Rupee@80: The Story Can Get Grimmer

Depreciation may not help exports because the composition of what we sell has changed

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Rupee falling below the 80-mark against dollar made headlines. There are nuances in story that, however, are being missed.

First, and contrary to what many are saying, rupee fall may not help our exports. Here's why.

- Exports of commodities that are price sensitive, that is, they do well when they are cheaper, benefit during depreciation. But exports of goods that are income sensitive, that is, they tend to perform well when there is an upsurge in foreign income, may not necessarily do well. For example, if incomes in foreign countries are under pressure.
- In case of India, there is a change in composition of exports from price-sensitive items such as leather footwear, dairy products, beverages, textiles and apparel products, to more income-sensitive items such as refined petroleum products, iron and steel, chemicals, machinery and transport equipment (engineering goods), and pearls and precious stones such as diamonds.
- However, weak global economic growth means lower demand for income-sensitive items that comprise a major chunk of India's exports basket.
- As per July 2022 estimate, real GDP growth in the Euro Area is expected to fall from 5.4% in 2021 to 2.3% in 2022. In China, India's another major trading partner, GDP growth rate is likely to come down from 8.1% in 2021 to below 5% in 2022. The US is also witnessing a surge in inflation (above 9%) denting the growth in real GDP.

Even in price-sensitive exports, India is losing out to competitors. This is explained by what economists call intra-industry trade (IIT).

- What's happening is that while India is exporting items such as leather footwear, textiles and apparel, active pharmaceutical ingredients, which do well when rupee depreciates, it is also importing many of these items.

Global income matters more for exports

- And in many such cases, the quality and therefore the value (price multiplied by quantity) of imported items are higher than similar exported items.
- Therefore, the final impact on the current account deficit is negative. Because the value of item x we have exported is lower than the value of the similar item we have imported.
- IIT is becoming more widespread because industrial tariffs have in general gone down across countries, promoting overlapping trade flows within the same product categories.

True, GoI has tried to make exports more competitive. But appreciable impact is yet to be seen. Meanwhile, India's major imports – crude oil, precious metals and coal – will continue to cost more as the rupee depreciates. And we can't do without them in a growing economy.

Rupee will likely fall further, going by what's happening in goods and asset markets.

- Both the markets for goods and that of assets (stocks, bonds etc) determine the exchange rate.
- Economic theory says under ideal conditions – no transport costs, no tariffs – the price of an identical (similar) commodity will be the same in both trading partners' domestic markets, when expressed in the same currency. This is the 'law of one price' (LOOP) theory. Under LOOP, if one dollar is 80 rupees, and a hairbrush costs Rs 80 in India, it will cost one dollar in the US. Therefore, the real exchange rate (nominal rate multiplied by the ratio of prices in the trading partners) under LOOP is 1.
- While LOOP obviously doesn't apply in the real world, it still tells us why inflation affects the rupee's exchange rate. Because, if inflation in India is higher than it is in a trading partner, then the real exchange rate will reflect that – that is, the rupee will depreciate against the dollar.
- Domestic inflation is one reason the rupee is under pressure.
- Rupee is also under pressure from asset markets. The exchange rate here is conditional upon the inflow and outflow of capital into and from the domestic economy.
- In foreign exchange markets, expectation plays a crucial role. High CAD and higher inflationary expectations, makes domestic assets less attractive. Over the last one year foreign institutional investors (FIIs) have been net sellers in the domestic stock market.
- Also, and as the World Investment Report published by UNCTAD showed, foreign direct investment (FDI) fell by 30% to $45 billion in 2021.

India can't do much about foreigners pulling money out. But will inflation moderate and ease one source of pressure on the rupee? Unlikely any time soon.

Although inflation numbers, CPI (7.02%) and WPI (15.9%), dipped a little in June in comparison to May, the recent imposition of GST on pre-packaged food items is likely to increase inflation numbers. Plus, imported inflation is not easing.

Going by this, we should not be surprised if the rupee falls to the 83-mark over the next six months.

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