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Despite pressures, the rupee's remarkable resilience

Even as the rupee has fallen sharply against the dollar, the depreciation has been relatively lower unlike previous times

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The Indian rupee has depreciated by around 7% against the U.S. dollar, since the start of the year, in response to various domestic and global factors. Specifically, a widening current account deficit, persistent risk-off sentiment as a result of geopolitical tensions, 'a strengthening dollar index, and continuous sell-off by foreign portfolio investors have all put pressure on the rupee'.

Safe-haven demand

It must be noted that the dollar has strengthened against all currencies, developed or emerging. The runaway inflation levels since last year, which have seen consumer price index (CPI) inflation in the United States reaching a multi-decade high of 9.1% in June 2022, have prompted the reversal in the monetary policy stance of the US Federal Reserve. With inflation rising unabated, the Fed is widely expected to continue raising interest rates. Unsurprisingly, the rate hiking cycle by the US Federal Reserve has precipitated the dollar's appreciation which has led the dollar index to strengthen by over 11% in 2022 so far, taking it to a 20-year high.

As a result of higher risk-free returns being available in the U.S., there have been persistent outflows of foreign portfolio capital since October 2021, which, on a cumulative basis, stands at $30 billion this year. This has intensified the downward pressure on the rupee. The safe-haven demand for the dollar amid geopolitical risks has bolstered the dollar index.

The Reserve Bank of India (RBI) has stepped in to arrest a large depreciation in the currency, with interventions in the spot and forward foreign exchange markets. Consequently, India's foreign exchange reserves have moderated by almost $55 billion from a high of $635 billion seen this year. Elevated global crude oil prices have impinged on India's oil import bill, in turn widening the trade deficit, thus increasing the demand for U.S. dollars, and affecting forex reserves further.

Notably, even as the rupee has fallen sharply against the dollar, the depreciation has been relatively lower compared with past crises such as the global financial crisis of 2008 (the rupee had weakened by over 20% between December 2007-June 2009) and the Taper Tantrum of 2013 (for seven months from the start of the crisis in May 2013, the rupee had depreciated by over 11%). Much of this is attributed to the lowering of India's external vulnerability measured in terms of a relatively high import cover and low short-term external debt. During the Taper

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Tantrum, India's import cover stood at over seven months as compared to around 12 months in the current period.

Effects of a weak rupee

The implications of a weak rupee on the economy are multi-fold. Among the benefits is the premise that the rupee's weakening should aid exporters in becoming more competitive. However, the concomitant depreciation of currencies of some of India's competitors such as South Korea, Malaysia and Bangladesh against the dollar, alongwith a high import intensity of some of its key export segments (petroleum, gems and jewellery and electronics), is likely to have blunted the ameliorative impact on India's exports. Slower global demand is expected to affect outbound shipments as well.

On the flip side, a weaker rupee is driving up prices of key import commodities such as coal, oil, edible oil, gold, thus impacting the imported component of inflation. The unhedged component of corporate debt denominated in dollars is also likely to bear the brunt of a weaker rupee.

Most importantly, a continuously sliding exchange rate discourages foreign investors from making fresh investments, which keep losing value in dollar terms. For this reason, it is ideal to provide confidence to investors by arresting a continuous slide in the exchange rate. Of course, any target should be avoided, as global forces remain fluid and market forces should be allowed to play.

The RBI's measures

Apart from intervening in the forex market to arrest the fall in the rupee's value, the RBI announced a slew of measures recently to liberalise foreign inflows into the country and make them more attractive.

Measures such as promoting trade settlements between India and other countries in rupee terms, offering higher interest rates on fresh Foreign Currency Non-Resident (Bank) and Non-Resident External deposits, a widening of investible universe of government and corporate debt, a relaxation of the interest rate and amount ceiling for External Commercial Borrowing loans, among others, have contributed to arresting the rupee's slide against the greenback.

Some other measures could be considered if the slide in the currency continues unabated. The Government could encourage some of the large market cap companies (private and public sectors) to be included in the major global indices such as MSCI and FTSE. This will help increase the weight of Indian equities in these indices, compensating for foreign portfolio outflows to some extent as investors are unlikely to be underweight on India.

The Government could also expedite India's entry into bond indices such as J.P. Morgan's Emerging-Market Bond Index and Barclays Global Bond Index. This will not only lead to forex inflows but also have a benign impact on interest rates. Such measures will keep the forex war chest of the RBI at a comfortable level, providing the central bank the requisite ammunition in case there is further weakness. Of course, any excessive capital inflow leading to an appreciation of the currency should also be avoided.

Overall, even as the rupee is expected to remain under pressure in the near term because of global uncertainty, high commodity prices and rising U.S. interest rates, mitigating measures have to be taken to partly arrest the slide. The maintenance of the U.S.-India interest rate differential along with timely forex market interventions by the central bank to manage volatility will prove to be salutary in preserving the rupee value against the greenback.

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