Is the Rupee "Weakening"?*

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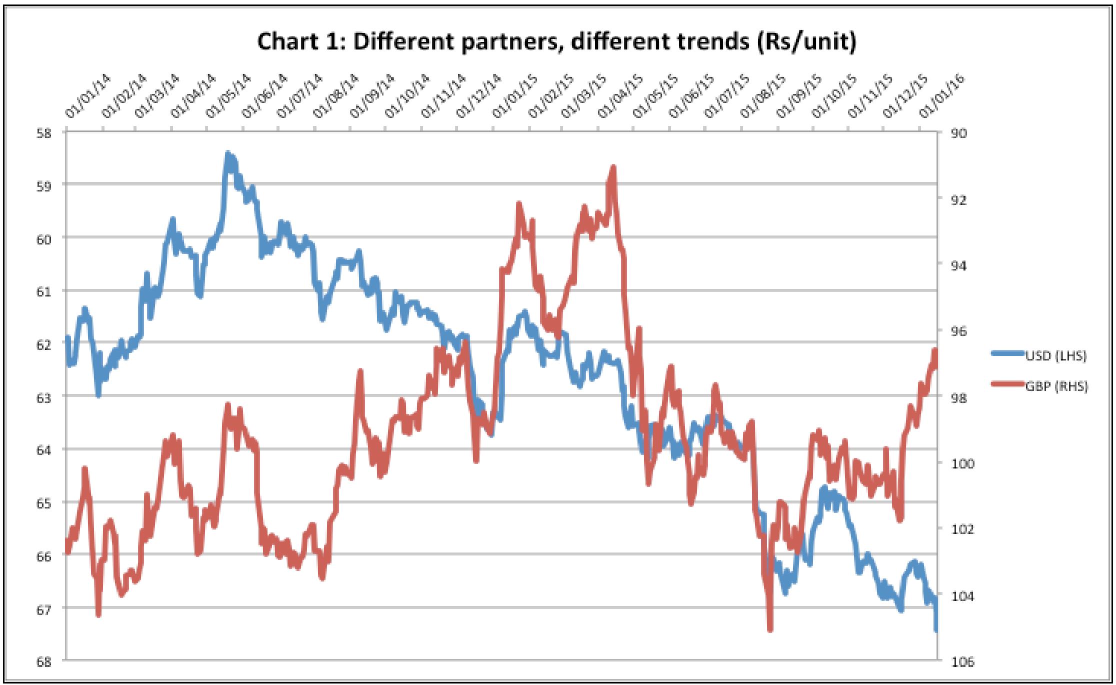
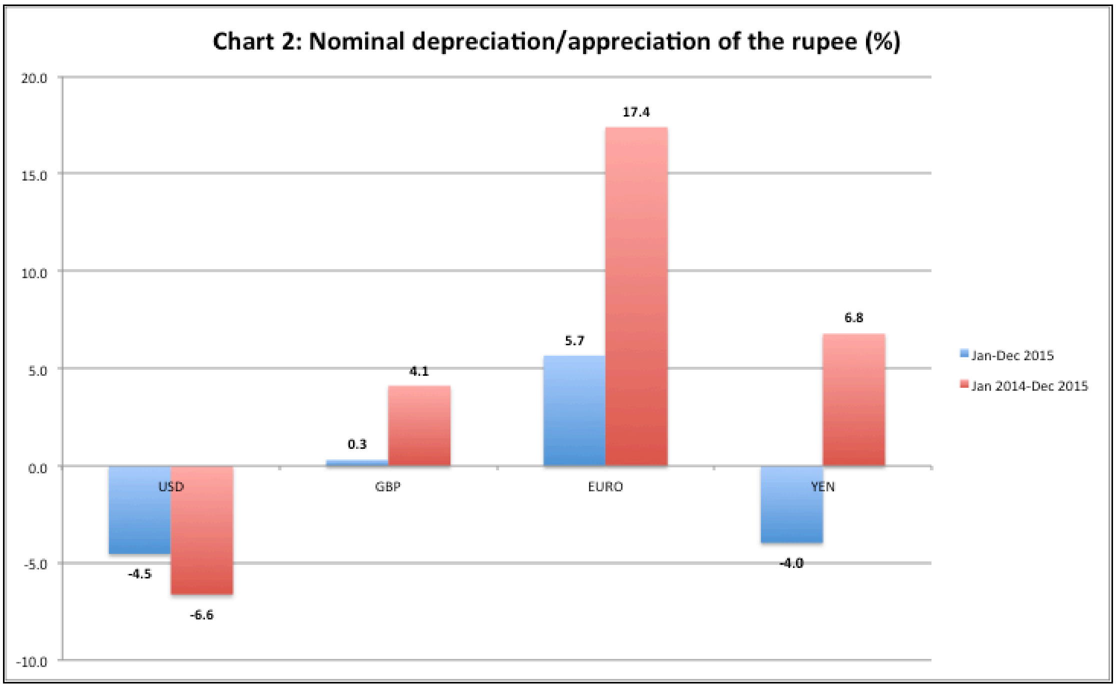
Analysts and commentators are expressing much concern about the weakening rupee. Much of this is based on short-term trends possibly fuelled by capital exit in the context of the collapse in both oil prices and the Chinese stock market. For example, over the last two days of the week ending January 15, the rupee depreciated to the tune of 74 paise vis-à-vis the dollar, or by 1.1 per cent. That is indeed significant for a period as short as that. But starting from these near term trends, which are extrapolated to the longer term, the argument is that the rupee is in long-term decline. The rupee, one report for example declared, had on January 15 touched a 28-month low relative to the dollar, suggesting that the depreciation is a long-term or possibly secular trend.



Relative to the dollar this does indeed seem true. From a level of Rs. 58.4 to the dollar in May 2014, the RBI's reference rate fell to a low of Rs. 67 by mid-December 2015. That is a sharp depreciation of 14.7 per cent over a year-and-a-half. But there are two points to be noted here. First, while the rupee has depreciated vis-à-vis the dollar, it has not reflected any clear trend vis-à-vis the British pound (GBP) (Chart 1), with appreciation overall (Chart 2). Relative to the Euro and the Yen too the cumulative movement over 2014 and 2015 seems to be one of appreciation. Overall, if we look at the end-2015 level relative to those a year and two years earlier, marginal appreciation vis-à-vis the GBP, significant appreciation vis-à-vis the euro and a mixed picture relative to the yen is what emerges.Thus, the depreciation of the rupee is essentially against the dollar, though this does matter since most transactions in international trade are dominated in dollars.

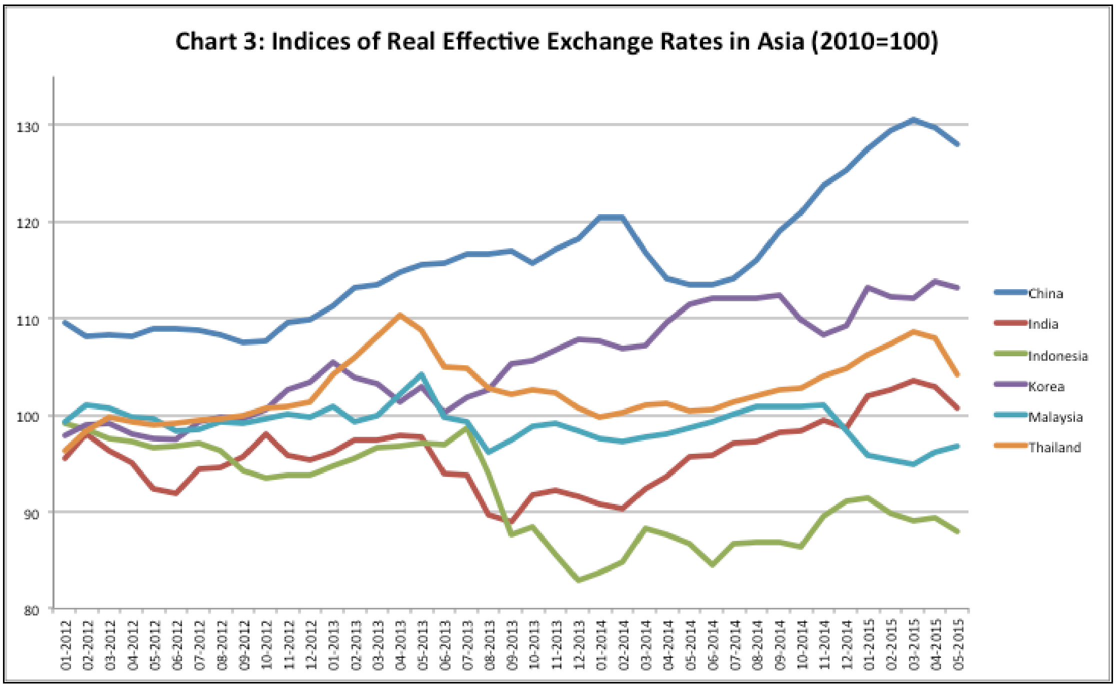


Second, even vis-à-vis the dollar the rupee's value has been volatile. Over 2015 as a whole the depreciation relative to the dollar was 4.5 per cent, while compared with its value at the beginning of 2014 it was just 6.6 per cent. So much of the depreciation has been more recent.

Third, the nominal depreciation of the rupee vis-à-vis the dollar does not reveal in full the impact it has on India's changing competiveness relative to its trading partners. Conventionally, a devaluation, which would reduce the dollar value of exports, is seen as increasing a country's export competitiveness. But the dollar has appreciated against most currencies, which means depreciation relative to the dollar is a generalised phenomenon. Any individual country's competitiveness declines if competing countries record a steeper nominal devaluation of their currencies vis-à-vis the dollar.

Moreover, inflation matters. If the relative rate of inflation is higher in one country, this would neutralise the benefits it gets from a given depreciation of its currency, since the local currency value of its exports rise. To capture this, analysts refer to the real effective exchange rate, which takes account of relative depreciations of currencies with respect to those of their main trading partners and the relative rates of inflation. The Bank for International Settlements has recently released a dataset on real effective exchange rates (REERs) in a large group of countries, taking into account the six most important trading partners of each and calculating an index that captures the change in value of the country's currency relative to this trade-weighted group and after adjusting for relative rates of inflation.

Chart 3 present the movements of the REERs of major Asian countries who can be seen as potentially India's principal competitors in the region. What emerges is that the six-currency, trade-weighted real effective exchange rate does not reflect the depreciation that the nominal rupee-dollar movements suggest. During 2012 and the first 3 quarters of 2013 most of these countries had a relatively stable REER, with only China and Thailand showing signs of real exchange rate appreciation. Since the last quarter of 2013, while Thailand, Malaysia and Indonesia have been characterised by currency depreciation, China, Korea and India have experienced appreciation. Real appreciation of India's trade-weighted real exchange rate seems to be sharp, even if less than China's. In fact relative to competing nations in Asia, starting early 2014 India has gained only relative to China, and lost out relative to Indonesia, Korea, Malaysia and Thailand. Clearly, a lower rate of depreciation of the rupee vis-à-vis the dollar, when compared to many other currencies, and the higher relative rate of inflation in India have led to the decline in competitiveness that the appreciation of the six-currency trade weighted exchange rate indicates.



This is not to say that India faces no threat to the stability of the rupee. The recent sharp depreciation of the rupee vis-à-vis the dollar suggests that capital exit can lead to devaluation. This is in addition to the effects of the strong dollar resulting from signs of a recovery from recession in the US and the observed long-term inverse relationship between oil prices and strength of the dollar. The proposed hikes in interest rates by the US Federal Reserve may also enhance the dollar's strength. Put together, appreciation of the dollar and depreciation of the rupee can be quite substantial. This is a real danger because it occurs at a point when India is likely to have exhausted the benefits that the sharp fall in the value of oil imports and increased remittances from workers abroad can have for its balance of payments. Oil prices cannot go much below the $30 a barrel they have reached and contraction in oil exporting countries is bound to affect remittances. So the strength the rupee derives from a reduced current account deficit (projected at 1-1.3 per cent of GDP for this financial year) may not last.

That makes the strength of the rupee dependent on large capital inflows. If the flight to safety to the US and the effect of rising interest rates in the US result in a squeeze on capital inflows, then the a precipitous depreciation could well follow. In sum, it is not the rupee's past record that is the problem. Rather, its likely direction in the near future is a cause for concern.

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