 1650 crores and is irrelevant for the economics of exports of \$ 450 bn a year, particularly when the rupee is overvalued by 25% in real terms, i.e. by Rs 15 per dollar! One is surprised that the crucial relevance of the exchange rate to foreign trade does not seem to be getting enough attention from policy-makers, or even business: while the latter lobby strongly for lower interest rates, higher duties on imports and regulatory simplifications, they are silent on the issue of the uneconomic exchange rate. (This is in sharp contrast to their

counterparts in the euro zone, who have welcomed the fall of the euro, even as US business profits are getting squeezed by the dollar appreciation.

To be sure, recent reports do suggest that policy makers in Delhi are getting concerned about *“the strong rupee .... hurting the nations merchandise exports”* and feel that *“a cut in interest rates will weaken the rupee”* (*The Economic Times, April 1<sup>st</sup>*). For one thing, a strong rupee also hurts exports of services and, equally, units making in India who have to face competition from imports. Again, the largest increase in portfolio flows into India over 2014 has come in debt securities rather than in the equity market (\$ 23 bn as compared to \$ 9 bn). My feeling is that much of the money in debt securities has come in anticipation of further rate cuts: given the inverse relationship between bond yields and prices, the capital gains are more attractive than the “carry trade” playing on interest differentials. Policy-makers should also not overlook that, lower interest rates are, in any case, a bullish factor for equity prices: overall, we could end up with higher inflows of portfolio capital by lowering interest rates. If they are serious about lowering the rupee – and, in my view, they should be, -- the only reliable way is for the central bank to intervene directly in the market, exactly what the Swiss central bank was doing to keep the Swiss franc from appreciating against the euro beyond CHF 1.20. (It recently abandoned the effort, and the franc has soared to .....***despite negative interest rates***).

But the question of intervention by the central bank raises two issues:

- ⇒ The sterilization of money supply resulting from intervention has a cost since it means replacing higher interest rupee assets on the central bank’s books with lower interest foreign currency reserves. But this is a very narrow way of looking at the economic impact of intervention and sterilization: the cost of an overvalued rupee, **in terms of loss of potential output, growth and unemployment is far higher than the cost of sterilization;**
- ⇒ An overvalued rupee is very useful for the Reserve Bank’s preferred single point agenda of targeting inflation, forgetting the impact of dis-inflationary measures like high interest rates and an overvalued currency, on growth and

employment: it is a myth that low and stable inflation is a necessary, let alone sufficient, condition for rapid growth of an economy! Interestingly, its US counterpart is worried about the impact of the appreciated dollar on job growth.

A related issue is whether we should “target” a particular level of reserves, as some argue. In my view, this is a way of putting the cart before the proverbial horse: targeting a real exchange rate is the independent variable, and the level of reserves is the dependent one.

In a recent article (Business Standard, April 4<sup>th</sup>) T.C.A. Srinivasa Raghavan wrote that *“Mr. Modi is fascinated by the way China runs its economy”*. If he is serious about “Make in India”, about the trade policy goal of doubling exports in five years, he should tell his central bank to follow China’s exchange rate policy. A rupee overvalued by 25% will not achieve it! Whether the paper on which currency notes are printed is made in India or imported (a point he is reported to have made in his interaction with the central bank last week) is irrelevant to the big picture!

A.V.Rajwade

Email: avrajwade@gmail.com