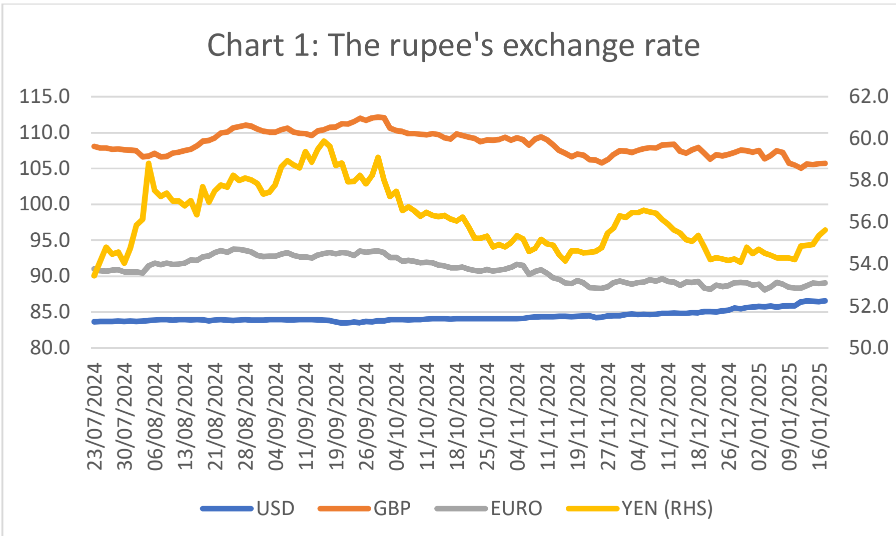
The odd behaviour of the rupee

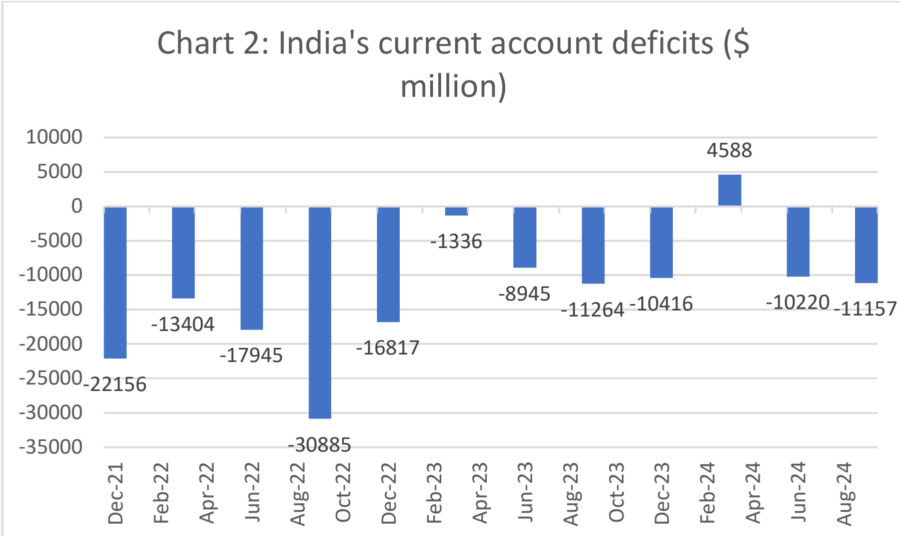
C.P. Chandrasekhar and Jayati Ghosh

If a spate of recent headlines in the media is to be believed, the rupee is in free fall. That is true when the rupee's value vis-à-vis the dollar is the sole focus. While the rupee stood at 84.1 to the dollar at the beginning of November 2024, its value has fallen to touch 86.6 to the dollar by the 17th of January 2025 (Chart 1). Given the time span involved that depreciation is significant.

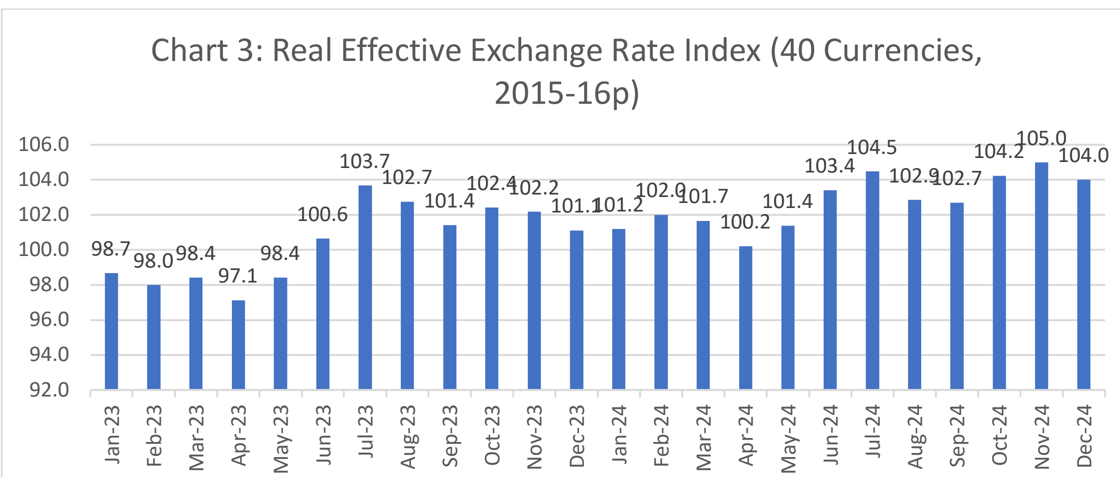


This fall could be interpreted as a result of weaknesses on the external front. The current account in India's balance of payments is chronically in deficit and has been so in all but one of recent quarters (Chart 2). In addition, there is recent evidence of a net outflow of foreign portfolio investments from the country following uncertainty over interest rate movements in the developed nations. Given these features, sole focus on movements of the rupee vis-à-vis the dollar makes the depreciation a signal of external weakness. It also raises questions about the Reserve Bank of India's ability to intervene in the market to stabilise the rupee. Foreign exchange reserves with the central bank have fallen by $23.5 billion over the five weeks ending January 10 and were, at $625.9 billion, $79 billion short of their previous peak at the end of September 2024. While this is the result of the Reserve Bank of India's market intervention in the form of sales of the dollar to stabilise the rupee's fall, the appetite for such intervention falls as reserves shrink.

In sum, it could be argued that the depreciation of the rupee is a sign of balance of payments vulnerability. This is indeed true in the long run, because ever since the adoption of a flexible exchange rate managed through market intervention, the rupee has been in steady decline. In January 1995 the rupee's value was 31.4 to the dollar. It fell to 43.6 to the dollar by January 2000 but fluctuated around that level till the onset of the financial crisis in the developed world in mid-2008 which led to an exit of capital from India. That resulted in a sharp depreciation to 50.2 to the dollar in April 2009. For almost 3 years after that the rupee's value vis-à-vis the dollar remained below that level, after which it fell to 61.8 in January 2015, 71.5 in January 2020, and above 86.6 in mid-January 2025.



These variations in the extent and speed of depreciation do suggest that the long-term structural weakness in India's balance of payments cannot be the sole determinant of the rupee's movements. This view is strengthened by the evidence that during the recent fall in the value of the rupee vis-à-vis the dollar, it has actually appreciated relative to the currencies of other trading partners. Adjusting for differences in inflation rates, it turns out that the 'real' effective exchange rate index of the rupee, computed using currencies of 40 export partners, has risen and ruled high in recent months (Chart 3).



The explanation for this lies in the fact that the movements in the rupee vis-à-vis the dollar reflect the appreciation of the dollar against most of the world's currencies. But since the consequent depreciation has been lower (after adjusting for inflation) for India than for many of its trading partners, the rupee has appreciated against those currencies, leading to the contrary trends in its nominal exchange rate relative to the US dollar and its real effective rate. To the extent that India trades goods and services denominated in the currencies of partners whose exchange rates are depreciating not just against the dollar but also the rupee, this trend undermines the competitiveness of India's exports. That partly explains the reticence of the Reserve Bank of India to stall in full the rupee's fall vis-à-vis the US dollar. The central bank is forced to display such reticence for this reason, even though, with a large proportion of Indian imports being denominated in dollars, the depreciation of the rupee vis-à-vis the dollar spurs domestic inflation. Managing both the exchange rate and inflation is proving tricky for the central bank.

It follows that the story that needs to be told to explain the dollar-related depreciation of the Indian rupee is one that elucidates the reasons for the dollar's appreciation. One factor underlying that appreciation is of course the rise in US interest rates, which has attracted capital back to the US or into dollar-denominated, US financial assets. That 'flight' into the dollar is strengthening the currency. It is also encouraged by signals that the pace of reduction of US interest rates is going to be lower than initially expected.

The other factor contributing to the strengthening of the US dollar is a version of the "Trump effect". With Trump having declared his intention to significantly raise tariffs on imports into the US, not just from China but from the rest of the world, there is a strong likelihood of a significant rise in demand for and therefore output of US products. Since this increased absorption of domestic output would be at the expense of imports, it would also improve the balance of trade of the US. That can only be positive for the dollar.

Expectations of such developments combine with the flight to US dollars, to encourage speculative holding of dollar denominated financial assets. That in turn further strengthens the dollar, leading to an across-the-board depreciation of the currencies of other countries. But that depreciation is not the same across countries and depending on variations in the rate of inflation affects the export competitiveness of these countries vis-à-vis each other. Since India is losing out in terms of such competitiveness, the Reserve Bank of India is holding back on preventing the slide of the rupee relative to the dollar.

(This article was originally published in the Business Line on January 20, 2025)