Slump of Indian Rupee

August 3, 2022

Manifest Pedagogy:

The Indian rupee breached the psychologically significant exchange rate level of 80 to a US dollar in early trade. Currency devaluation is actually detrimental to a nation's interest, growth story and impacts its competitiveness in the long run. The government must take all the measures to keep the rupee stable and strong which is quintessential for macroeconomic stability.

In News: The Indian rupee is experiencing its worst slump in four years. Since the start of 2022, the currency has depreciated by more than 7% against the U.S. dollar.

Placing it in Syllabus: Economy

Static Dimensions

- Currency Depreciation

Current Dimensions

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- Factors responsible for rupee depreciation
- Implications of Rupee depreciation
- Measures announced by RBI
- Other Measures by Government

Content

More on News

- The Indian currency is not alone in faring poorly against the greenback, with even the historically strong euro and the British pound taking a hammering and weakening by more than the rupee.
- The **dollar index**, a measure of the **greenback's value**

against a basket of six major currencies, too offers little reassurance to the rupee.
    - The index indicates that investors are betting strongly on dollar-backed assets.
- The rupee's real effective exchange rate (REER), which provides a weighted average value in relation to a basket of currencies of its major trading partners, is also signalling that the Indian currency is still overvalued and has room to depreciate further.

Currency Depreciation

- Currency depreciation is a fall in the value of a currency in a floating exchange rate system.
- Rupee depreciation means that the rupee has become less valuable with respect to the dollar.
- For example: USD 1 used to equal to Rs. 70, now USD 1 is equal to Rs. 77, implying that the rupee has depreciated relative to the dollar i.e. it takes more rupees to purchase a dollar.

Factors responsible for rupee depreciation

- **Russia-Ukraine conflict** and **soaring crude oil prices** as major drivers of the rupee's depreciation.
- **Foreign portfolio investors** were "selling off assets and fleeing to safe haven" in the wake of global monetary policy tightening.
    - So far in 2022, **FPIs have dumped $29.6 billion** in Indian equity and debt after three straight years of net investments, with the prospect of more, sharp interest rate increases by the Federal Reserve to tame four-decade-high U.S. inflation likely to do little to staunch the outflows.
- **Rising bond yields**– India's 10-year benchmark bond ended at a high of Rs 93.69 recently, yielding 7.46 per cent after reaching a high of 7.49 per cent earlier.
- **Inflation concerns**– Russia's invasion of Ukraine,

combined with renewed Covid-19 lockdowns in China, have exacerbated inflationary pressure.

- **Strengthening Dollar**– The anticipation of more rate hikes in the future by the US Federal Reserve pushed the dollar to its highest levels in recent times, driven by higher treasury yields.
- **Widening Trade Deficit**: A widening trade deficit has added pressure on India's current account deficit (CAD), which in turn has added pressure on the outlook for the local currency.
  - In FY22, India incurred a CAD of $38.7 billion, or 1.2% of the GDP.
- **Rising Gold Imports:** While India's production of gold is negligible, the country is the second highest consumer of gold in the world.
  - In FY22, India imported gold worth $46.17 billion, which is 33% higher than the year earlier.
- **Monetary policy**: Steps taken by RBI to tighten the monetary policy to counter rising inflation has also led to depreciation.

Implications of Rupee depreciation

- **Positive:** Weaker rupee should theoretically give a boost to India's exports, but in an environment of uncertainty and weak global demand, a fall in the external value of rupee may not translate into higher exports.
- **Reduced Forex Reserves**: In order to smoothen the rupee's fall and curb excess volatility, the RBI has been selling dollars in the forex markets from its reserves from time to time.
  - The drawdown of dollars by the central bank has dented reserves. From a high of $642 billion in September, reserves plummeted to $593 billion as of June 24, **a drop of $49 billion**.
- **Loans**: Those with large foreign loans will also see rupee interest costs rise.

- **Imports**: Importers need to buy US dollars to pay for imported items. With the dip in the rupee, importing items will get more expensive. Not just oil but electronic items, such as mobile phones, some cars and appliances, are likely to get expensive. This can widen India's trade deficit.
- **Foreign education**: The rupee losing value against the US dollar would mean foreign education just became more expensive and education loans too have become costlier following the interest rate hikes by the RBI.
- **Tourism**: Another major impact of the falling rupee might be felt on the tourism sector.
- **Remittances**: However, non-resident Indians (NRIs) who send money back home will end up sending more in the rupee value.

Measures announced by RBI

- The RBI regularly monitors the foreign exchange market and intervenes in situations of excess volatility. It has raised interest rates in recent months that increase the attractiveness of holding Indian rupees for residents and non-residents.
- Cap on interest rate that lenders can offer on foreign deposits by NRIs has been removed till October.
- External commercial borrowing (ECB) limit under the automatic route has been increased from $750 million or its equivalent per financial year to $1.5 billion.
- All-in cost ceiling under the ECB framework has been raised by 100 basis points, subject to the borrower being of investment grade rating.
- In the case of NRE deposits, interest rates shall not be higher than those offered by the banks on comparable domestic rupee term deposits.
- Banks have been exempted from cash reserve ratio (CRR) and statutory liquidity ratio (SLR) on incremental FCNR(B) and NRE term deposits.

- All new issuances of G-Secs of 7-year and 14-year tenors, including the current issuances of 7.10 per cent GS 2029 and 7.54 per cent GS 2036, will be designated as specified securities under the fully accessible route (FAR).
- As part of the macro prudential framework under the medium-term framework (MTF), FPIs will be provided with a limited window till October 31, 2022 during which they can invest in corporate money market instruments viz., commercial paper and non-convertible debentures with an original maturity of up to 1 year.
- FPIs can invest in government securities and corporate bonds through three channels: the MTF; the Voluntary Retention Route (VRR); and the Fully Accessible Route (FAR).

Other Measures by Government

- **Countering Rising CAD and Gold Import:** In order to rein in the widening CAD and reduce pressure on the weakening rupee, the government raised the import duty levied on gold to 15% from 10.75%.
- **Cess on Export of Fuel**: The government also imposed a cess on the export of petrol, diesel and jet fuel. Private refiners have been exporting fuel and earning 'windfall' profits while pumps were running dry in some parts of the country.
    - High-speed diesel and motor gasoline exports more than trebled in March 2022, while the exports of jet fuel more than doubled.

Way Forward

- Focus on reducing the trade deficit by import substitution alternatives.
- Reducing crude oil import bill by giving further push to renewables.
- Creating a conducive environment to attract FDI and

other investments.

- Most analysts believe that the better strategy is to let the rupee depreciate and act as a natural shock absorber to the adverse terms of trade.
- The RBI should focus on containing inflation, as it is legally mandated to do, and the government should contain its borrowing
- The depreciation of the currency is likely to enhance export competitiveness, which in turn impacts the economy positively.

Mould your thoughts

1. Discuss the factors responsible for depreciation of Indian rupee in recent times and implications it will have on the Indian Economy. Highlighting the measures taken by the government, suggest some measures to contain the free fall of rupee.

Approach to the answer-

- Introduction about fall of rupee
- Factors responsible
- Implications of rupee depreciation
- Government measures including RBI
- Possible solutions
- Way Forward and Conclusion