The Strong Rupee - Refocusing The Debate

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The recent public debate on the strong rupee missed three essential points.

1. Large capital inflows: First, the falling EURO only partly explains our appreciating exchange rate. As from 2007, the large capital inflows have more than offset the widening trade and current account deficits resulting in Balance of Payments (BoP) surpluses. There has been a continuing build-up in foreign reserves and an upward pressure on our Nominal and Real Effective Exchange Rate (REER).

Thus the main source of the rupee's ascent comes from sustained foreign direct investment inflows (mainly to IRS Schemes) in addition to portfolio investment inflows due to the relatively higher interest rates, external commercial borrowings and the plunging EURO.

Table 1: Balance of Payments Surplus

Balance of Payments (BoP)	2007	2008	2009	2010	2011
Trade Balance (CIF) (Rs m)	-51,329	-64,195	-56,622	-65,332	-72,165
- as a % of GDP	-21.0	-23.4	-20.1	-21.8	-22.2
Current Account Balance (Rs m)	-13,248	-27,633	-20,836	-24,539	-31,684
-as a % of GDP	-5.4	-10.1	-7.4	-8.2	-10.0
BoP Surplus (Rs m)	13,880	4,624	12,103	6,177	5,200*

** provisional*

2. External competitiveness: Second, one should examine the trend in our rupee not in isolation but vis-à-vis our main export competitors. The weakening of the Euro affects all economies equally. However all economies are not having the same price developments, cost developments, productivity and unit labour costs. The REER that takes in these developments is a good indicator of competitiveness. For 2011, a comparative analysis of the textile producing countries showed that we are one of the few countries whose currency has been appreciating against the euro and the dollar. In real terms, we have been appreciating excessively -- around 8-10% -- meaning that we have not been able to maintain our external competitiveness vis-à-vis some of our immediate rivals, especially some African and Mediterranean countries that have seen a depreciation in their currencies. The appreciation of the rupee has undermined the competitiveness of enterprises and also eroded their profitability.

Table 2: Appreciation of the rupee

Main Textile Exporters' Currency January to December 2011 ***(% change)***	Nominal Exchange rate **Rs to euro**	Nominal Exchange rate **Rs to $**	Real Exchange rate **Euro mkt**	Real Exchange rate **$ mkt**
Indian Rupee	-16	-16	-7	-8
Indonesian Rupiah	2	0	6	4
Malaysian Ringgit	-2	-3	0.1	-1
Pakistani Rupee	-3	-4	7	5
Thai Baht	-1	-2	2	0.1
South African Rand	-17	-19	-11	-13
Tunisian Dinar	-1	-3	2	1
Moroccan dirham	0	-1	0.3	-1
Egyptian pound	-2	-3	7	5
Turkey Lira	-18	-19	-11	-12
Sri Lanka Rupee	-1	-3	4	2
Mauritian Rupee	5	3	10	8

Appreciation = +ve

3. Overvaluation of the rupee: Lastly, given that the rupee appreciation has been triggered by the foreign capital inflows with the particular characteristics of a large trade deficit and a current account deficit of about 10 per cent of GDP in 2011 Balance of Payments, we must ask whether the rupee is appropriately valued. That is, it is important to assess whether the exchange rate is properly aligned. If the exchange rate is badly misaligned, it is likely to lead to macroeconomic difficulties if policies are not adjusted. So the exchange rate needs a benchmark – the equilibrium real exchange rate. Our calculation using the macroeconomic balance (MB) approach that has as determinants economic growth, oil and fiscal balance, net foreign assets, and current account balance shows an overvaluation of some 13% above its equilibrium level. Taking in consideration the note of caution of '*Mauritius: 2011 Article IV Consultation—Staff Report'* of the REER being overestimated because of the liability side of the Global Business Corporations' activity that may be underestimated in external sector statistics, the more recent figure (Week-end, 4 March 2012) of an 11% rupee overvaluation in 2011 looks reasonable.

The rationale of the Central Bank's stance: The Central Bank (CB) exchange rate policy has been beneficial in the short run. The strong exchange rate helped keep inflation low although oil and food prices were firming up internationally. The CB's success at denting inflation and anchoring inflationary expectations earned the government considerable goodwill. Moreover, in the short term, rupee appreciation has forced the companies that traditionally excessively relied on competitive depreciation to plan for an appreciation of the rupee by hedging their foreign earnings, which however involves a cost and making the necessary efforts at improving manufacturing efficiencies and production. The logic was that instead of tinkering with the nominal exchange rate to maintain external competitiveness, exporting firms were expected to work towards direct cost-cutting measures such as wage and operating cost reductions, improving labour productivity and enhancing capabilities.

A depreciation of the rupee while enhancing export competitiveness would have jeopardised all that has been achieved so far -- a stable rupee, low inflation, declining interest rates and confidence in the currency and the country's financial sector. Moreover, as a small open economy, the cost reduction from the depreciation can be quickly eroded through higher inflation. Worse, the higher inflation tends to become entrenched, with adverse consequences for the economy. But the generous wage policy without a corresponding improvement in productivity and the expansionary fiscal positions have not helped in putting the money stance in a less stressful position.

The way forward: In the absence of the losses due to currency appreciation being neutralized with lower cost of production emerging from higher productivity (equity participation, restructuring and improvements in management, technology upgrading and product rationalisation and general cost-cutting), Mauritius cannot afford the

luxury of an appreciating currency. In the long run real exchange rate appreciation reduces export competitiveness. This effect cannot be ignored when our trade and current account deficits are so large and our capital inflows are not sustainable.
Most of FDI inflows go to construction and real estate activities. These are one-off investments which do not in any way boost our export potential or enhance our productivity and flexibility. There is no transfer technology or know-how or any multiplier effects on the economy especially for the IRS projects that are not integrated to the tourism industry. These real estate activities, competing with government spending on badly needed infrastructure projects, have destabilized our economy by propelling the currency upward, squeezing export-oriented industries ranging from manufacturing to tourism and boosting inflation. Mauritius can be said to be suffering from the "Dutch disease", a term that broadly refers to the harmful consequences of large inflow of foreign currency.
Export-led economies, of course, can not take currency appreciation lightly – it undermines competitiveness and risks eroding the country's share of the global market. It also invites destabilising hot-money capital inflows. With our policymakers fretting about the persisting slowdown in demand from Europe, the possibility of a moderation in demand from China, as well as the prospect of long-term near-zero rates and the likelihood of further liquidity measures by both the US Federal Reserve and the European Central Bank, our exporters who have so far maintained competitiveness in world markets by reducing their profit mark-up in the face of an appreciating currency feel that they have reached their upper limit . It cannot be sustained in the long run given that productivity gains had not proved to be sufficiently large to contribute significantly to enhancing export price competitiveness.

Low value-added products and those with very low or zero import intensity are the ones that are witnessing a decline in growth. Industries with high import content have been able to offset the negative impact due to the lower cost of imported inputs. Thus, it is not wrong to state that low value-added and price sensitive export items have been adversely affected by the strong rupee. These products, already facing intensive competitive pressures, are likely to be further impacted as world trade and output growth continue 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.
In the long term, the strong rupee driven by the capital inflows in real estate inevitably leads to other parts of the economy becoming hollowed out meaning a weakening of the competitiveness of the country's exports and the shrinkage of the export sector. Thus, it is important that the Central Bank reconsiders its stance for the long term. The Central Bank can be expected to gradually settle for the pause mode in its strong rupee

stance in the near future, now that core inflation is under control, such that we maintain a competitive exchange rate.

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