Lombard Street Research

LSR Daily Note

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Who is the most competitive of 'EM all?

- **India is one of the most competitive emerging markets (EMs)**
- **Competitiveness offers it a head start, although...**
- **...it may not be sufficient to determine the growth path**

Competitiveness increasingly important as world trade growth to stay modest at best

World trade growth lacks the vigour of the past as global rebalancing is incomplete. It is thus more difficult for economies to carve out a share of a world export pie that is expanding relatively slowly. Competitiveness has become increasingly important to assess which countries have a better chance of increasing growth through exports and overall productivity gains. It also helps gauge the progress economies have made towards adjustment and rebalancing.

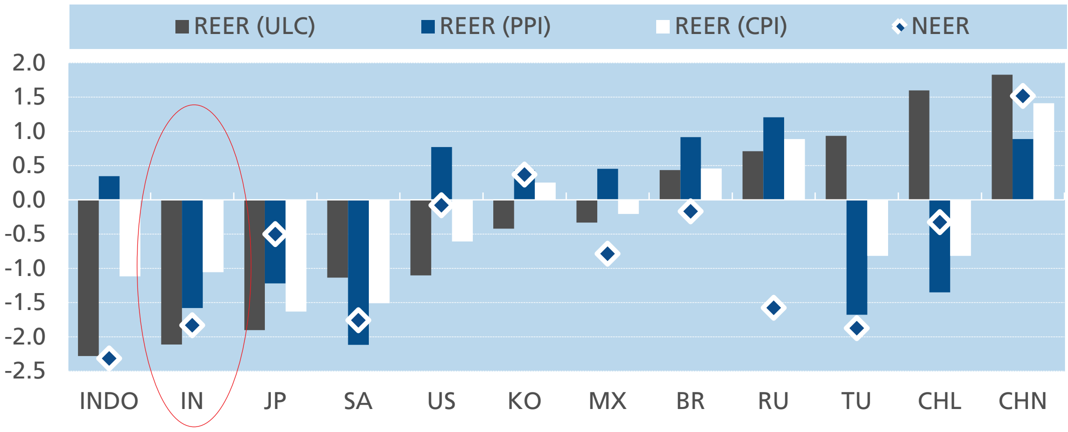
There is no perfect way to measure competitiveness. We use the OECD's estimates of real effective exchange rates (REER) based on unit labour costs (ULC) as the starting point of our analysis. We then add more layers to this assessment by taking into account other measures of EER - nominal and adjusting for producer price index (PPI) and consumer price index (CPI) differences. We also intersperse it with our take on the economy's structural and cyclical position.

India is the most competitive EM

India appears as the most competitive emerging market followed by Indonesia (see chart below). China, Chile, Turkey, Russia and Brazil lie at the other end of the spectrum. South Africa, Korea and Mexico lie somewhere in between. In this note, I will focus on India and extend the analysis to other countries in subsequent pieces.

EM competitiveness

Standard deviations from 10-year average



Source: OECD, BIS, DS, LSR

India's 'actual' competitive edge lies somewhere in between the REERs estimated by adjusting for ULC and PPI. The OECD's estimate of ULC likely overstates the country's competitiveness as the data may be skewed towards the more productive 'organised' sector. On the other hand, the PPI-based REER may understate competitiveness as it does not adequately capture productivity gains.

India has sharpened its relative advantage thanks to nominal currency depreciation and faster labour productivity growth and slower wage gains than in its trading partners. Meanwhile, producers have cut back on price increase to gain market share.

It is one of the very few EMs where the decline in relative unit labour costs has been greater than nominal FX depreciation over the last decade, implying a chunky contribution to competitiveness. However, most of this improvement occurred before the Global Financial Crisis (GFC). After the crisis, the rupee's nominal decline outstripped that of ULCs on the back of a widening current account deficit.

Domestic policy errors, poor progress on structural reforms and populist fiscal policies that drove wage growth above productivity growth are largely to blame. Indeed, India appears less competitive after adjusting for CPI (vs. for ULC and PPI), reflecting entrenched inflation expectations and supply-side bottlenecks.

Competitiveness gives India a head start, but may not guarantee growth

Gains in competitiveness did not prevent profit margins from shrinking post-GFC. Besides, the increase in India's share in world exports has been modest given the extent of its competitive edge, although quite meaningful in comparison to other EMs. Manufacturing firms (whether focussed on exports or not) are relatively small. They are inhibited from expanding to achieve efficiencies of scale by regulatory impediments - rigid labour and land acquisition laws, in particular. Thus, while the rupee may appear competitive in real terms, the scope for nominal INR appreciation without hurting growth is limited.

To be sure, India is one of the EMs better placed to achieve structurally higher growth rates. Greater competitiveness is one of the various reasons underlying our relatively constructive view on the Indian economy (see link, link and link). Yet this does not imply that faster economic growth is guaranteed.

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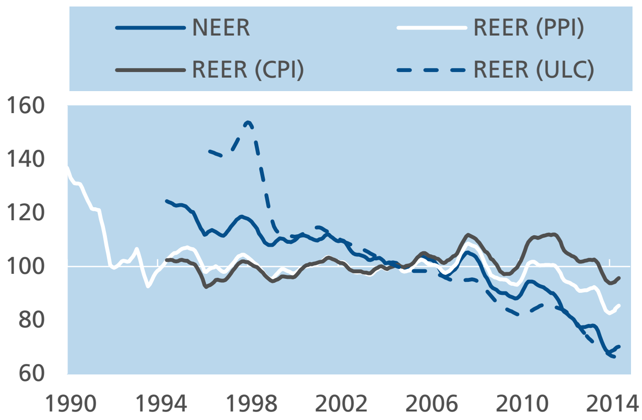
What is driving India's competitiveness gains?

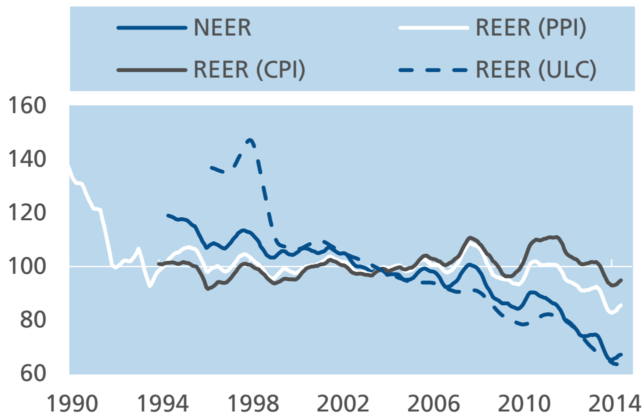
Indices, June-04=100, 6MMA



Source: OECD, BIS, DS, LSR

Competitive vs. a 'guesstimated' par

Indices, Average 2000-06=100, 6MMA



Source: OECD, BIS, DS, LSR