

# STABLE FOREX RATE THROUGH EXPORT PERFORMANCE: SOME LESSONS FROM CHINA

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## Abstract

Global factors like tightening of global financial conditions, soaring crude oil prices and the Ukraine-Russia war have resulted in a considerable depreciation of Indian rupee against the US dollar since the beginning of this year. Government has adopted a few temporary measures to contain the free fall in the value of Indian rupee. However, these measures may not be very effective and tangible in stabilizing the rupee. It is here that India can learn a few important lessons from China. The Chinese Yuan has always been stronger than the Indian rupee with respect to USD. Whereas China has built up its foreign exchange reserves through current account surplus, a relatively large part of India's foreign exchange reserves comprises volatile foreign portfolio investments. China has obtained this trade surplus mainly through a spectacular export performance on one hand and the development of the domestic capabilities to manufacture the import substitutes on the other. This in turn, has been achieved through developing a strong trade infrastructure (especially the ports), cutting down the rates of tariffs, gaining from the increasing fragmentation of production across countries and managing its inflation effectively.

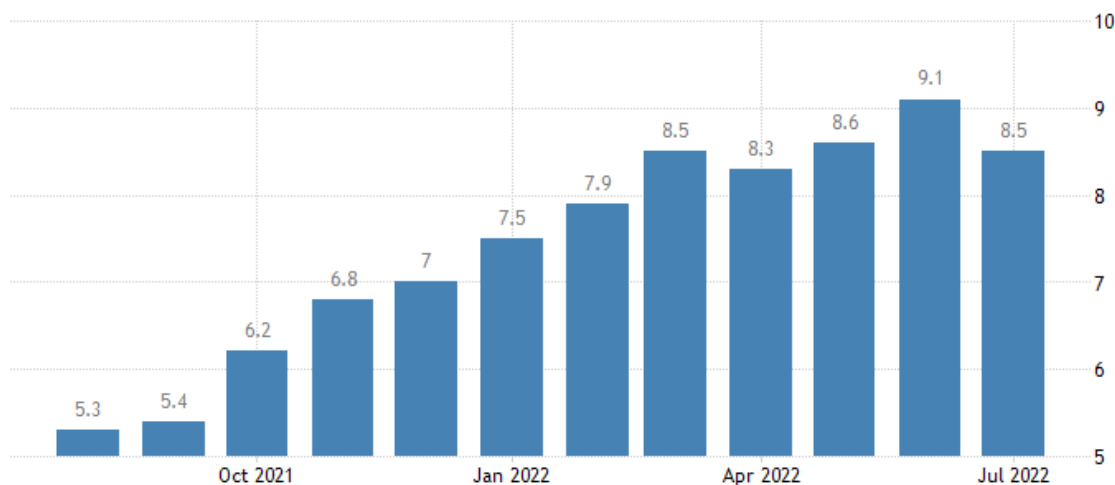
**Key Words:** Depreciation of Rupee, Exports, Infrastructure, China, Inflation

The Indian rupee had depreciated significantly by around 8% against the US Dollar since the beginning of 2022; once reaching Rs. 80 per dollar on 18 July, 2022. The finance ministry had pointed towards global factors such as tightening of global financial conditions and soaring crude oil prices for the weakening of the Indian Rupee against the US dollar. The Ukraine-Russia war further worsened the situation by disrupting the supplies.

The exchange rate between INR and USD primarily depends on the demand (outflow) and supply (inflow) of USD in India. Any outflow of foreign exchange (USD) from the country is likely to reduce the value of domestic currency (INR), resulting into a currency depreciation. Similarly, an inflow of foreign exchange in the country is likely to increase its value termed as currency appreciation.

Most world economies had opted for expansionary monetary and fiscal policies around a year ago as they grappled with pandemic induced recession at that time. A variety of economic packages and tax-cuts were put in place to revive the economies and instil liquidity in the market. This fiscal and monetary stimulus brought about a robust recovery in demand. The gradual weakening of the pandemic due to the weakened variants of virus and the consequent easing of the lockdowns further helped the economies recover. However, the recovery was so strong at most places that it led to high rates of inflation almost everywhere. A steep hike in prices in USA took the rate of inflation to a staggering 9.1% in June, 2022, a forty-year high number.

## Inflation Rate: USA



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This forced the US fed to increase the federal fund rate from a mere 0.25% in March, 2022 to 2.5% in July, 2022. This triggered the outflow of foreign portfolio capital from many countries including India.

**Fed Rate Hikes (2022): Taming Inflation**

FOMC Meeting Date	Rate Change (bps)	Federal Funds Rate
July 27, 2022	+75	2.25% to 2.5%
June 16, 2022	+75	1.5% to 1.75%
May 5, 2022	+50	0.75% to 1 %
March 17, 2022	+25	.25% to .50%

Source: federalreserve.gov

Foreign portfolio investors have withdrawn about USD 21.755 billion so far (9<sup>th</sup> September, 2022) from Indian equity markets since the beginning of the calendar year 2022; though there was some recovery in August, 2022.

More selling is expected with the prospect of more, sharp interest rate increases by the Federal Reserve to tame the four-decade high US inflation.

Monthly FPI Net Investments in India (Calendar Year - 2022) USD Billion	
January	-3.815
February	-5.075
March	-6.562
April	-2.961
May	-4.730
June	-6.592
July	.239
August	7.107
9, September	.634
<b>Total - 2022</b>	<b>-21.755</b>

Source: NSDL, FPI Monitor Report

The second main reason for the depreciation of rupee is rise in global oil prices. There was a steep increase in the price of Brent Crude from \$ 66 per barrel in August, 2021 to \$101 per barrel in August, 2022. However, it fell to \$ 92.42 in September, 2022. More than 80% of India's oil requirement is procured through imports. So, whenever the oil prices spike steeply, India's import bills rise significantly. This increases the demand (outflow) of USD weakening the Indian rupee. According to some experts Ukraine-Russia war has also disrupted supply chains causing rise in prices of oil and many other essential commodities.

The month of August brought some relief as the price of crude fell and FPI inflows increased to some extent. However, rupee has remained weak at Rs. 79.66 per dollar (11-09-2022).

To prevent the free fall of rupee, the RBI has taken many initiatives. Besides selling USD in the forex market, it has also provided exemption on Incremental Foreign Currency Non-Resident (Bank) and Non-Resident (External) Rupee deposits from the maintenance of CRR and SLR up to November 4, 2022, revision of regulatory regime relating to Foreign Portfolio Investment in debt inflows, raising of External Commercial Borrowing limit (under automatic route) to \$1.5 billion and more.

Notwithstanding the efforts of the central bank, several analysts believe that the Rupee could decline further against the dollar in the coming times if oil prices go up again and the FII sell-off continues.

As these short-term temporary fixes have limited effectiveness, it calls for a long-term strategy to preserve the value of rupee. India will have to find innovative ways to contain the outflow and augment the inflow of foreign currency.

There are a few important lessons to be learnt from China in this regard. The Chinese Yuan has always been much stronger than the Indian rupee with respect to USD. Whereas the dollar was just worth 6.96 Chinese Yuan on 6<sup>th</sup> September, 2022; it was worth 79.89 INR at the same time. The strong Chinese Yuan was largely owing to the humongous and relatively stable Chinese forex reserves. China has highest forex reserves in the world. They were at a whopping \$ 3.19 trillion in March, 2022 declining slightly by around 2.8% in July, 2022 to \$ 3.10 trillion. During the same time period, India's forex reserves declined steeply by around 7.8% from \$ 619.68 million to \$ 571.56 million. Interestingly, the stability of forex reserves largely depends on the

composition of forex reserves. The contribution of foreign portfolio investments (FPI) in India's forex reserves has always been higher than that in China's forex reserves, which relies more on export earnings. According to C. Rangarajan, "Our forex reserves have been built up largely from capital inflows. This is far from how China built up reserves. China has primarily built its reserves out of its current account surplus. This makes a difference to reserves. Out of the various elements that have helped India accumulate reserves, some are volatile. The most significant among them is foreign portfolio investment. Investment in the stock market can flow out easily if perceptions change." These fluctuations in forex reserves further cause fluctuations in the exchange rates.

Thus, the only long-term solution to maintain stability in the value of rupee is to improve the current account position of the balance of payments. The recent depreciation is likely to make the exports cheaper and imports expensive. This change in the prices of tradable goods following currency depreciation must be leveraged by working towards enhancing the price elasticities of imports and exports. Unless India finds innovative ways to boost its exports and reduce its dependence on imports, a stable rupee will remain a far-fetched dream.

India had achieved highest monthly value of merchandise export in March 2022 amounting USD 40.38 billion, an increase of 14.53% over USD 35.26 billion in March 2021 and an increase of 87.89% over USD 21.49 billion in March 2020.

The value of exports stood at USD 33 billion in August, 2022 but that of imports was USD 61.7 billion leading to a trade deficit of USD 28.68 billion.

In spite of improving exports, the country's current account deficit is likely to touch USD 105 billion or 3 per cent of the GDP this fiscal, according to a report by Bank of America. On the other hand, even after a significant fall, China still had a current account surplus of USD 79.39 billion in August, 2022.

Among numerous factors contributing to the spectacular export performance of China and the resultant trade surplus; the four main reasons identified here are (i) excellent trade infrastructure especially the sea-ports, (ii) lower rates of tariffs (iii) greater emphasis on processing trade vis a vis manufacturing trade and (iv) price competitiveness.

According to Martin Humphreys, a Lead Transport Economist at the World Bank, "Inefficient ports represent a significant risk for many developing countries in that they can hinder economic growth, harm employment, and increase costs for importers and exporters". Many of India's major ports suffer serious congestion problem. Truck lines often extend up to 10 km on any given day at Nhava Sheva, India's second busiest port. A key indicator of a port's efficiency is turnaround time, or the time it takes a ship to enter, unload, load, and exit the port. Turnaround time at India's major ports averages 2.59 days against a global average of 0.97 days, according to the Economic Survey 2020-2021. With 95 percent of India's trade by volume transported by sea, clogged ports are a huge hurdle to trade flow.

On the other hand, three of the large Chinese gateways, Shanghai (Yangshan), Ningbo and the southern port of Guangzhou, feature in the top ten of the Global Container Port Performance Index (CPPI) developed by the World Bank and S&P Global Market Intelligence. India's Pipavav port in Southwest Gujarat is the highest ranked at number 26, while Mundra is ranked at 48.

Secondly, China has progressively reduced its tariff rates over the years which India has failed to do. India's tariff gap as compared to China has widened over two years on the trot. According to World Bank, India's average effective applied tariff rate across all products is 10.2% compared to 5.39% for China. The lower import duties allow China to procure imported components, materials and equipment at a lower cost making its products, especially the exports globally more competitive.

Thirdly, China paid more attention to processing-trade. Mary Amity, senior economist with US Federal Reserve and Caroline Freud, senior economist at IMF's Research Department observe that the dramatic transformation of China's trade implies that its business environment is relatively flexible, enabling it to move in and out of different sectors. Besides taking advantage of large supply of workers and rapidly improving infrastructure, China has mainly taken advantage of increasing fragmentation of production across countries. The increasing amount of processing trade has enabled China to export increasingly sophisticated products by assembling high quality duty free imported inputs. In the process, exports of many goods have increased dramatically.

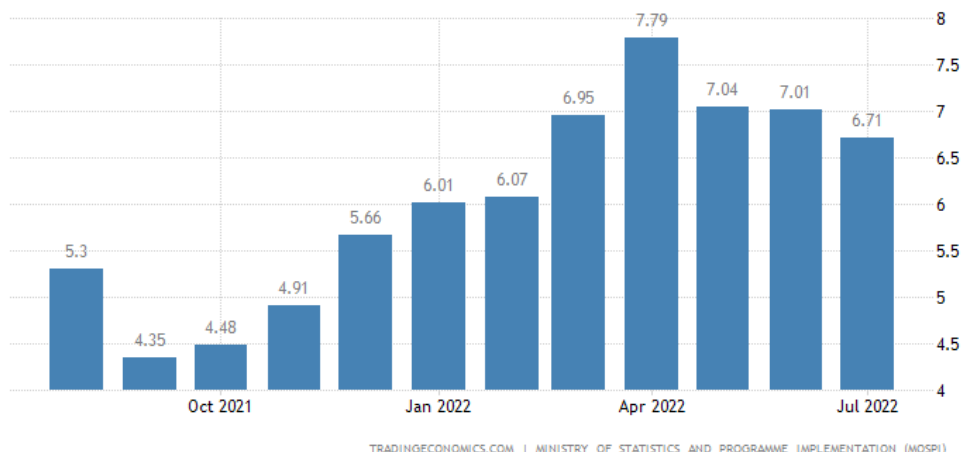
The Chinese trade strategy of ‘Dual Circulation’ also needs a special mention. The “dual circulation strategy” (DCS) was first introduced by President Xi Jinping in May 2020. DCS is a combination of import substitution and domestic demand expansion. Instead of religiously adopting the recommendations of the traditional theories of international trade based on comparative cost differences, China had followed an unconventional path of import substitution. Despite facing comparatively higher costs in the initial phases, China, ever since 1970s had persisted with the trade policy of import substitution. The most interesting aspect of China’s policy of import substitution in the last few years has been its execution without protecting the domestic industry through very high tariffs. The stress was more on facilitating the scientific community, technical personnel and incentivising the industry with an environment and eco-system to develop these products. Instead of importing the finished products, China started importing the intermediate goods. The same were then assembled within the country to produce the viable substitutes of imports. The results have been astonishing. Goods which China used to import a few decades ago, are now being exported from China a big time.

Taking a leaf from the Chinese policy, Sushim Banerjee (Financial Express, Nov. 18, 2020), former DG of the ‘Institute of Steel Development and Growth’ observed that import substitution strategy is not against free and fair trade. The call for ‘make in India’ and ‘vocal for local’ is an attempt to rebuild and restructure Indian manufacturing predominated by MSME sector to achieve higher standards of performance. The declaration of Production Linked Incentive (PLI) Scheme by the government of India in 2020 is a step in right direction. But more important would be to make it work to achieve its goals. Jayant Dasgupta, India’s former ambassador to the World Trade Organization pointed out that yet another lesson to be learnt from China is to build multiple supply chains. According to him, “We have a lot of capability in sectors such as pharmaceuticals, auto and electronics, but we need to build alternative supply chains with partners in the Far East, Europe and the US, so as to cut our dependence on China,” However, he said these changes won’t happen overnight and would take at least five years of efforts, considering that China achieved this level of manufacturing capability over 20 years”. A few imports like crude oil are non-substitutable as India is not naturally endowed with crude-oil deposits. Nevertheless, preparation of a focus list of India’s top imports followed by a systematic effort to develop their cost-effective domestic alternatives would be an effective strategy. The research institutes, engineers and scientists must be facilitated and inspired to work in this direction, just as China had done over the years. Similarly, a focus list of products in high demand in international market and efforts towards their production would be another big step in the right direction e.g., development of indigenous Tejas fighter planes, not only strengthened the domestic defence capabilities but could also generate significant export earnings. Nurturing tourism and exploring ways to expose the world to the rich Indian culture with its varied forms of dances, cuisines, iconic historical monuments and breath-taking geographical landscapes too have an enormous potential to generate foreign exchange. Finally, China has been able to manage its inflation much better than India and many other countries. The average rate of inflation in China for the period ranging October, 21 to August, 22 has been mere 1.8% as compared to India’s 6.08%.

Inflation Rate (China)



Inflation Rate (India)



In his article titled 'Policy Cues from a Depreciating Rupee' (Mint, 31<sup>st</sup> August, 2022), C. Rangarajan points out that 'inflation differentials between countries count. Export competitiveness is correlated with low inflation. Our own inflation targets cannot be too far away from the targets of other countries, if we want to contain depreciation of the rupee'.

If India can learn some of these lessons from its neighbour, it can contain the depreciating rupee in a more tangible and effective manner. After all, good economics is all about identifying the right causes for the economic issues, learning lessons from success stories of others (besides our own past failures) and accordingly designing appropriate policies to deal with them.

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