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Opinion

Forces behind the falling rupee

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The Indian rupee has been depreciating since October 2024. On January 8, the third day of the first full working week in the New Year, the fall in the value of rupee was still unabated. . The rupee opened at Rs 85.82/US$ and touched the lowest-ever level of Rs 85.89. The irony is India's foreign exchange reserves (Forex) touched historically the highest figure of US$ 705 billion on the weekending September 27 with the exchange rate Rs 83.79/US$.

The fall commenced after the big bang cut of 50 basis points (bps) on September18 by the United States (US) Federal Reserve (the Fed) in its policy interest rate from 5.50% to 5.0%, The Fed effected two more subsequent cuts before the end of the year by 25 bps on November 7 just after Donald Trump's victory in the presidential election and by another 25 bps on December 18. The markets in USA were pleased with three cuts raising hopes of recovery. Meanwhile, the economists started debating whether the US economy was nearing "a neutral interest rate" , where growth has been commendable at 2.7 per cent with inflation (2.7 per cent), slightly above the Fed target rate of 2 per cent. Is the US economy closer to tasting the fairytale "Goldilocks soup, neither too hot nor too cold"?.

The US dollar on the roll

A very optimistic picture of the future of the US America emerged, after Trump entered the election with his slogan : "Make America Great Again" and a slew of campaign promises. They included big reduction in the rate of corporate tax, from 21% to 15%, and bringing back from China, the US owned manufacturing companies. Threats of high tariffs on imports followed – 100 per cent on imports from China, and 60 per cent on those from India, which he called "the king of tariffs."

These utterances instigated the "hot money" outflows from the emerging economies to the US. Foreign portfolio investors (FPIs), known for their fickle mindedness were highly impressed with campaign promises by Donald Trump . As their interests are only in short term gains, they pulled out their investments in stocks and bonds from emerging economies. As US dollar inflows rose, the dollar strengthened!

We often heard how if America catches cold, the less developed countries would get pneumonia. Now, we have seen if US is hale and hearty, the developing economies will face the outflows of capital, which will leave them "high and dry", pushing down other currencies down. Yet, the rupee performed well in 2024. It went down only by 2.8%, when currencies of other emerging economies, including Brazil's real (20%), Mexico's peso (18%) and Korea's won (12%) depreciated much against the US dollar

Navigating man-made shocks

One effective tool which was systematically employed by India in similar situations earlier has been Reserve Bank of India (RBI)'s foreign exchange market intervention. It was resorted to again. RBI began selling dollars to reduce the volatility. Critics say under the floating exchange rate regime, India should permit the exchange rate to be determined by market forces. The IMF in 2023, the post-Covid 19 era, advised India that instead of intervening, "a flexible exchange rate should act as the first line of defence in absorbing external shocks.".

But, Indian economy is not diversified as USA and China . The shocks are not natural shocks. They are created by policies which are not in global interest: protectionism, threats of tariffs, and inducing manufacturing units shifting to US to produce behind tariff wall., It is the US dollar which is strengthening. Further, all emerging and developing countries were impacted by the dollar's rise. Their capital outflows became inflows to the US. Theoretically, a depreciation of the rupee renders Indian exports cheaper to the importers outside. However, that demand for Indian exports abroad is relatively price inelastic. Hence Indian exporters do not have any chance of making big money. On the last occasion in 2022, the narrow range within which India's exchange rate fluctuated had led to the impression that India intervened excessively aiming at a particular exchange rate.

The RBI assured that it did not target any specific exchange rate. Its intervention in the foreign exchange market is "both ways only to tackle undue volatility." In October, 2023, the then RBI Governor Shaktikanta Das told IMF officials that market intervention should not be viewed in "black and white, the term is more nuanced, as emerging market economies have to deal with consequences of policy actions of the countries in developed world.".

Time has come to place much greater emphasis on export -oriented growth. Trade is the engine of growth in a globalized world. Closer integration with global value chains is needed.

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