Exporting the Exchange Rate?

In two speeches in the South, Dr. Raghuram Rajan recently spoke about the Reserve Bank's exchange rate policy. In the Kochi speech, he argued that, "*Until we bring inflation down….there will be a certain amount of depreciation (of the rupee) which is necessary to ensure that we don't become uncompetitive…. Our focus is on bringing down inflation*". However, "*If you look at the real effective exchange rate, it is flat.*" (Times of India, February 15). On the very next day, in Thiruvananthapuram, his emphasis was different – namely that unlike China, Japan or Korea, the RBI does not believe in an undervalued rupee to push up growth as this leads to problems in other areas and "*was not a feasible or desirable strategy for growth.*" He firmly believed in the "*RBI's philosophy of not focusing on the level of exchange rate…. but trying instead to minimise …extreme volatility.*" (Is there some discord between the statements in Kochi and Thiruvananthapuram?) Dr. Rajan went on to advise the audience, which consisted of small and medium enterprises (MSMEs), to focus on "*cost effectiveness, innovations and ideas*" (Indian Express, February 16). I recall that his predecessor had also advised business to improve productivity to cope with an appreciating rupee.

These speeches have raised several questions in my mind:

- Is inflation being brought down to make the rupee competitive, or is an overvalued rupee being used to bring down inflation?
- As for the "flat" REER, data on RBI's website suggests something else: in August 2013, the 6-currency index was 108; it was 124 in January 2016 (the broader 36-currrency index also shows a similar trend). In other words, the REER has hardly been flat.
- Howsoever desirable the improvement in productivity, innovation, etc., such organisational improvements are neither easy nor quick to achieve.

As for the last point, the Governor's year-end communication addressed to RBI professionals evidences the difficulties. He believes that the RBI needs to transform itself from a "*traditional, unimaginative organisation" to a "dynamic, intelligent one.*" His frustration in achieving the transformation is obvious when he says that "*Our regulations are not always very clear, our staff sometimes is neither well-informed of* *our own regulations nor willing to help the customer, our responses are occasionally extraordinarily slow and bureaucratic"* (The Economic Times, January 12, 2016). If it is so difficult to change the culture and quality of work in an organisation consisting of some of the most highly educated and intelligent professionals, how far is it realistic to expect MSMEs to increase productivity and innovate?

This apart, domestic industry uncompetitive in global markets and unable to compete with imports in the domestic markets, adding to banks' non-performing assets, is not the only effect of an overvalued exchange rate. A couple of others: a few years back, I had studied hundreds of transactions between banks and their mostly MSME clients, involving complex, structured derivatives. Most of these transactions were dated between mid-2007 and mid-2008, a time during which the rupee had appreciated to Rs. 39 per dollar and exporters were incurring losses. In these circumstances, it was not very difficult for banks to persuade them to enter into complex, structured products which were supposed to make them money and help mitigate the losses on the exchange rate: the actual end result was quite different, with exporters incurring large losses on the derivatives. I have often wondered whether the mis-selling would have been equally easy, were the exchange rate to be more reasonable.

Again, a persistently overvalued currency encourages "carry trades" by way of unhedged long term foreign currency loans since the change in the exchange rate is less than interest/inflation differential between the borrowed currency and the rupee. RBI's exhortations to hedge will be helped if the economics of unhegded exposures is made unattractive through a suitable exchange rate policy which depreciates the rupee to the extent of inflation differential.

If the RBI is not focussing on the level of the exchange rate, as Dr. Rajan said, then who is determining it? In my view, it is the foreign portfolio investor. When there are net inflows, the rate appreciates; when there are net outflows, as there have been over the last 8 months or so, the rupee falls. Is it wise to leave the exchange rate to the mercy of a score or so foreign fund managers? Instead of exporting goods and services, we seem to have exported the level of the exchange rate!

A.V.Rajwade (avrajwadegmail.com)