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Exchange Rate Not Just the RBI's Baby

Fiscal and farm policies matter a great deal

India's exchange rate is a stumbling block in rapid export growth and the country will miss out on the opportunity to cash in on the high world growth visible now, unless corrective action is taken. Delivering a lecture last week in memory of former Planning Commission member and ET columnist Saumitra Chaudhuri, C Rangarajan weighed in against any aggressive policy of undervaluation but strongly recommended adjusting the nominal exchange rate to keep the real exchange rate steady, while working towards price stability and productivity growth, particularly in the traded sectors.

The two factors driving export growth, by any estimate, are world growth and the real effective exchange rate (REER). The higher world growth, the higher export growth. The higher India's REER, the lower India's export growth. REER, with 2004-05 as 100, has been climbing: 122.71 for 2015-16, 125.17 for 2016-17 and 126.77 last month. The good news is that the February figure is lower than that for January. If the US Fed does go ahead and raise rates as it has announced it would, an outflow of dollars from the capital markets is likely to lower both the nominal and real exchange rates. The reality is that capital flows, both direct and portfolio, have a greater role in determining the exchange rate than current account transactions. Thanks to India being the world's largest recipient of remittances and being a robust exporter of services, a large surplus in non-merchandise flows allows India to run up a huge deficit in trade in goods: 5% of GDP in 2016-17, when the current account deficit (CAD) was just 0.7% of GDP. CAD this year is expected to be 2% of GDP, still within prudent limits. India has over $420 billion of forex reserves, but these are derived from unabsorbed capital inflows and not current account surpluses, making it imperative that India maintain external confidence, for which a low current account deficit is essential.

Lower interest rates would stem hot money inflows, but that calls for a grip on inflation, in turn, calling for fiscal restraint and good supply-side management.