THE WIRE

A Rising Real Exchange Rate Hurts India's Exports

By T.K. Jayaraman on 25/04/2017

Nirmala Sitharaman's insistence that currency fluctuations are the "new normal" hides a crucial fact: that the "real effective exchange rate" is affected by domestic food and non-food prices

The REER started rising from March 2016 to reach 119.50 in March 2017. Credit: Reuters

Once again, focus is on the exchange rate.

Last week, commerce and industry minister Nirmala Sitharaman, speaking at the Hero Mindmine Summit in New Delhi, wanted exporters to know that the value of the currency is not the only factor affecting export competitiveness. She was reminding them that there are other factors such as infrastructure and raw material costs that could affect exports.

This is not new. India's exporters have been told this time and time again. The Narendra Modi government has been pushing its infrastructure programme. The usual delays in implementation of projects in the public sector continue and they do matter to exporters. In the private sector, the much-talked about "twin balance sheet problem", where both the banking and corporate sector are simultaneously under stress, has diverted depositors' funds to unproductive waste under the garb of excessive bank lending. Most of the public sector banks are largely responsible for this debacle.

The ultimate losers are in the real sector. The slowdown in the implementation progress of projects in various sectors, which include infrastructure, power, telecom, metals (iron and steel, in particular) affect raw material costs as well.

Oft-repeated reason

However, Sitharaman’s casual remark that currency fluctuations are the “new normal” and that appreciation of Indian rupee from January to April this year is due to strengthening of the Indian economy hides an important fact: It is not the nominal value of the currency that matters for export competitiveness. It is the real exchange rate that determines export competitiveness, which seems to have been overlooked by the minister.

Real exchange rate is the product of nominal exchange rate (units of foreign currency or the US dollar per one rupee, which is the reference rate for the RBI) and the ratio of domestic price level to world price level. Given the nominal rate, if domestic inflation rises relative to world price level, the real exchange rate rises. The rise in real exchange rate renders exports becoming more expensive to foreigners and it decreases the export earnings.

No doubt, the world price level is beyond the control of the government. Domestic inflation, however, can be controlled by two agencies: one by the independent, autonomous agency, the RBI through its monetary policy measures aimed at containing aggregate demand consistent with current aggregate supply. The other agency is the government: the central and state governments, through prudent fiscal policies.

Real exchange rate

Exchange rates are categorised into three sets: currency-based, trade-based and export-based. Our concern is with export based.

The RBI publishes two sets of export-based exchange rate indices: nominal and real exchange rate indices. Since there are 36 major currencies of the world, RBI derives the average nominal exchange rate, using the proportion of exports to each currency area as weights, known as nominal effective exchange rate (NEER). The base year for calculating index numbers is 2004-05 equal to 100.

The real exchange rate unlike NEER goes one step ahead by taking into account the movements in domestic price level relative to average foreign price level. It is defined as the product of NEER and the price index of the country and the world price index. Known as ‘real effective exchange rate’ (REER), the index numbers are calculated using the fiscal year 2004-05 as base year equal to 100. Movements in REER index would indicate whether REER has been stable, appreciating or depreciating.

Domestic price is controllable. The movements in consumer price index (CPI), the base year being 2012 = 100, have to be watched closely. Since India is a net importer of petroleum and petroleum products, one more price is also watched. It is the oil price, which is the simple average of three: Brent, West Texas and Dubai Fateh rates per barrel expressed in US dollars.

The Table1 below gives details relating to CPI, crude oil price, nominal exchange rate (US$ per one rupee), NEER and REER for past 15 months: Jan 2016 to March 2017.

Table 1: CPI, Crude Price and Exchange Rates						
Year/Month	**Crude price (US$/barrel)**	**CPI index**	**Market Exch. Rate Rs/US$**	**Market Exch. Rate US$/Rs**	**NEER index**	**REER index**
2016 Jan	29.92	126.30	67.31	0.01486	76.16	115.31
Feb	31.05	126.00	68.30	0.01464	74.52	112.18
Mar	37.34	125.90	68.87	0.01452	75.30	113.28
Apr	40.75	127.30	66.47	0.01504	75.17	113.09
May	45.98	128.60	66.94	0.01494	75.07	113.34
June	47.69	130.10	67.35	0.01485	74.79	113.77
July	44.22	131.10	67.13	0.01490	75.13	115.35
Aug	44.84	131.10	66.94	0.01494	75.18	115.70
Sep	45.06	130.90	66.74	0.01498	75.60	116.35
Oct	49.29	131.40	66.73	0.01499	76.10	117.20
Nov	45.28	131.20	67.73	0.01476	76.18	117.90
Dec	52.61	130.40	67.81	0.01475	77.30	118.64
2017 Jan	53.65	130.10	68.07	0.01469	76.89	117.17
Feb	54.36	130.60	66.96	0.01493	77.68	117.49
Mar	50.91	130.80	65.87	0.01518	79.01	119.50

Source: CPI (Base 2012=100), NEER and REER (Base 2004-05 = 100) and nominal exchange rate: RBI Bulletin - various issues

Watch on food prices

While there has been a steep rise in crude price by 70.1% from $29.92 in January 2016 to $50.91 in March 2017, the CPI has been relatively very steady. It rose only by 4.5%. This confirms the observation made by a 2016 IMF study: that direct role of oil prices in India's inflation was modest, given the limited pass-through into domestic prices. Changes in CPI are more attributable to changes in food prices (62%) and the remaining 38% is attributable to changes in non-food prices.

This underlines the need for keeping a watch on food prices, in particular.

The nominal exchange rate when expressed as the price of American dollar, which is the reference rate, has been fluctuating: though it rose from Rs 67.31 in January 2016 to Rs 68.30 in February and Rs 68,87 in March 2016, it began to slide down from April 2016 with fluctuations around third quarter of 2016. It started rising from November 2016 when it was Rs

67.73 and reached the peak at Rs 68.07 per US$ in January 2017. The slide began in February 2017 with Rs 66.96 and Rs 65.87 in March. On April 22, it was Rs 64.65 per US$.

The inverse of the exchange rate expressed as rupees per US$ is the value of the rupee in terms of dollars, in cents. The appreciation of the dollar means depreciation of the rupee and vice versa. The slide down of the dollar from February 2017 means appreciation of the rupee. That is the one exporters have been worried about.

The competitiveness of exports is determined by the REER as the latter reflects the movements in relative price levels. The table above shows the rise in real exchange rate consistently now for some time. It was at its lowest at 112.18 in February 2016. It started rising from March 2016 to reach 119.50 in March 2017.

That is the slide down in India's export competitiveness. This is the one everybody should worry about. Policy makers know very well domestic price level is the culprit. Inflation is now near RBI's 4% medium-term target. The CPI which was 125.9 in March 2016 has risen to 130.8 in March 2017, a rise by 3.9%.

The RBI is conscious of the need for controlling inflation. It has already assumed a tightening monetary stance.

It is helpless, however, when it sees it does not have a control on spending, let alone the massive giveaways. The latest is the writing off of loans due from farmers in Uttar Pradesh. The RBI governor has gone on the record to state that the UP government's decision reeks of moral hazard. Other state governments are expected to announce similar populist measures.

So where are we heading? Back to the "old normal" of unproductive and wasteful decisions?

Professor T.K. Jayaraman teaches at Fiji National University.