# Strengthening of Rupee

## Why in news?

From 2014, the rupee has depreciated by 27.6% against the US dollar, from Rs 60.34 to Rs 83.38.

## What is currency depreciation?

- **Currency depreciation**- It refers to a decrease in the value of a country's currency relative to other currencies in the foreign exchange market.
- It means that the currency can buy fewer units of another currency or goods and services in international markets.

| Key aspects | Depreciation | Devaluation |
|---|---|---|
| **About** | It implies the dip in the value of currency in relation to other currencies, due to market forces. | It means the fall in international value of home currency in terms of other currencies due to government intervention. |
| **System** | It exists under flexible exchange rate system | It exists under fixed exchange rate system |
| **Process** | Automatic | Deliberate |
| **Occurs due to** | Market demand and supply factors | Government intervention |

- **Trade imbalance**- If India's imports exceed exports, there is higher demand for foreign currencies (like the US dollar) to pay for these imports, this increased demand for foreign currency that can lead to depreciation of the domestic currency.
- **Differential inflation rates**- If India's inflation rate is higher than that of its trading partners, the purchasing power of the rupee decreases relative to other currencies.
- **Interest rate differentials**- If interest rates in the US are higher than in India, investors may seek higher returns by investing in US assets. This can increase demand for US dollars, causing the rupee to depreciate.
- **Market speculation**- Investor perceptions of India's economic and political stability, as well as global economic trends, can influence currency markets.
- **Capital flows**- In times of uncertainty or when there are better investment opportunities abroad, capital may flow out of India, increasing demand for foreign currencies and putting downward pressure on the rupee.
- **External factors-** Events such as changes in global oil prices, geopolitical tensions (Russia-Ukraine war, Israel Hamas conflict etc.,)or monetary policy decisions by major central banks can also impact the value of the rupee against the US dollar.
- **Effective Exchange Rate (EER)-** India trades with countries other than US, hence the strength or weakness of rupee is a function of its exchange rate with not just US

dollar but also with other global currencies.

*The types of effective exchange rate are Nominal Effective Exchange Rate (NEER) and Real Effective Exchange Rate (REER)*

## How does effective exchange rate impact trade?

- The EER is an index of the weighted average of the rupee's exchange rates vis-à-vis the currencies of India's major trading partners.
- The currency weights are derived from the share of the individual countries to India's total foreign trade, just as the weights for each commodity in the CPI are based on their relative importance in the overall consumption basket.

| NEER | REER |
|---|---|
| • It is a measure of the value of India's currency against a weighted average of several foreign currencies.<br>• It is calculated using nominal exchange rates, which are the actual exchange rates in the foreign exchange market without adjusting for inflation.<br>• It reflects changes in the external value of the currency relative to its trading partners<br>• It is useful for understanding how a country's currency is performing in international trade without considering inflation differentials. | • It adjusts NEER for inflation differentials between India and its trading partners<br>• It takes into account both nominal exchange rates and relative price levels (*inflation rates*) between the India and its trading partners.<br>• By factoring in inflation, REER provides a more accurate measure of a country's currency's real purchasing power in international markets<br>• It helps assess whether a country's currency is overvalued or undervalued in real terms by comparing its current value to a base period value adjusted for inflation. |

### Impact on Exports

- **Depreciation**- A depreciation of the domestic currency (a decrease in its value relative to other currencies) can make *exports cheaper* for foreign buyers.
- This is because foreign buyers need to spend less of their own currency to purchase goods and services denominated in the depreciated currency.
- Therefore, a weaker exchange rate (both NEER and REER) tends to boost exports by enhancing their competitiveness in international markets.
- **Appreciation-** It can make *exports more expensive* for foreign buyers, potentially leading to a decrease in export competitiveness.

### Impact on imports

- **Depreciation-** It makes imports more expensive for domestic consumers, this is because domestic consumers need to exchange more of their own currency to purchase goods and services denominated in foreign currencies.
- As a result, a weaker exchange rate (both NEER and REER) tends to reduce imports by increasing their costs for domestic consumers.
- **Appreciation**- It makes imports cheaper for domestic consumers, potentially leading

to an increase in import levels.
- Overall, while both NEER and REER influence a country's trade balance by affecting the competitiveness of exports and the cost of imports, REER provides a more accurate assessment by considering inflation differentials.

| BASIS | DEPRECIATION | APPRECIATION |
|---|---|---|
| | | |
| **Meaning** | It refers to decrease in the value of domestic currency in relation to foreign currency. | It refers to increase in the value of domestic currency in relation to foreign currency. |
| **Causes** | (1) Increase in demand<br>(2) Decrease in supply | (1) Decrease in demand<br>(2) Increase in supply |
| **Effect on Exports** | It leads to increase in exports because more goods can be purchased with the same amount of currency. | It leads to decrease in exports because less goods can be purchased with the same amount of currency. |
| **Effect on Imports** | It leads to decrease in imports because the domestic country needs to pay more to get the same amount of goods and services. | It leads to increase in imports because the domestic country will have to pay less to get the same amount of goods and services. |

## Reference

[Indian Express- Rupee strengthened in India]