New Year 2025 brings fresh challenges to the stability of the Indian Rupee

■ *Dr. T. K. Jayaraman*

As 2025 begins, it's heartening to read some good, optimistic news. According to the latest monthly report from the Ministry of Finance (MoF), the Indian economy is projected to grow by 6.5% in the fiscal year (FY) 2025, compared to 8.1% in FY 2024. The report notes that the Reserve Bank of India's (RBI) reluctance to end its monetary tightening policy, adopted in early 2023, has contributed to the slowdown, despite a downward trend in inflation in July and August 2024. The RBI's Monetary Policy Committee (MPC) met on December 6, 2024, and decided to maintain the policy interest rate at 6.5% based on October inflation data (6.21%).

By routine procedure, the data processing for the whole nation as well for states and rural and urban and checking and approval for release takes a fortnight and so the data for the month is released in the second week of the following month. I have pointed out for the past six years, that the MPC should consider holding its bimonthly meeting in the third week of each month, allowing access to the previous month inflation data. It would be beneficial for the new RBI Governor, Sanjay Malhotra, to reschedule his first MPC's meeting, in February 2025 to the third week, instead of holding it on February 5-7, 2025.

Now for the good news

The MoF report acknowledges the global slowdown and domestic structural weaknesses that have contributed to a decline in growth, with the economy slowing to 6.7% in Q1 (April-June) and 5.4% in Q2 (July-September) of FY 2025. This follows a period of high growth, with India recording 8.2% in FY 2024. In his last MPC meeting, the outgoing Governor Shaktikanta Das, whose term was coming to end on December 10, noted that inflation remained stubbornly high. He, therefore, decided, based on October's inflation data, to keep the policy rate unchanged at 6.5%. However, the RBI did reduce the cash reserve ratio (CRR) from 4.5% to 4%, aiming to improve liquidity in the economy while maintaining a neutral policy stance.

Encouragingly, the MoF's Monthly report highlights that inflationary pressures have softened in the last two months (October and November) due to an influx of fresh vegetables and fruits, which helped moderate food inflation. Another positive development is the current account deficit (CAD), which has narrowed slightly to 1.2% of GDP in the second quarter (July-September) of FY25, compared to 1.3% in the same period the previous year. In absolute terms, the CAD stood at $11.2 billion, down slightly from $11.3 billion a year earlier. This moderation can be attributed to increased net services receipts, private transfers, foreign portfolio investment (FPI) inflows, and non-resident deposits.

The growth outlook for the October-December 2024 quarter appears promising, with resilient rural demand. Sales of two- and three-wheelers grew by 23.2% and 9.8%, respectively, while domestic tractor sales also saw strong growth. Urban demand is recovering, with passenger vehicle sales rising by 13.4% year-on-year and domestic air traffic continuing to grow robustly.

Reports received on the eve of the New Year indicate that rural consumption is on the rise, narrowing the gap between rural and urban spending. Additionally, the upcoming budget is expected to include relief measures aimed at boosting middle-class consumption. However, slow growth in the first half of FY 2025 has been attributed to cuts in capital expenditure due to pending elections, heavy rainfall impacting agricultural production, and lingering global uncertainties.

Global concerns

Global concerns have eased somewhat, although fears of trade disruptions remain as the US prepares for the inauguration of President-elect Donald Trump on January 20, 2025. Trump's "Make America Great Again" policies, including corporate tax cuts and incentives for companies returning from China, have already encouraged short-term capital inflows into the US. Meanwhile, the Federal Reserve has reduced its policy rate three times, totalling 100 basis points, from 5.5% to 4.5%. On December 18, 2024, the Fed announced that no further rate cuts were expected for at least six months, with any future cuts likely limited to 50 basis points in 2026. This policy shift comes in response to inflation at 2.7%, slightly above the target of 2%, and strong growth of 2.7% with a low unemployment rate of 4.2%. There is growing speculation that the current rate is approaching a "neutral rate," the level neither too high nor too low, akin to the fairy tale "Goldilocks" soup.

Outflow of short-term capital

As the new year begins, the outlook for India's foreign exchange reserves and the rupee remains a concern. In October and November 2024, there was a significant decline in India's reserves, which had peaked at a record

$705 billion on September 27, 2024. On December 16, 2024, the government informed the lower house of the parliament that the fall in reserves during the week ending November 15, 2024 (2.63%), was not the largest decline in the country's history. The steepest decline occurred during the global financial crisis in October 2008, when reserves dropped by 5.65%. The recent pressure on India's foreign exchange reserves and the Indian Rupee (INR) is attributed to several factors, including capital outflows, fluctuations in the dollar index, rising global interest rates, and increasing crude oil prices. The government has emphasized that the value of the Indian Rupee is determined by market forces, without any fixed target or band.

The RBI has undertaken efforts to reduce volatility in the rupee's value, a routine task for any central bank. It intervenes in the market by selling dollars for rupees to stabilize the currency and buying bonds for putting the equivalent rupees. This process, known as "as sterilized intervention, helps system retaining the required liquidity while ensuring that credit availability to the public remains unaffected and monetary policy remains unchanged. The RBI's approach focuses on maintaining both price stability and exchange rate stability, in line with its independent monetary policy objectives.

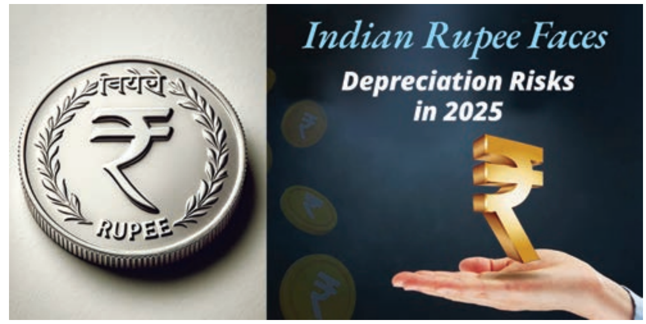
India's Foreign Exchange Reserves and Exchange Rate in 2024

Year: 2024	Forex Reserves US$ (billion)	Exchange Rate Rs/ US $
January	622	83.03
February	646	82.90
March	638	83.39
April	642	83.43
May	647	83.42
June	652	83.37
July	675	83.69
August	684	83.68
September*	705	83.79
OCTOBER		
Weekending 4	701	83.97
Weekending 11	690	84.06
Weekending 18	688	84.08
Weekending 25	685	84.09
NOVEMBER		
Weekending 1	682	84.03
Weekending 8	676	84.34
Weekending 15	658	84.41
Weekending 22	657	84.44
Weekending 29	658	83.99
DECEMBER		
Weekending 6	655	84.69
Weekending 13	653	84.83
Weekending 20	644	85.09
Weekending 27	TBA	85.83

*On 27 September, the highest level of reserves, $705 billion was reached

TBA: to be announced on Jan 3 Friday 2025

Source : Reserve Bank of India

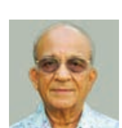


India's interventions to reduce exchange rate volatility are not new. (See my article: The IMF advice: RBI's rebuttal, *Business Economics*, February, 2024). The IMF has frequently criticized such interventions, calling them "excessive" and a divergence from free-market principles. However, these interventions are a response to external shocks, including protectionist policies and rising tariffs, particularly from the US, which have led to a strengthening dollar and capital outflows from emerging economies like India.

While a depreciating rupee can make Indian exports more competitive, demand for Indian goods abroad remains relatively price inelastic. Consequently, the impact on export earnings is limited. In 2022, India's exchange rate regime was re-classified as a "stabilized arrangement" between December 2022 and October 2023, even though the de jure regime remained floating. The IMF argued that a flexible exchange rate should absorb external shocks. However, the RBI has consistently maintained that its interventions aim only to curb excessive volatility and do not target a specific exchange rate. The rebuttal to IMF Article IV Mission 2023 from the then RBI Governor Shaktikanta Das is now part of essential supplementary reading for the post graduate student in *Monetary Economics*.

> "One has to get out of the one-sided approach to call someone a manipulator or a currency stabilizer and put on the watch list. Market intervention should not be viewed in "black and white", … the term is more nuanced, as emerging market economies and developing countries have to deal with consequences of policy actions of the countries in developed world."

Looking ahead, it is clear that India must place greater emphasis on export-oriented growth. In a globalized world, trade is a key driver of economic growth, and closer integration with global value chains will be essential for sustained progress.



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