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Is the INR overvalued?

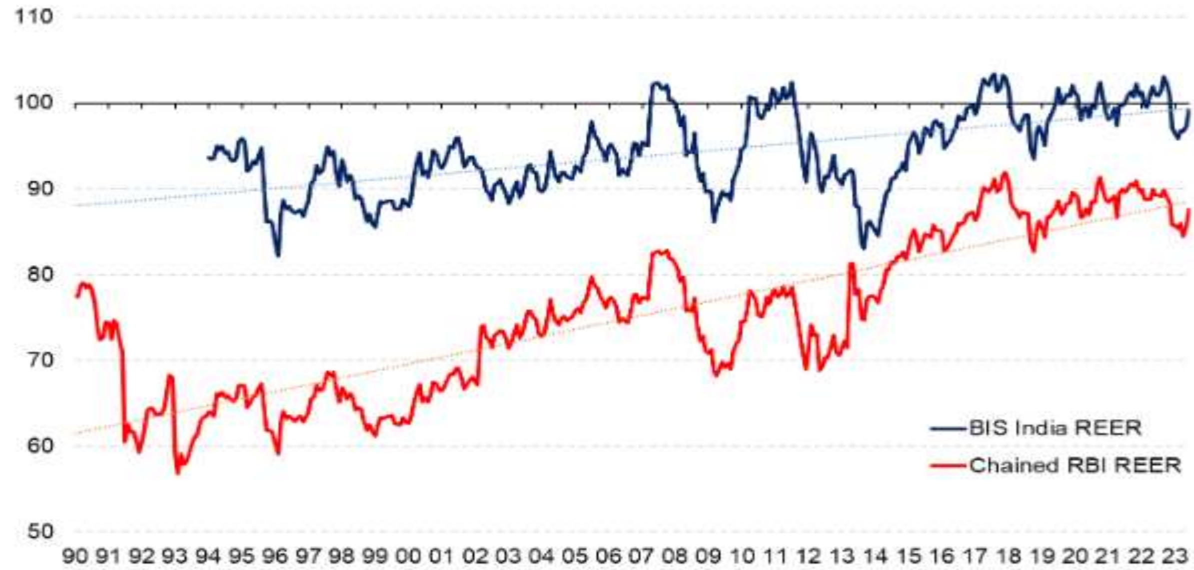
Issues with measurement through REER over the long term clubbed with current macro stability, indicates INR is within fair value range.

The true value of INR has been a matter of debate over several years,

- Many commentators indicated that steady appreciation on an REER (real effective exchange rate) basis seen over the years (2012-2018, or alternatively 1999-2007) is ultimately responsible for sluggish export growth.
- Commentators also argue or that manufacturing competitiveness would be boosted by a weaker INR.
- INR has had a tendency to appreciate on an REER basis over a long period starting in the mid-1990s.
- This is seen in both the RBI's indices of REER (chained with old indices to give a continuous series), and the BIS indices of REER.

Note: REER as a concept involves weighting a currency against currencies of trade partners, based on their share in trade, with adjustments also made for price changes in in the home country and trading partners. In essence, creating a gauge for cost of goods vis-à-vis trading partners.

Chart 1: INR REER over the years (different bases of RBI and BIS indices) - note that there has been a tendency to appreciate over the past many years - is this indicative of export competitiveness given away?



Source: Axis Bank Business and Economic Research Team

In theory, the REER should be an excellent predictor of export competitiveness at first glance.

- All else remaining constant, a weakening of the currency should make exports more competitive, while a stronger currency should reduce competitiveness.
- In practice, China's share of global merchandise exports since the mid-1990s has risen sharply despite a ~80% appreciation in the CNY REER.
- At the other extreme is South Africa, which has seen share of merchandise exports stay constant despite a 50% drop in the value of the ZAR.
- Relatively limited INR REER appreciation has not stood in the way of India gaining share in global merchandise exports either.
- Over the past two years, the weaker CNY has seen China's share of global exports actually weaken.

A closer look at how India exports and imports behave with the REER level is also illuminating.

- Exports do pick up when the INR weakens and do contract when it strengthens. But the same effect is also seen with imports.
- This is despite considerable talk about India's imports being largely inelastic. Not only do imports move with the currency, but in the same direction as exports.
- The current account also tends to widen with a weaker INR and strengthen with a stronger INR. This raises questions on, does the currency drive CAD or is it the other way around?

Chart 2: India current account deficit along with movements in REER - periods after the taper tantrum might be explained by various controls, but the rest of the trajectory (except COVID) shows the current account leading movements in the REER

Source: Axis Bank Business and Economic Research Team

The answer to these questions also lies in theory, because all else does not remain constant when the exchange rate moves.

- Changes in the exchange rate might initially give a boost to competitiveness but this is quickly eaten away by the interaction of the exchange rate with other domestic variables (called the J-curve).
- A weaker exchange rate leads to higher input costs and higher export demand, which raises domestic prices through parts of the economy where capacity constraints exist across value chain stages in industries, even if aggregate capacity utilization is sub-par.
- This leads to exchange rate effects quickly being neutralized. Changes to price levels return REER back to earlier levels.
- A change in the equilibrium takes place when productivity increases. Resources are used more efficiently, which allows the currency to strengthen on a real basis without adversely impacting competitiveness over time – like in the case of China.
- In the case of South Africa, productivity has potentially weakened due to mismanagement of public goods.

In general, REER suffers from a few issues:

- Assumption of single traded goods and uniform domestic pricing mechanism: The mix of traded goods and services of a country will likely shift over time, with industries where productivity is seeing faster growth. This will over time lead to increased productivity and different changes in relative prices across countries, allowing for long-term REER increases or decreases.
- No adjustment for value chain nature of trade, or for trade competition: REER weights are based on bilateral trade, solely in goods, and does not take into account the modern value chain method of trade where bilateral trade might only represent a pass-through, while relative pricing of the actual consumer might actually be very different. REERs do not adjust for countries that compete in the same markets - even if INR's REER has appreciated against trade partners, this might be true for competitors as well (say because of higher crude oil prices), and not affect competitiveness in a major way. Note: The BIS REER indices do attempt to adjust for this.
- Most REERs in use today only compute competitiveness based on merchandise trade, ignoring services, where trade growth is high and barriers lower.

Is the INR then overvalued?

- The answer lies not in the level of the REER, but in whether an equilibrium has been reached.
- Despite the heavy depreciation in 2022, performance of both exports and imports has normalised, with the weaker INR internalised – REER has gained fast.
- Longer term REER appreciation trends also appear to be continuing, with the 2022 discontinuity in line with past moves.
- With INR seeing healthy two-way flows and limited volatility, adding to stability of the long term REER trend (productivity), and steady increases in global share of trade, arguing that INR is overvalued might not hold water.
- An argument of INR appreciating with the financial cycle (FPI flows) can be made, but this tendency has largely been limited by RBI intervention.

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