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The Appreciating Rupee and India's Exports: Should Policy Makers Worry?

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Indian currency will sink if allowed to float used to be the answer one would often get during classroom discussions in the 1980s on flexible and fixed exchange rates. However, with the remarkable Indian economic performance in the last few years, the Indian rupee has attained respectability and suggests strong underlying fundamentals. The current rupee price of the United States dollar stands at Rs39.29 per dollar (as on 10 January 2008) as against Rs44.53 exactly a year ago, indicating a 12 percent appreciation. This is appreciation of nominal exchange rate and one should perhaps look at real effective exchange rates (REER) that take into account relative price movement in trading partners. The Reserve Bank of India (RBI) estimates REER (based on 36-currency trade based weights) with different base years. Without going into details, it is suffice to note that REER, either based on five currencies or a 36-currency basket, has also appreciated since September 2006.

So what has been the impact of the appreciation of the rupee on Indian exports? The answer would be that there has been no impact if one goes by the latest available data on export. The monthly economic report of the Ministry of Finance, India, October and November 2007, indicates that exports in dollar terms have risen by 22.1 percent in the period April-November 2007, compared to the same period the year before.

Based on this scenario, should one then conclude that real exchange rate does not matter in India's competitiveness? The answer is no, simply because an appreciating rupee will impact exports but there will be a time lag before the impact is visible. Further, one can already observe a deceleration in the growth rate of exports in 2007 relative to that in 2006. The growth rate of exports is lower by 10 percentage points in 2007 (April to September) relative to the growth rate achieved in the same period in 2006.

What caused the appreciation of the rupee? The reason can be found in the large capital inflows comprising foreign direct investment (FDI), external commercial borrowings (ECB), foreign portfolio investment and remittances. One just needs to examine recent information on each of these based on the latest quarterly balance of payments data released by the RBI[1] to understand the appreciation of the rupee.

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[1] See 'India's BOP Developments…" at www.rbi.org.in released on 31 December 2007.

The net FDI into India between April-September 2007 amounted to US$9.9 billion and its impact was largely offset by outflows to the tune of US$6 billion. The emergence of India as an attractive FDI destination due to its growing and potential large domestic market is passé. One may add that the low penetration of consumer durables in India and the perceptions of improved conditions of doing business in India have also been positive factors in the increase in FDI in to the country.

The net ECB reached US$10.6 billion between April-September 2007, double the amount from US$5.7 billion during same period in 2006. This was due to lower interest rates on ECB and rising financing requirements of domestic capacity expansion. Indian companies have been able to raise capital abroad by taking advantage of lower cost via global depository receipts and American depository receipts. Portfolio investment recorded an absolute increase of US$16.8 billion in the period April-September 2007, reflecting India's better stockmarket performance in 2007. The average annual inflow of portfolio investment between 2003 and 2006 was around US$9 billion.

Also, investment and remittances from the large number of Indians working abroad are growing rapidly. Private transfers comprising primarily remittances reached US$19 billion in 2007 (April-September), recording growth rate of 49 percent over the same period in 2006.

Net short term credit has also caught the attention of many market watchers in India – it recorded an increase of US$5.7 billion during April-September 2007 and included inflows under the heading 'Suppliers Credit up to 180 days' amounting to US$1.9 billion. Other capital receipts (such as leads and lags in exports, advance for share purchase, etc.) amounted to US$5.9 billion during April-September in 2007. The net addition to India's foreign exchange reserves is reported to be US$40.4 billion during April-September 2007.

Impact on Indian Exports

The rupee appreciated by 12 percent between September 2006 and September 2007**.** Unfortunately, detailed commodity-wise trade data is not readily available corresponding to this period. Alternatively, let us consider export growth during April-September 2007 relative to that achieved during April-September 2006.[2] India's total exports increased by 17 percent, in dollar terms, between the two periods. However, several individual industries experienced a decline in export growth. They were sports goods (-6.6 percent), readymade garments (-3.3), natural silk textiles (-14.3 percent) and wool manufactures (-4.9 percent). Cotton textiles grew by only 1.2 percent. The other products with negative export growth were coffee (-10 percent), handicrafts (38.2 percent) and carpets (-6.8 percent). Low value-added products and those with very low or zero import intensity were the ones that witnessed a decline in growth. Industries with high import content (for example, machinery, gems and jewellery) have been able to offset the negative impact due to the lower cost of imported inputs.

Between September 2005 and September 2006, when the rupee depreciated by five percent, low value-added and price sensitive products grew quite well. Looking at the period April-September 2006 for which commodity-wise export data is available, India's total exports grew at 27 percent – sports goods grew by 13.55 percent, readymade garments by 10.8 percent, coffee by 27 percent, carpets by 12.6 percent and cotton textiles by 12.9 percent.

[2] This is the most recent period for which commodity-wise data is available. One hopes that the trend changes for the better when more recent data trickles in.

Thus, it is not wrong to state that low value-added and price sensitive export items have been adversely affected by the appreciating rupee. These products, already facing intensive competitive pressure from the United States and the European Union markets, are likely to be further impacted as world trade and output growth are likely to slow down. And in such a scenario, price renegotiation with buyers will provide a further nightmare for these exporters, especially in the case of buyer-driven industries such as sports goods, footwear, garments and textiles.

The competitiveness of a country depends on the cost of imported intermediates. Appreciating the rupee would make imported intermediates cheap. Consequently, it would not negatively impact import-intensive industries such as automobile and engineering. Low value-added products with zero or very low import intensity are likely to suffer. The profit margin in software-exporting firms is also likely to decline, reducing the dollar value of information technology (IT) software exports. The Indian stockmarket seems to have already taken this account and stocks/securities of IT companies have undergone sharp price corrections in recent months.

One school of thought argues that the real exchange rate appreciation is productivity driven and reflects a natural evolution of the economy towards long run equilibrium. This emphasises supply-side factors such as technological change and labour mobility. At the same time, other demand-side factors such as transitory demand shocks like fiscal expansion and structural factor like rising real income growth, leading to higher services (non-tradable) demand, could cause appreciation. In the Indian case, the driving factor is capital inflows. This appreciation is more likely to negatively impact small and medium firms who are more likely to be credit constrained. They will have less back up, in terms of reserves and access to working capital, to sail through the difficult times as in the current case. Some of them may go out of business if they are not able to mange the declining rupee profit margins and competitiveness.

Indian exporters certainly need state support as they operate in markets with greater uncertainty and competition. How can Indian government help exporters? There are several ways. Firstly, it could reduce import duty, excise and service taxes (domestic taxes) to compensate for the reduced export realisation of exporters in rupee terms. In simple words, it could facilitate the reduction of transaction costs of businesses and exporters. Secondly, it could speed up the implementation of the policy measures announced by the Ministry of Commerce and Industry in June 2007 such as the reduction of pre-shipment credit, mandated export credit disbursement by commercial banks and so forth.

It is often said that only a crisis will force the state to carry out certain reforms. One may anticipate that the current situation of the appreciating rupee, while may not be a crisis, will compel the Indian government, both at the centre and state level, towards export facilitation measures. However, even with reforms, given the current state of global economic environment, the task of achieving export target of US$160 billion for 2007-08 has become all the more difficult for India.

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