All about Exchange Rate

What is the issue?

Recently, the Indian rupee hit an all-time low exchange rate of 77.6 against the US dollar.

What is exchange rate?

- An exchange rate is the value of one nation's currency versus the currency of another nation or economic zone.
- Typically, exchange rates can be free-floating or fixed.
- A free-floating exchange rate rises and falls due to changes in the foreign exchange market.
- A fixed exchange rate is pegged to the value of another currency.
- The rupee’s exchange rate vis-a-vis a particular currency, say the US dollar, tells us how many rupees are required to buy a US dollar.

> *Currency depreciation is a fall in the value of a currency in terms of its exchange rate versus other currencies. It can occur due to factors such as economic fundamentals, interest rate differentials, political instability, or risk aversion among investors.*

How is the exchange rate determined?

- **Supply and demand of the currency**- In a free-market economy, the exchange rate is decided by the supply and demand for rupees and dollars.
- For instance, if the Indians demand more dollars in comparison to Americans demanding the rupee, the exchange rate will fall or weaken for rupee and rise or strengthen for dollar.
- **Central bank intervention**-In India, the exchange rate is not fully determined by the market.
- From time to time, the RBI intervenes in the foreign exchange market to ensure that the rupee price does not fluctuate too much or that it doesn’t rise or fall too much all at once.

What determines the rupee’s demand and supply?

- The rupee’s demand and supply vis-a-vis other currencies is best understood by looking at India’s **Balance of Payment (BoP).**
- The balance of payments (BOP) is a statement of all transactions made between entities in one country and the rest of the world over a defined period.
- It summarizes all transactions that a country's individuals, companies and government bodies complete with individuals, companies and government bodies outside the country.
- The balance of payments includes the
  - Current account
  - Capital account
- **Current account**- It refers to all transactions that are related to current consumption including a nation's net trade in goods and services, its net earnings on cross-border

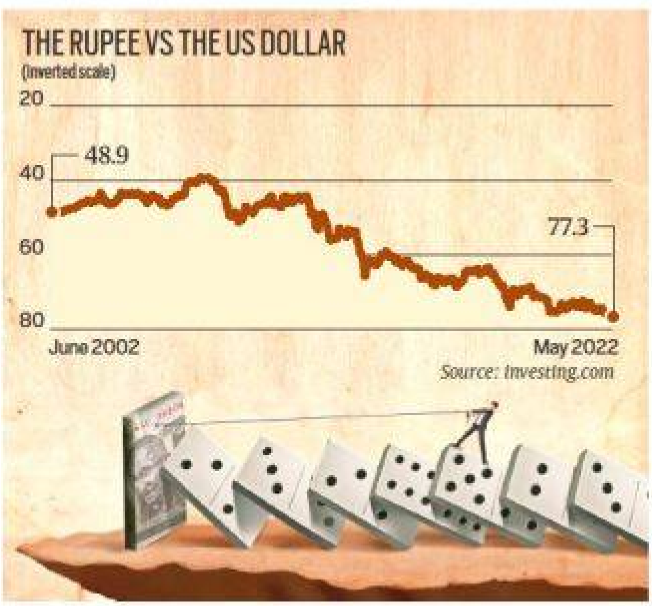
investments, and its net transfer payments.

- **Capital account**- It refers to transactions for investment purposes and consists of a nation's transactions in financial instruments and central bank reserves.

The sum of all transactions recorded in the balance of payments should be zero; however, exchange rate fluctuations and differences in accounting practices may hinder this in practice.

How does the rupee's exchange rate fluctuate?

- **Crude oil prices-** When crude oil prices go up sharply, India would need more dollars to buy crude oil in the international market.
- That would weaken the rupee because India's demand for dollars would have gone up while the world's demand for the rupee stayed the same.
- This would show up as a trade deficit as well as the current account deficit in the BoP table.
- **US central bank's interest rates-** If the US central bank raises its interest rates, global investors who had been putting their money in India would consider taking it out and investing in the US.
- Again, the rupee would weaken and such a transaction would be recorded in the capital account.



Getty Images

INDIA'S BALANCE OF PAYMENT ($ bn)

	April-December 2021
Current account deficit	-26.6
Trade deficit (Goods export – import)	-135.6
Invisibles surplus (a+b+c)	109.0
a. Services	79.2
b. Transfers	59.3
c. Income	-29.3
Capital account surplus (a to f)	90.1
a. Foreign investment	24.9
(i) Foreign Direct Investment (FDI)	26.5
(ii) Foreign Portfolio Investment (FPI)	-1.6
b. Banking Capital	12.6
c. Short term credit	13.3
d. External Assistance	2.7
e. External Commercial Borrowings	4.9
f. Other items in capital account	31.7
Total change in forex	-63.5

Source: RBI, Express Research

What is the RBI's role in this?

- The most important thing about the BoP is that the balance of payment always balances i.e., a deficit in the current account must be balanced by a surplus in the capital account, or vice versa.
- RBI plays a crucial role in balancing the massive fluctuations.
- To soften the rupee's fall, the RBI would sell in the market some of the dollars it has in its forex reserves.
- This will soak up a lot of rupees from the market, thus moderating the demand-supply gap between rupee and dollars.

What will be the impact of a weaker rupee?

Negative impacts

- **Inflation**- The biggest impact of a weakening rupee is on inflation, given India imports more than 80% of its crude oil, which is India's biggest import.
- **Imports**- A depreciation of the domestic currency results in higher import costs for the country.
- India is also heavily dependent on other countries for fertilizers and edible oils and the country's fertilizer subsidy bill is already set to hit a record high of as much as Rs 1.9 trillion this fiscal.
- **Forex reserves**- India's foreign exchange reserves have fallen below $600 billion for the first time in a year as the RBI intervened in the forex market to defend the rupee.
- **Foreign education**- Foreign travel and overseas education becomes costlier.
- **Interest-** The interest burden would increase on foreign currency denominated debt.
- **Investor confidence-** A large and rapid devaluation may scare off international investor and makes investors less willing to hold government debt

Positive impacts

- **Exports**- Exports become cheaper, more competitive to foreign buyers providing a boost for domestic demand.
- **Local industry**- Travel to India gets cheaper and local industry may benefit.
- **Remittance**- Those working abroad can gain more on remitting money to their homeland.
- **Current account deficit**-It assists in reducing the current account deficit.

References

1. https://indianexpress.com/article/explained/explained-making-sense-of-exchange-rate-7910455/
2. https://www.business-standard.com/podcast/economy-policy/how-a-weaker-rupee-will-impact-the-indian-economy-and-people-122051100115_1.html#:~:text=The%20biggest%20impact%20of%20a,will%20add%20to%20inflationary%20pressures.
3. https://www.investopedia.com/terms/e/exchangerate.asp
4. https://www.investopedia.com/terms/b/bop.asp
5. https://www.mbarendezvous.com/general-awareness/a-weak-indian-rupee-advantages-and-disadvantages/