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India is vulnerable to a currency crisis

Analysis of Rupee Depreciation and RBI's Forex Strategy

Context and Recent Developments In a recent editorial, it was discussed that the Reserve Bank of India (RBI) should allow the Indian rupee to depreciate, intervening only to curb excessive volatility. This viewpoint arises from the current global capital dynamics where investors are flocking to safer assets, primarily due to uncertainties sparked by policies and global reactions to the actions of the Trump administration. The Indian rupee, like many global currencies, is under pressure due to these capital flows favoring the US dollar.

Challenges in Managing the Rupee's Value The primary challenge lies in managing the expectations surrounding the rupee's value. Foreign portfolio investors closely monitor these expectations, and a rapid depreciation could prompt them to withdraw their investments, accelerating the rupee's fall. This scenario could necessitate even larger interventions from the RBI, which might prove less effective if the rupee's decline steepens unexpectedly.

Historical Perspective on Forex Management Since the 1990s, after the liberalization of India's exchange rates and the opening up of the capital account, the rupee has experienced significant volatility influenced by portfolio capital flows. These flows are distinct from foreign direct investment (FDI) and commercial bank lending due to their ability to swiftly enter and exit markets. Despite various interventions by the RBI, the long-term trajectory of the rupee has been a consistent depreciation from an annual average of 45.56 rupees per USD in 2010-11 to 82.78 in 2023-24, with the monthly average continuing to decline since September 2024.

Underlying Factors of Depreciation Two main factors contribute to the long-term depreciation trend:

1. **Inflation Differential**: Generally, India's inflation rates have been higher than those in international markets, reducing the rupee's domestic purchasing power more rapidly than the dollar in international markets. This inflation differential inherently pushes the rupee to depreciate against the dollar.

2. **Trade and Current Account Deficits**: India consistently spends more on imports than it earns from exports, creating a perpetual foreign exchange deficit. While remittances from overseas Indians help, they do not fully cover the deficit. This structural gap necessitates reliance on capital inflows to build foreign exchange reserves, which the RBI uses to manage the rupee's value and mitigate short-term volatility.

Implications of Market-Determined Exchange Rates The market-driven exchange rate and the ongoing depreciation have not rectified the fundamental issue of trade competitiveness. India's inability to boost competitive manufactured exports limits its attractiveness for FDI that could enhance export capabilities.

Potential Risks and Long-Term Outlook The liberalization of capital flows, while providing certain economic flexibilities, has left the Indian economy vulnerable to potential currency crises similar to those experienced by other nations over recent decades. Although India has managed to avoid such extreme scenarios so far, the historical pattern of the rupee's value shows sporadic sharp declines amid periods of relative stability. This pattern underscores the persistent risk of a severe currency crisis.

Conclusion The continuous management of the rupee's value against global economic shifts and internal market dynamics presents a complex challenge for the RBI. The nuanced approach of allowing gradual depreciation while preventing drastic falls is critical to maintaining economic stability and avoiding scenarios that could trigger rapid declines in the currency's value. The RBI's strategy must balance market interventions with the need to foster an environment conducive to sustainable long-term economic growth and stability.

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