

### **The real exchange rate and deficits**

As I argued last week, *“the current account deficit, (even) as conventionally calculated, was fairly modest until 2006-07, but has galloped since then.”* Is the root cause a savings investment imbalance, or does it have more to do with the exchange rate? The point is important because once you attribute it to the former, it logically follows that the exchange rate, or external value of the domestic currency, has no bearing on it. But this is not very logical. Surely, the exchange rate is the most important variable affecting the current external income and expenditure directly, by determining the competitiveness of the tradeables sector, particularly of non-differentiated goods and services, indirectly influencing savings and investment. On first principles, net exports is a part of GDP and, to the extent it is negative, GDP, in other words domestic output, is reduced through both lower exports than what they otherwise would have been, and the inability of segments of domestic manufacturing to compete with imports. This directly impacts the savings side of the equation -- lower output means lower fiscal revenues (i.e. higher government dissavings than what they otherwise would have been), lower jobs and therefore a lowering of private savings, and a negative impact on corporate earnings and, therefore, corporate savings. Clearly, it is difficult to argue that the real exchange rate has nothing to do with the current account deficit. What I find truly amazing is that this point even needs to be argued about.

To turn to some numbers, please see the attached table. One does not need a Ph.D. in econometrics to see the close relationship or correlation between the real exchange rate against the dollar and the deficits. I have deliberately used that number, not the more conventional model of a bilateral trade weighed basket of currencies. The rationale was argued by me in detail in an earlier article (see World Money January 3, 2011). To summarise, the real rate against the invoicing currency matters much more than the destination of trade: an Iranian importer's decision whether to import garments from Bangladesh or India would depend on the pricing in the invoicing currency, not the bilateral rial rupee exchange rate. And, 80% of our external transactions are invoiced in the dollar.

The following conclusions seem fairly obvious:

- ⇒ The real dollar: rupee exchange rate was fairly stable until end March 2003, and so was the trade and current account deficit until 2003-04;
- ⇒ The real rate appreciated sharply over the next five years, to end at a level 25% below 2002-03 (from 44.74 to 33.11);
- ⇒ The year 2008-09, with the financial crisis, the rupee fell, which, as even proponents of free capital movements and market determined exchange rates concede, as it benefited the competitiveness of the tradeable sectors. (But the end of the year rate was still 10% lower than the 1<sup>st</sup> three years of the data.)
- ⇒ In the very next year, we “corrected” the fall and at the end of 2009-10 the rupee was back to roughly 2007-08 level. My estimate for the 31.3.2011 level is a further rise to around 30, a rise of 30% from 31-3-2003

The unbridled appreciation of the rupee will doubtless lead to less investment in industry (Recently, the head of Siemens in Brazil warned that it *faces the risk of “deindustrialization” until it imposes more extreme capital controls to rein in the surging local currency.* (Financial Times, May 5, 2011) No wonder FDI investments in new projects, totaled just \$ 20 bn last year, the lowest number for four years. And, Tata Group recently decided to invest PDS 5 bn in Jaguar to make the British company as good as the best German names. Obviously Tatas want to take on BMW and Mercedes, through their British company, one more evidence of a trend of Indian businesses finding investing abroad more attractive which people like Deepak Parekh have been warning about.

Of the impossible trinity (an independent monetary policy, free capital movements and a managed exchange rate) our policymakers seem to have chosen to give up the managed exchange rate, which, to my mind, is a complete reversal of the policy of the previous 15 years. And, this was undertaken unannounced, un-debated. This can be dangerous, a point I will come back to next week.

(Deficit figures in USD mn, exchange rates INR/USD)

Year	Trade deficit	Current Account Deficit net of remittances	End of fiscal year Exchange rate	Real exchange rate against USD end of year**
<b>31.03.2000</b>			43.61	
2000-01	12,460	15,520	46.63	44.99
2001-02	11,574	11,998	48.81	46.73
2002-03	10,690	10,042	47.56	44.74
2003-04	13,718	7,525	43.52	39.71
2004-05	33,702	22,995	43.77	38.52
2005-06	51,904	34,395	44.63	38.91
2006-07	61,782	39,390	43.57	36.81
2007-08	91,626	58,739	39.96	33.11
2008-09	119,403	71,947	50.97	40.58
2009-10	118,400	90,466	45.15	34.57
2010-11*	102,100	78,400	44.86	
<b>31.03.2011</b>			44.72	

\* For 2010-11 till Q3 (December 2010)

\*\* Using WPI for fiscal year for India and immediately and US CPI for the most recent calendar

A.V.Rajwade

Email: avrajwade@gmail.com