Significance of a Competitive Exchange Rate

What is the issue?

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Major economies like China are using the instrument of competitive exchange rates for a stabilized economy, which India can also follow.

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What is Rupee appreciation?

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- Exchange rate is the price of foreign currency (USD, Yen, Euro, Pound etc) in terms ofdomestic currency (rupee) i.e. amount of domestic currency needed to buy one unit offoreign currency.
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- Exchange rate tells us the value of domestic currency in relation to one unit of foreign currency.
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- Rupee prices keep fluctuating all the time. Sometimes we need more rupees to buyone unit of foreign currency and sometimes we need fewer rupees to buy one unit offoreign currency.
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- This change in rupee price is known as rupee appreciation or depreciation.
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- Rupee appreciation is when value of rupee increases (becomes expensive) and fewer, when Rupees can buy one unit of foreign currency.
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- This is also known as strengthening of rupee as now INR is worth more than foreign currency.
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What are economic concerns before India?

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- India's demographic dividend is on the verge of becoming a curse as it is

unable to create new jobs fast enough for its growing young population.
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- In the discussion on improving the business case for value addition and job creation in India, the critical importance of the exchange rate hardly gets any attention.
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- India is not yet able to take advantage of its low wages and the inherent talent of its young people to get enough investment, both domestic and foreign, into job creation and value addition.
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- India has been for years the largest recipient of capital inflows from its expatriate community who send remittances.
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- In addition its stock market has been attractive enough for FIIs (Foreign Institutional Investors).
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- Such inflows when not matched by higher rates of investment in the economy usually lead to asset price bubbles in the stock and real estate markets, in addition to an appreciation of the exchange rate and decline in competitiveness.
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- In India the perception among political and civil society elites has been that a strong currency is a sign of economic strength and depreciation is a sign of economic weakness.
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How rupee appreciation will be beneficial for Indian economy?

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- The movement of the real exchange rate, the nominal rate adjusted for the differential in inflation rates with major trading partners, has a similar effect as changes in tariff rates.
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- A 10 per cent real exchange rate appreciation is equivalent to a 10 per cent lowering of tariffs across the board and a 10 per cent depreciation is equivalent to a 10 per cent increase in tariffs.
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- The greater the depreciation the higher is the impact on the business case for domestic value addition.
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- This impact is experienced not only by exporters but also by those who serve

the domestic market as imports become cheaper with appreciation and more expensive with depreciation.
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- India's trade deficit with China is over $60 billion, all that is being imported from China can be made in India.
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- Appreciation is beneficial to FIIs as the gains from the increase in the prices of their stocks in India can be taken out fully.
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- Similarly, large corporates who have foreign currency debt gain as the real debt repayment burden declines with appreciation.
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- The wealthy Indian has to pay less for his holidays, child's education overseas and consumption of imported chocolates and cheeses.
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What measures needs to be taken?

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- Investments, which need a competitive exchange rate, could be seriously considered only if there is the expectation that henceforth the real exchange rate would not be allowed to appreciate.
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- For this, a consensus on the imperative need for maintaining a competitive exchange rate as a necessary precondition for increasing value addition and job creation in the country would be needed.
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- This should then become a clearly enunciated policy objective of the RBI with explicit backing of the government.
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- The policy instruments that could be used could include building up of reserves, and reviewing the liberal tax regime for FIIs as well as the encouragement of foreign currency borrowings by large corporates.
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- This is a necessary condition for improving the business case for value addition and job creation.
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Source: Business Line

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Quick Facts

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Nominal Exchange Rate

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- Nominal exchange rate means a rate by which you can exchange your domestic currency with the foreign currency at any financial institutions like banks, NBFCs etc.
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- It is the value of money which is received in an exchange with another currency.
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- So in short, the nominal exchange rate is the rate which is presented by the financial institutions.
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- If the Nominal exchange rate is high it will benefit an economy a lot in the trading activities.
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- If it is high, the goods and services get more foreign units
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- If there is a change in the Exchange rate, Nominal Exchange rate is less affected as compared to the Real exchange rate.
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Real Exchange Rate

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- The real exchange rate is a rate which measures how many times an item of goods purchased locally can be purchased abroad.
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- So, it indicates the ratio of items purchased in the domestic market to the items purchased in the foreign market.
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- Real exchange rate actually determines the ratio of price in the local market to the price in the foreign market.
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- So, it indicates the goods and services consumed as compared to another country.
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- It is complex and also a difficult method to calculate the real exchange rate, thus it measures the purchasing power of domestic currency to the foreign currency at a prevailing time.
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- Real exchange rate is highly affected by the change in the exchange rate in the global market.
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Source: Business Line

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