RUPEE DEPRICIATION - ECONOMY

NEWS: The recent depreciation of the Indian rupee has generated significant public and expert commentary, along with speculation regarding a potential change in exchange rate management policies.

WHAT'S IN THE NEWS?

Overview of Recent Rupee Depreciation

- However, a regime change is highly unlikely as the Reserve Bank of India (RBI) has consistently described the Indian exchange rate regime as "market-determined" since the 1990s liberalisation. Interventions by the RBI are intended solely to curb excessive volatility rather than alter the fundamental structure of the regime.

Degrees of Intervention

- **Unchanged Regime with Evolving Implementation:** While the core exchange rate framework remains unchanged, the RBI's implementation strategy has adapted over time to align with evolving policy priorities, external conditions, and the goal of deepening domestic foreign exchange (FX) markets.
- **Higher Volatility in Crisis Periods:** Volatility tends to increase during periods of significant net capital outflows, as seen in the current scenario.
- **Historical Patterns and Lessons:**
    - During the initial decade of liberalisation, nominal depreciation often offset higher domestic inflation, maintaining a competitive real effective exchange rate (REER).
    - With the expansion of market activity in the 2000s, FX market volatility increased. Notably, the first instance of rupee appreciation caused widespread concern and debate.
    - The global financial crisis underscored the limitations of intervention in stabilising the rupee. Excessive interventions in the following years led to real appreciation, which adversely impacted exports. These experiences have shaped the RBI's approach to more balanced interventions.

Capital Flow Volatility

- **India's Vulnerability to Global Crises:** India's economic liberalisation coincided with recurring global crises, exposing the economy to volatile capital flows.
- **Patterns of FPI Flows:**
    - Foreign Portfolio Investment (FPI) outflows during global "risk-off" episodes are often followed by periods of inflows.

- Outflows provide an opportunity for the rupee to depreciate, moderated by RBI's reserve sales, while inflows help rebuild reserves. This balanced approach prevents excessive currency appreciation.

- **Stability in REER:**
  - The export-weighted REER has been maintained near equilibrium in recent years, ensuring competitiveness. For instance, it was 101.2 in FY24 and slightly increased to 102.7 in September 2024.
  - Nominal rupee depreciation between February 2020 and October 2024 was steady, moving from ₹71.5 to ₹84.06, with relatively low volatility compared to other emerging markets.

Managing Volatility and Risk

- **Risk Premiums in Emerging Markets (EMs):**
  - EMs generally experience risk premiums that exceed actual currency depreciation, averaging around 3%.
  - In 2023, the absence of intervention could have led to over-appreciation, raising expected depreciation rates and impacting interest rate differentials.
- **Significance of Reserves:**
  - Adequate reserves play a critical role in sustaining market confidence during volatile periods.
  - The depletion of reserves, as seen in Sri Lanka's crisis, can lead to severe consequences, including hyperinflation and currency collapse.

Balancing Capital Flows and Market Dynamics

- **Role of FPIs:**
  - Foreign portfolio investors contribute significantly to domestic market development and growth but are inherently volatile.
  - Increased domestic participation in stock markets has mitigated the impact of FPI-driven volatility, showcasing the resilience of Indian financial markets.
- **Innovations in Payments Systems:**
  - Advances in India's domestic payment systems could be extended to cross-border transactions, enhancing the efficiency and stability of FX markets.

Impact of Volatility on the Economy

- **Adverse Effects on the Real Sector:**

- Excessive volatility adversely impacts businesses and market stability, though banks benefit by charging higher fees for hedging products.

- **Export Competitiveness:**
  - Maintaining a competitive REER (~100) is essential to support exports, especially when the trade deficit is high and exports have the potential to generate significant employment.
  - Depreciation raises import costs but ensures export competitiveness in the long run, although prolonged depreciation can lead to inflation-induced real appreciation.

Preferred Exchange Rate Management Approach

- **Managed Flexibility:**
  - A managed yet flexible nominal exchange rate reduces excessive volatility and real misalignments without triggering severe domestic deflation or inflation.
  - Controlled nominal volatility within a 5-10% band facilitates price discovery in FX markets and prevents speculative one-way movements.
- **Global Central Bank Practices:**
  - Similar to the RBI, most EM central banks employ tools such as reserves, prudential measures, and strategic interventions to manage volatility and maintain market confidence.

What is an Exchange Rate?

- **About:**
  - An **exchange rate** is the rate at which **one currency can be exchanged for another currency**. It represents the value of one currency in terms of another currency.
  - **Exchange rates** are typically expressed as the amount of one currency needed to purchase one unit of another currency.
- **Types**:
  - **Fixed Exchange Rate**: Governments or **central banks set the value of their currency** in relation to other currencies and maintain that value by buying or selling their own currency in foreign exchange markets.
  - **Floating Exchange Rate**: Value of a **currency is determined by the forex market based on supply and demand.** Most major currencies operate under this system.
  - **Managed Float**: A **mix of fixed and floating exchange rates** where governments intervene occasionally to stabilise their currency's value.

- **Factors Affecting Exchange Rates:**
  - **Interest Rates:** Higher interest rates in a country tend to attract foreign investment, increasing demand for that country's currency and strengthening its exchange rate.
  - **Inflation**: If inflation is higher in a country compared to its trading partners, its currency weakens as its purchasing power decreases.
  - **Economic Growth:** A strong and growing economy fosters confidence in a country's currency, leading to a stronger exchange rate.
  - **Political Stability**: Political instability can deter foreign investment and weaken a country's currency.
  - **Supply and Demand**: The fundamental principle of supply and demand plays a major role. If more people want to buy a particular currency (higher demand), its exchange rate strengthens.

What is Effective Exchange Rate (EER)?

- **About:**
  - The **Effective Exchange Rate (EER)** of a currency is a weighted average of its exchange rates **against other currencies,** adjusted for inflation and trade competitiveness.
  - The currency weights are derived from the **share of the individual countries to India's total foreign trade.**
- **Effect on Strength of a Currency**:
  - **Strength or Weakness of a Currency** depends on the **Exchange rate** of that currency with the currency of all trading Partners.
  - **For India,** The strength or weakness of the Rupee is, hence, a function of its exchange rate with not just the US dollar, but also with other global currencies.
    - In this case, it would be against a basket of currencies of the country's most important trading partners, termed as the rupee's "**Effective Exchange Rate"** or **EER.**
- **Types of Effective Exchange Rate(EER):**
  - **Nominal Effective Exchange Rate (NEER):** NEER is a simple **average of bilateral exchange rates** between the domestic currency and the **currencies of major trading partners,** weighted by the respective trade shares.
    - **NEER measures the overall strength** or weakness of a currency relative to a basket of other currencies **without adjusting for inflation.**

- The **NEER indices** are with reference to a **base value** of **100 and base rear as 2015-16.**
- The **Reserve Bank of India** has constructed NEER indices of the rupee against a 2 different **baskets of Currencies :**
  - **6 Currency Basket:** It is a trade-weighted average rate at which the **rupee is exchangeable with a basic currency basket,** comprising the US dollar, the euro, the Chinese yuan, the British pound, the Japanese yen and the Hong Kong dollar.
  - **40 currencies Basket**: It covers a bigger basket of 40 currencies of countries that **account for about 88% of India's annual trade flows.**

- **Real Effective Exchange Rate (REER)**:
  - REER **adjusts NEER for differences in inflation rates** between the domestic economy and its trading partners. It **reflects changes in the relative price levels of goods and services.**
  - REER provides a **more accurate measure of a currency's trade competitiveness** by accounting for changes in price levels.
  - REER is calculated by dividing NEER by a **price deflator** (such as **Consumer Price Index)** for the domestic economy and multiplying by 100.

What are the Implications of Currency Depreciation on the Indian Economy?

- **Positive Impacts:**
  - **Boosts Exports:** Indian **exports become cheaper for foreign buyers,** potentially increasing demand and boosting export earnings.
  - **Inward Remittances**: A **weaker rupee will enable workers** abroad to send more rupees back home when they convert their foreign currency earnings.
    - This can **increase disposable income in India.**
- **Negative Impacts:**
  - **Higher Import Costs:** Imported goods, including essential items like oil and machinery, become more expensive.
    - This can lead to **inflationary pressure**s, where the general price level of goods and services rises, impacting the common man's purchasing power.
  - **Costlier Foreign Debt**: If India has borrowed money in foreign currencies, a weaker rupee means it has to pay back more rupees to settle the debt.
    - This can **strain the government's finances.**

- **Discourages Foreign Investment**: A depreciating rupee can be seen as a sign of economic instability, potentially discouraging foreign investors from investing in India.

Key Takeaways for Policy Implementation

- **Market-Friendly Strategies:**
  - Integrating interventions with market mechanisms helps prevent overshooting and stabilises FX markets.
- **Deepening FX Markets:**
  - Post-pandemic, FX market turnover has doubled, contributing to reduced volatility and improved liquidity.
- **Continuity of Policy:**
  - Despite evolving global and domestic conditions, the RBI's post-liberalisation exchange rate regime remains robust, efficient, and unlikely to change.

Source: https://www.thehindubusinessline.com/opinion/the-rupee-hasnt-overly-depreciated/article69120777.ece#:~:text=The%20nominal%20value%20of%20rupee,periods%20of%20capital%20flow%20surges.