Strengthening of Rupee

For Prelims: Depreciation of Indian Rupee, REER, NEER, Currency depreciation, inflation, Depreciation Vs Devaluation, Appreciation Vs Depreciation

For Mains: Impact of Depreciation of Indian Rupee on economy, Factors affecting strengthening and weakening of Indian Rupee

Source: IE

Why in News?

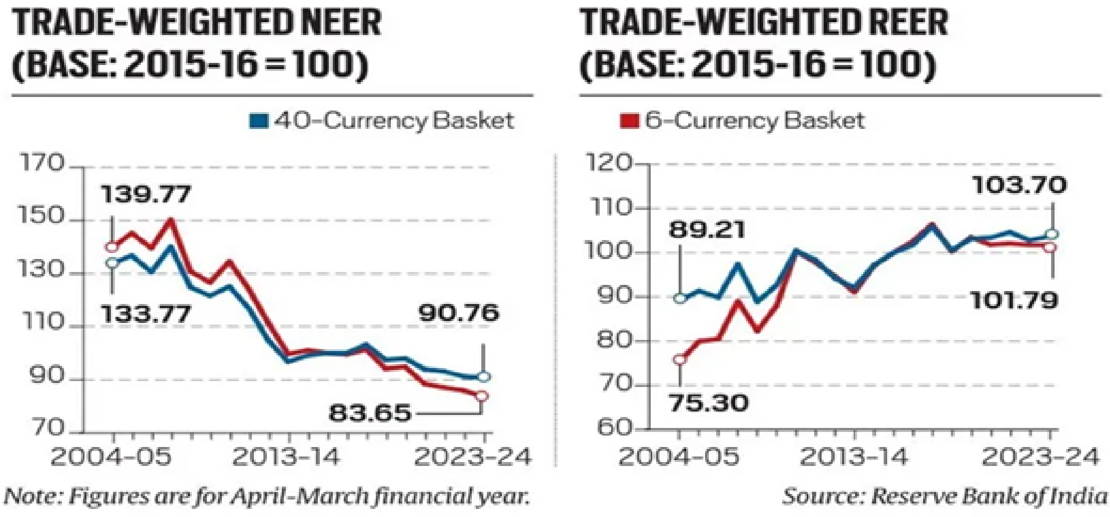
The **Indian Rupee** depreciated by around **27.6%** against the **US dollar** in the last 10 years.

- The currency has gained real value when considering its exchange rate against major global currencies.

How is the Decadal Journey of the Indian Rupee?

- The rupee fell from Rs 44.37 to Rs 60.34 (**26.5%)** from **2004 to 2014** against the **US dollar.**
- The rupee has further **depreciated** from Rs 60.34 to Rs 83.38 (**27.6%)** against the US dollar in the last between **2014 to 2024.**
  - Appreciation and depreciation of currency refer to changes in the value of a currency relative to other currencies in the foreign exchange market.

//



- Between 2004 and 2024, **rupee declined** by **32.2%** (from 133.77 to 90.76) as per **40-currency**

basket NEER and **40.2%**, (from 139.77 to 83.65) as per **6-currency basket NEER** and during the same period.
    - The rupee's average exchange rate against the **US dollar** dropped by **45.7%,** from Rs 44.9 to Rs 82.8.
    - Therefore, between 2004 and 2024, the rupee has undergone a **smaller depreciation** against the currencies of India's major trading partners compared to its depreciation solely against the US dollar.
- Also rupee's **trade-weighted** REER **for both 40-currency and 6-currency basket** has increased in the last 20 years indicating that **Rupee strengthened between 2004-05 and 2023-24.**
    - Rupee has strengthened in **real terms** over time, while ruling at 100 or above most of the time in the last 10 years.

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.

Devaluation and Depreciation of Currency

Feature	Devaluation	Depreciation
Cause	Government Action	Market Forces (Demand and Supply)
Exchange Rate System	Fixed	Floating
Intentionality	Deliberate Action to Weaken Currency for economic gain	Natural Decline in Value
Control	Government Control Exchange Rate	Market Determines Exchange Rate

Drishti Mains Question:

Analyse the relationship between inflation and exchange rates in the Indian economy. Discuss the challenges posed by this relationship and suggest policy measures to manage them.

UPSC Civil Services Examination Previous Year Question (PYQ)

<u>Prelims</u>

Q1. **Which one of the following is not the most likely measure the Government/RBI takes to stop the slide of the Indian rupee? (2019)**

(a) Curbing imports of non-essential goods and promoting exports

(b) Encouraging Indian borrowers to issue rupee-denominated Masala Bonds

(c) Easing conditions relating to external commercial borrowing

(d) Following an expansionary monetary policy

Ans: (d)

Q2. Consider the following statements:

1. The effect of devaluation of a currency is that it necessarily
2. improves the competitiveness of the domestic exports in the foreign markets
3. increases the foreign value of domestic currency
4. improves the trade balance

Which of the above statements is/are correct?

(**a)** 1 only
(b) 1 and 2
(c) 3 only
(d) 2 and 3

Ans: (a)

<u>Mains</u>

Q. How would the recent phenomena of protectionism and currency manipulations in world trade affect macroeconomic stability of India? **(2018)**