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RUPEE'S DECLINE: A CLOSER EXAMINATION

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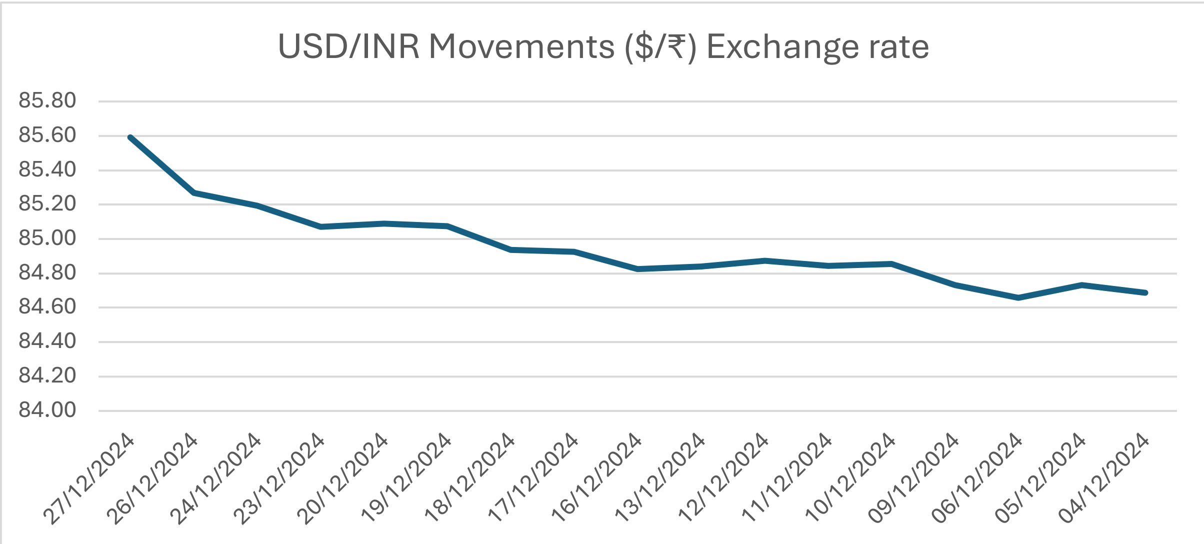
The recent continuous decline in the USD-INR exchange rate has created a concern regarding the stability of the currency and for import costs. While the intraday decline has reached as low as 85.80 per dollar, the latest final day settlement value on 27 Dec'24 has reached at 85.59 (USD/INR).



Source: RBI.

Multiple factors remain accountable for such decline, however, continued strengthening in the US dollar index after the US election results have contributed significant decline in emerging market currencies. During the period Oct~Dec'2024, the USD index have increased in the range of around 102~108.[1] The USD index gained strongly after the US President-elect Donald Trump has announced a forthcoming 'tariff-war' with US's major trading partners including India to strengthen and increase competitiveness of the US manufacturing. The US dollar will continue to remain a strong currency despite some feeble attempts to promote BRICS currency and Chinese renminbi. However, in an era of 'de-globalisation' and 'protectionism' such bilateral payments system is likely to prevail.

[1] https://www.marketwatch.com/investing/index/dxy/charts?mod=mw_quote_tab

There are also substantial capital outflows as FII has pulled substantial amount particularly from the equity segment. In October'24, net portfolio investment declined by US$ 10.87 billion [(-) ₹96358 crore], whereas in November' 2024 the decline was at (-) ₹21,444 crore. In October 2024, the FIIs has withdrawn ₹94017 crore from the equity segment itself. Nonetheless, compared to the second quarter of the last financial year (2023-24), net foreign portfolio inflows increased to US$ 19.9 billion during the same period of the current financial year (2024-25). Settlements in currency futures and the non-deliverable forwards (NDF) markets led to substantial dollar buying as pointed out by some treasury experts.

India faced certain current account stress due to higher gold imports. The gold import surged 30 per cent to $ 45.54 billion in 2023-24. However, there was some official declaration from the Indian government regarding possible miscalculation in the import figures, which are under the process of revision. Switzerland is the largest source of gold imports, with about 40 per cent share, followed by the UAE (over 16 per cent) and South Africa (about 10 per cent).

However, India's current account deficit (CAD) moderated marginally to US$ 11.2 billion (1.2 per cent of GDP) in the second quarter (Q2) of 2024-25 from US$ 11.3 billion (1.3 per cent of GDP) in Q2:2023-24, according to the latest data published by the RBI on 27th December 2024. Nonetheless, India's trade deficit increased to US$ 75.3 billion in the second quarter (Q2) of 2024-25 from US$ 64.5 billion during the same period of the last financial year. [2]

[2] On the positive side, Services exports have increased on a year on year (y-o-y) basis across major categories such as computer services, business services, travel services and transportation services. Further, remittances by Indians employed overseas, grew to US$ 31.9 billion in the second quarter (Q2) of 2024-25 from US$ 28.1 billion in Q2:2023-24. Another big positive is that Non-resident deposits (NRI deposits) recorded net inflows of US$ 6.2 billion, higher than US$ 3.2 billion a year ago.

Amid the continued decline of the rupee and current account deficit (CAD), India's foreign exchange reserves dropped by $8.4 billion to $644 billion in the week ended 20th December 2024, as RBI has tried to protect rupee's downward bias by selling dollars as well as revaluation of foreign currency assets. Foreign exchange reserves (Forex) are down by $61 billion since they hit an all-time high of $705 billion in the week ended September 27, 2024.

The RBI has tried to diversity and attract forex reserves in different periods. Recently, to attract more capital inflows, RBI decided to increase the interest rate ceilings on FCNR(B) deposits. Banks are permitted to raise fresh FCNR(B) deposits of 1 year to less than 3 years maturity at rates not exceeding the ceiling of overnight Alternative Reference Rate (ARR) plus 400 bps as against 250 bps at present.

Period	Forex Reserves (USD Billion)
20-Dec-24	644.39
13-Dec-24	652.86
06-Dec2024	654.85
29-Nov-24	658.09
22-Nov-24	656.58
15-Nov-24	657.89
08-Nov-24	675.65
01-Nov-24	682.12
25-Oct-24	684.80
18-Oct-24	688.26

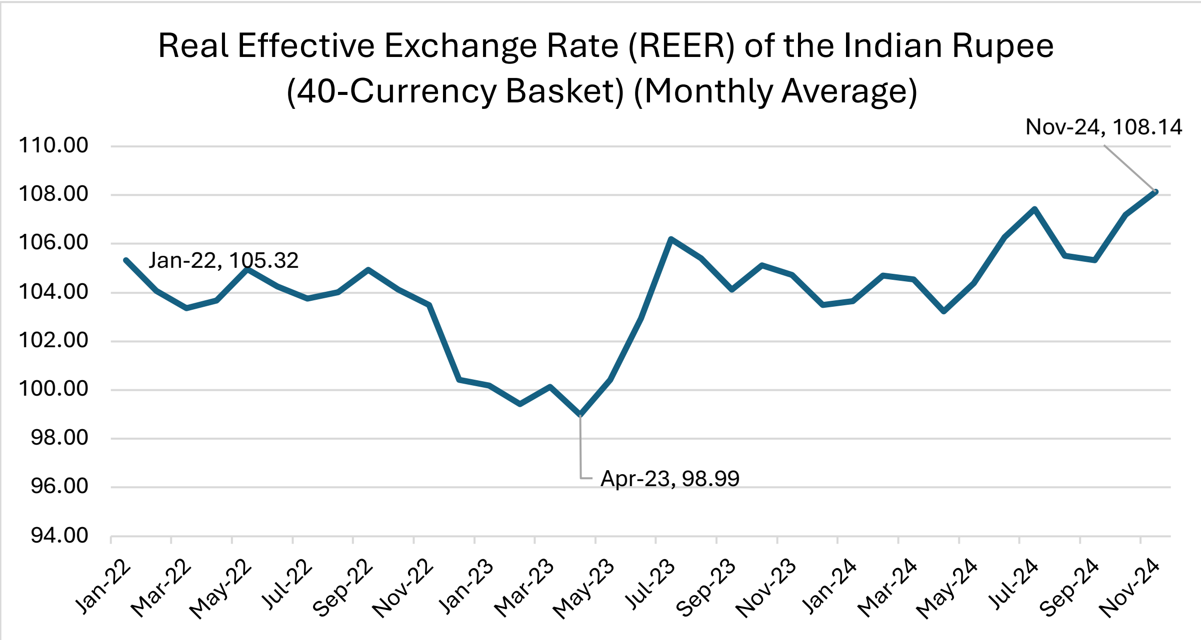
Source: RBI.

Among other impacts, a potential worry that has been flagged earlier also is that there is a 'moral hazard' problem where even many large importers try avoiding hedging costs as they speculate that the Central Bank of India, i.e. RBI would not allow to depreciate the rupee after a certain limit, by intervening in the market. Though depreciation of rupee ideally seems to enhance export competitiveness of Indian exporters, the overall impact of exchange rate depreciation on domestic prices depends on the extent of pass through of international commodity prices to the domestic market as well as subject to the so-called Marshall-Lerner condition.

Furthermore, the import in the economy also depends on various factors including the demand and supply of commodities in the international market. In this regard, a recent RBI paper has highlighted that Real Effective Exchange Rate (REER) depreciation impact on trade balance being more than an equivalent REER appreciation in the short-run and vice versa in the long-run. REER represents the inflation-adjusted, trade-weighted average value of a currency against its trading partners, and it is often used as an indicator of external competitiveness.

Interestingly, REER continued declining until April 2023 (reaching its lowest point at 98.99), but after that it is increasing steadily. According to the RBI study, hence the adverse impact on trade balance is relatively less than the positive gain that accrued before it has started rising.

Despite its continued decline vis-à-vis US dollar, INR remains one of the best-performing Asian currencies. In comparison, major Asian currencies like the Japanese Yen and South Korean Won declined by 8.8% and 7.5%, respectively, as on November 19, 2024. Notably, all G10 currencies, except the British Pound (GBP), depreciated by over 4.0% during CY 2024.[3] This can partly explain why the export competitiveness in real terms is falling because of rupee being relatively stronger compared to its peer currencies.



Source: RBI, Economic Survey.

The recent decline in the rupee is largely a fallout of the adverse impact on the emerging market (EM) currencies due to strong US dollar index, which is a global phenomenon. Certain other factors like geopolitical tensions and external factors have also contributed to the decline. One potential challenge could be for some domestic manufactures if the 'moral hazard' problem persists, i.e. if substantial portion of foreign exposure are getting unhedged due to the perception that RBI intervention would stabilise the rupee. Therefore, prudential measures are imperative to prevent any such market distortions loss of confidence.

[3] LOK SABHA UNSTARRED QUESTION NO. 989 TO BE ANSWERED ON 02.12.2024.