Depreciation of Indian Rupee

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

For Mains: Impact of Depreciation of Indian Rupee on economy

Why in News?

The Indian rupee fell to an all-time low of **77.44 against the U.S. Dollar.**

What is Depreciation?

- **About:**
    - 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.**
        - It means that the rupee is now weaker than what it used to be earlier.
        - **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.
- **Impact of Depreciation of Indian Rupee:**
    - Depreciation in rupee is a **double-edged sword for the** Reserve Bank of India.
        - **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.
        - **Negative:**
            - It **poses risk of imported** inflation, and may make it difficult for the central bank to maintain interest rates at a record low for longer.
            - India meets **more than two-thirds of its domestic oil requirements through imports.**
            - India is **also one of the top importers of edible oils**. A weaker currency will further **escalate imported edible oil prices** and lead to a higher food inflation.

Appreciation Vs Depreciation

- In a floating exchange rate system, **market forces (based on demand and supply of a currency)** determine the value of a currency.
- **Currency Appreciation:** It is an increase in the value of one currency in relation to another currency.
    - Currencies appreciate against each other for a variety of reasons, including government policy, interest rates, trade balances and business cycles.

        - **Currency appreciation discourages a country's export activity** as its products and services become costlier to buy.
- **Depreciation Vs Devaluation:**
    - If the value of the **Indian Rupee is weakened through administrative action,** it is devaluation.
        - While the **process is different for depreciation and devaluation,** there is no difference in terms of impact.
    - India used to **follow the administered or fixed rate of exchange until 1993,** when it moved to a **market-determined process or floating exchange rate.**
        - **China still adheres to the former.**

What are the Reasons for Current Depreciation of Indian Rupee?

- **Sell-off of the Equity:**
    - A **sell-off in the global equity markets** which was triggered by the hike in **interest rates by the U.S. Federal Reserve** (central bank), the war in Europe and growth concerns in China due to the **Covid-19** surge, led to the rupee depreciation.
- **Outflow of Dollar:**
    - The outflow of dollars is a result of **high crude prices** and the correction in **equity markets is also causing adverse flow of dollars.**
- **Tightening of Monetary Policy:**
    - Steps taken by **RBI to tighten the monetary policy** to counter rising **inflation** has also led to depreciation.

How the Depreciation of Rupee Impact the Overall Economy?

- The **current account deficit** is bound to widen, depleting **foreign exchange reserves** and **weakening the rupee.**
- With higher landed prices of crude oil and other crucial imports, the economy is **definitely inching towards cost-push inflation.**
    - Cost-push inflation (also known as wage-push inflation) occurs **when overall prices increase (inflation) due to increases** in the cost of wages and raw materials.
- **Companies may not be allowed to fully pass on the burden of high costs** to consumers, which, in turn, affects government dividend earnings, raising questions about budgeted **fiscal deficits.**

UPSC Civil Services Examination, Previous Year Questions

Q. Which one of the following is not the most likely measure the Government/RBI takes to stop the slide of 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)

- Currency depreciation is a fall in the value of a currency in a floating exchange rate system. Currency depreciation can occur due to factors such as economic fundamentals, interest rate differentials, political instability or risk aversion among investors. India follows the floating exchange rate system.
- **Curbing imports of non-essential goods will lessen the demand for Dollars** and promoting export will help in increasing the flow of Dollars into the country, thus, helps in control rupee depreciation.
- The **Masala Bond is directly pegged to the Indian currency.** If Indian borrowers issue more

rupee denominated Masala Bonds, this would increase liquidity in the market or increase in the rupee stock against few currencies in the market and this would help in supporting the rupee.
- **External Commercial Borrowing (ECB) is a type of loan in foreign currencies,** made by non-resident lenders. Thus, easing conditions of ECB's helps in receiving more loans in foreign currencies would increase the inflow of forex, leading to rupee appreciation.
- **Expansionary monetary policy is set of policy measures used by the RBI to stimulate the economy.** It will lead to the money supply in an economy. However, it may not influence the variations of rupee value.
- Therefore, option (d) is the correct answer.

Q. Consider the following statements:

The effect of devaluation of a currency is that it necessarily

1. improves the competitiveness of the domestic exports in the foreign markets
2. increases the foreign value of domestic currency
3. 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)

Exp:

- Currency devaluation is the deliberate reduction in the value of a country's currency against another currency. The main effects of currency devaluation are:
  - Exports become cheaper to foreign customers
  - Imports become expensive
  - In the short-term, a devaluation tends to cause inflation
  - Higher employment and faster GDP growth
- A country pursues a policy of devaluation to boost its exports as its products and services become cheaper to buy. In other words, the competitiveness of domestic exports improves in the foreign markets. Devaluation will not increase the foreign value of domestic currency. **Hence, 1 is correct and 2 is not correct.**

Source: TH