Mains Practice Question

Q. Examine the impact of exchange rate volatility on the Indian economy. What measures does the Reserve Bank of India (RBI) employ to manage exchange rates? (250 words)

15 May, 2024 GS Paper 3 Economy

Approach

- Introduce the concept of exchange rate volatility.
- Mention the impact of exchange rate volatility on the Indian economy.
- Highlight the measures of the Reserve Bank of India (RBI) to manage exchange rates.
- Conclude positively.

Introduction

An exchange rate is the rate at which one currency is exchanged for another currency. Exchange rate volatility refers to the significant and frequent fluctuations in the value of a currency compared to others. For India, it means the rupee's value against major currencies like the US dollar keeps changing rapidly. Fluctuations in exchange rates can have significant multifaceted impacts, influencing trade, investment, and overall economic stability.

Body

Impact of Exchange Rate Volatility on the Indian Economy:

- **Varying Cost of Exports and Imports:**
  - A depreciating rupee can make Indian exports cheaper in the global market, potentially boosting export volumes. However, it simultaneously increases the cost of imports, leading to inflationary pressures on domestically consumed goods.
  - Conversely, an appreciating rupee can have the opposite effect, dampening exports while making imports cheaper.
- **Uncertain Foreign Investment:**
  - Volatile exchange rates introduce uncertainty for foreign investors, potentially discouraging foreign direct investment (FDI) and portfolio investments.
  - This can limit access to crucial foreign capital for domestic businesses and infrastructure development.
- **External Debt Burden:**
  - India has a significant public debt-to-GDP ratio of 81% in 2022-23.
  - A large portion of external debt is denominated in foreign currencies like the US dollar.
  - A depreciating rupee increases the rupee equivalent of this debt, putting a strain on government finances.
- **Exchange Rate Speculation:**
  - High volatility can attract speculative activity in the foreign exchange market.
  - Speculators may exploit short-term fluctuations in the exchange rate, further amplifying market volatility and creating instability.

RBI's Tools for Exchange Rate Management:

- **Market Interventions:**
    - The RBI can directly intervene in the foreign exchange market by buying or selling dollars or other major currencies.
        - **Selling Dollars:** When the rupee is depreciating excessively, the RBI can sell dollars from its foreign exchange reserves. This injects rupees into the market, increasing the supply of rupees and potentially arresting the depreciation.
        - **Buying Dollars:** Conversely, if the rupee is appreciating too rapidly, the RBI can buy dollars from the market. This reduces the supply of rupees and can help to slow down the appreciation.
- **Interest Rate Adjustments:**
    - The RBI's monetary policy tool of adjusting repo rates can indirectly influence the exchange rate by impacting the flow of foreign capital.
        - **Higher Repo Rates:** By raising repo rates, the RBI makes borrowing in India more attractive for foreign investors. This can lead to increased foreign capital inflows, which can appreciate the rupee.
        - **Lower Repo Rates:** Conversely, lowering repo rates can make borrowing in India less attractive for foreign investors, potentially leading to capital outflows and a depreciation of the rupee.
- **Foreign Exchange Reserves:**
    - The RBI maintains a stockpile of foreign currency reserves (USD 646.42 billion as of end-March 2024). This stockpile acts as a buffer to manage exchange rate volatility.
        - **Stabilization**: During periods of high volatility, the RBI can use its reserves to buy rupees in the market when it depreciates excessively, or sell rupees to prevent an overly rapid appreciation.
        - **For example:** The Market Stabilisation Scheme (MSS) is used by RBI to withdraw excess liquidity from the market through the issuance of bonds and securities.

Conclusion

Exchange rate volatility presents both opportunities and challenges for the Indian economy. The RBI's proactive management through market interventions, interest rate adjustments, and utilization of forex reserves helps mitigate the negative impacts and promote a stable exchange rate environment, fostering economic growth and development. However, maintaining a stable exchange rate requires a delicate balancing act, and the RBI's effectiveness depends on various external factors beyond its direct control.

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