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Is the Rupee Overvalued or Undervalued?

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India's central bank, the Reserve Bank of India has been claiming from time to time that it doesn't target any level of exchange rate but is only looking to maintain price stability.

The mandated retail inflation rate for RBI is 4% with a margin of minus or plus 2%. However, its monetary policy changes in June and early August this year have proved to be supportive of stabilising the value of the rupee as well, when there has been a growing concern about the falling value of the Indian currency in terms of US dollar.

The rupee has been depreciating since the beginning of this year for various reasons, including the recent trade and currency wars between US and China.

Rising inflation in India has also been one major reason. The June inflation rate was the highest in last three years, as the targeted retail inflation, year-on-year (YoY) change in consumer price index (CPI) of 4% was breached. The YoY change in wholesale price index (WPI) was much higher.

No longer "a safe bet"?

Overseas foreign portfolio investors appear to have lost confidence in Indian policy makers and the country's macro story. They perceived the country and its government to be failing in dealing with inflationary conditions. As India has been importing 75% percent of its crude oil requirements, which also happened to be 50% of India's total imports, our country's trade deficit was seen as worsening.

The fickle-minded hot moneys justified their name. The pull-out of short-term funds by portfolio investors was not unexpected.

Net capital outflows in the first quarter of 2018 were $26.3 billion; and in the second quarter, the figure came down to $6.8 billion. These outflows made the Indian currency weaker. The Indian rupee emerged as the worst performer amongst all major currencies of Asia.

More recently, in the first half of August 2018, India was also caught up in worsening trade and political bilateral tensions between the US and Turkey. The overshooting of currencies, in the short-run, is one of the worst and most destabilising consequences of the flexible rate regime adopted by emerging economies ever since the 1990s. Sanctions by the world's most powerful country against Turkey made the Turkish lira plunge by 40%. This, consequently, adversely affected all the currencies of emerging economies, including India.

The short-term funds seeking higher returns in safer havens left the emerging economies and flowed out to US.

Changes in interest policy rate

On August 1, RBI raised the policy interest rate by 25 basis points from 6.25 %to 6.50%. This was the second hike in two months. In June, RBI increased it by 25 basis points from 6% to 6.25%. These changes were aimed at containing inflation. In addition, in a less publicised way, RBI has been intervening in the currency market for arresting the fall in the value of the rupee, by making rupee dearer and the US dollar weaker.

It was selling dollars from its international reserves and buying rupees. It was also selling US Treasury Bills. The two actions, naturally, have an impact the level of India's foreign exchange reserves.

Hiking interest rates to fight inflation is a right move – the RBI has done what it should do. No doubt, stepping up the interest rate would make borrowing costs becoming more expensive. Selling of dollars and buying up rupees would also result in decreasing rupee liquidity. Both were essentially deflationary moves, affecting aggregate demand.

As every coin has two sides, there is one favourable aspect as well.

If the credibility of RBI is established and inflation also gets slowed down, there were justifiable hopes, in accordance with the theoretical expectations: overseas portfolio investors would come back and there would be a reversal of outflows. The rupee should gain. The overshooting effects of the Turkish lira depreciation would be lessened. Those emerging economies, whose fundamentals are stronger than those of Turkey in terms of low public debt, small external debt, manageable trade deficit and above all credible monetary policies with an independent central bank, should get back to normalcy.

A theoretical debate

That said – ever since the start of the year, with the fall of the rupee, an economic question with political consequences has arisen. Is there any "normal rate" or in jargon, any equilibrium rate?

Former chief economic adviser Kaushik Basu raised this point recently. In the first week of August, he claimed that India's exchange rate was "overvalued" and a reasonable rate was Rs 70 to Rs 71.

What he didn't specify was whether he was talking about the real or nominal exchange rate. He explained that Indian rupee was overvalued all these days, due to net inflows of capital, especially portfolio investment funds of short term nature – and the fall in rupee was by way of a correction, as portfolio investors are pulling out. The reports have it that Professor Basu expected Indian rupee would ultimately fall to Rs 70/71 if the ongoing correction process gets completed.

It appears what he had in mind is the nominal rate.

This gives rise to some relevant questions: If a currency is overvalued or undervalued, what is it with respect to? Is there any benchmark or equilibrium nominal rate? What are the factors or forces behind the nominal rate? Are these factors or forces not dynamic? In that case, is there any equilibrium rate relevant for one year or a period of years and can they be relied upon for another period?

The answer is broadly clear. The forces of supply and demand are influenced by several factors: growth expectations, actual output deviations from the trend rate of the recent past, internal political stability and external global conflicts, and a host of other factors beyond control.

They also vary over a period. They are not replicable. They are not repetitive in dimensions and certainly they are not predictable. In these circumstances any econometric determination of a long run exchange rate, either nominal or real based upon past data series, is not reliable for any future guidance. The well known "Lucas critique" makes it clear the coefficients or parameters derived on the basis of past data series cannot be relied upon for any fresh policy changes, as they might have undergone changes in the mean time. Any forecasts are at best hunches or 'guesstimates'.

Importance of real exchange rate

The real exchange rate, not the nominal exchange rate, matters the most. Real exchange rate (RER) is the nominal exchange rate (NER), which is defined as units of foreign currency per unit of domestic currency, duly adjusted for domestic inflation relative to inflation overseas. The RER is calculated as the product of NER and the ratio of domestic price level index to the price level index of the rest of the world. RER is often expressed as index numbers for comparison over time.

A rise in RER reflects appreciation of the domestic currency and a decrease in RER denotes depreciation. Given the NER, it is the domestic price level relative to overseas inflation which determines the RER. If domestic inflation is higher than overseas inflation, RER rises and adversely affects export competitiveness and vice versa. The RBI calculates three sets of real exchange rate indices.

The first set is called trade based real effective exchange rate index (REER) as it uses trade (both exports and imports) as proportion of total trade of India as weights to calculate average index covering each of 36 major countries. The second one is called exports based REER as it uses exports as proportion of total exports to 36 major countries. The last one is called currency trade based REER using proportion of trade to total trade conducted in six major currencies of the world as weights to arrive at an average REER .

Watching the movements in any of the three indices month to month and taking early action to maintain the stability in the REER indices are the most pragmatic way to tackle the problem. Given the nominal effective exchange rate, which is determined by the forces of supply of and demand for domestic currency and overseas inflation, the only way out for decision makers is to deal with inflation.

If the authorities feel the need for a change in NEER, the way out is to effect a change in NEER, which is either devaluation or upvaluation, as may be needed.

Certainly, not a final word

The forces of supply and demand for currencies under flexible exchange rate regimes cover payment for conventional goods and financial assets. In a globalised world, which is now not only open but also comes with a high degree of capital mobility, trade in goods and services such as insurance and shipping and insurances play only a small part.

The global trade in financial assets is several times larger than the value of traded good and services. In the advanced economies such as the US, financial transactions are 25 times greater than the sum of exports and imports of goods. In the digital world, the click of a single button moves millions of dollars across the ocean faster than ships would move.

In a well researched article all the way back in 2001, Ila Patnaik and Peter Pauly wrote that financial reforms which began in the 1990s have led to the integration of domestic financial markets with international markets and the importance of interest rate differential in the determination of exchange rate came to be well recognised. They observed: “When the rupee became overvalued due to heavy inflows of capital, it did not take long for a mounting current account deficit to put pressure on the exchange rate to depreciate. When it was undervalued, India’s usual higher than the US inflation , ensured the real value of the rupee goes up, even when the nominal value did not move up.”

Their observations underscore the need to focus attention on real exchange rate. Obsession with nominal exchange rate movements has to be given up.

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