Be sure of what you want

Politicians turn left when in doubt. Experts follow them. When in doubt, they recommend stimulus—government spending, lower interest rates and cheaper currencies. For deep-rooted problems, they are placebos with side effects. So, we should be sure of what we want lest we get it.

First, is the rupee overvalued? Computing the purchasing power parity (PPP) exchange rate of the Indian rupee bilaterally against the dollar using Organization for Economic Cooperation and Development data (quarterly data for 20 years) on gross domestic product price indices (gross domestic product deflators), I found that, currently, the rupee is about 10% overvalued against the dollar. It is not big. Trade is conducted with many countries and hence, effective exchange rates matter more than bilateral exchange rates.

The real effective exchange rate (REER) of the rupee as per data from the Bank for International Settlements (BIS) has appreciated by 17% since the present National Democratic Alliance (NDA) government took office in May 2014. However, the appreciation since 2010 (base year for the index) is around 12%. Not a cause for worry. As per data from the Reserve Bank of India (RBI), REER has appreciated less (around 10%) since May 2014 whether it is trade-weighted or export-weighted.

Export growth has many causative factors. Empirically, over the years and across nations, it has been found that income effects (growth in importing countries) dominate price effects (exchange rate change). India's merchandize exports surged 2.5 times and export of software services more than trebled in dollar terms between 2004 and 2008 despite rupee appreciation of about 20% against the dollar in that period.

As a bloc, India's biggest trading partner is the European Union. India's trade with Europe is instructive for two reasons. First, in the years in which the euro was much stronger and the Indian rupee had plummeted (2012-13 and 2013-14), India's exports to the European Union hardly grew. Again, it underscores the relevance of economic growth in the importing region for exports than the exchange rate. Second, in the last two years, the euro appreciated more against the dollar than the rupee has. From around 1.05 (euro-dollar), it strengthened to 1.20. That is a 14% appreciation. During the same period, the rupee strengthened against the dollar by less than 5%. Further, European economic growth rebounded in this period. Yet, India's export to the eurozone (in euro terms) picked up by only 7%, despite the price and income effect working in India's favour. What gives? Low productivity stands in the way of India's export competitiveness.

The nominal effective exchange rate (NEER) of the rupee is below 80 as per RBI calculations. BIS data shows the same. In other words, in nominal terms, the rupee is competitive. It is India's historically higher inflation than the average inflation of its trading partners that has caused REER appreciation. That is a problem to be fixed with productivity improvements, better infrastructure and easier operating conditions for businesses. Over the years, the controlling streak in our bureaucracy, whether it is corporate affairs or the tax department or the RBI, has returned with a vengeance. Compliance costs have risen substantially. In a recent interview, the vice chairman of NITI Aayog has done well to highlight, for example, the need to reduce turnaround time in Indian ports. The prime minister must spearhead a campaign similar to Swachh Bharat for improving labour productivity in India—in and outside the government.

Further, BIS Annual Report 2015-16 notes that international supply chains have made the export sensitivity of exchange rates weaker. Country of origin is difficult to trace with international supply chains and hence products do not reflect domestic costs alone. Of course, how much of it is relevant for Indian exports is a good question to ask.

As for imports, if they are price sensitive, higher import prices would lead to a surge in imports and vice-versa. India's oil import bill halved from $164.8 billion in 2013-14 to $82.9 billion in 2015-16. But, the quantity index of India's crude oil imports had remained virtually unchanged in these two years (assuming reliability of data, of course). So, crude oil imports do not seem elastic and may not decline if the rupee weakened and the rupee price of crude oil went up. In any case, India's policy on personalized modes of transport is not particularly enlightened. It encourages rather than discourages vehicle ownership. In that context, weaker rupee may worsen the trade deficit. In any case, as Sajjid Chinoy has written recently, the surge in imports in the current financial year might well be due to temporary supply disruptions.

Finally, India's net international investment position is $(-)406 billion as of June. Liabilities on account of debt securities, trade credit and loans constitute $345 billion. If the rupee depreciated by 2%, these liabilities go up by $7 billion straightaway. The challenge is to make sure that export gains are at least $7 billion for depreciation to be useful. Evidence and arguments presented above suggest that export gains from a weaker currency are far from assured.

In the final analysis, the external value of a currency mirrors its internal value. The rupee is not overvalued against other currencies but it is overvalued relative to India's poor economic fundamentals. Manipulating the mirror will not improve the reality.

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