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Strong dollar and its Implication for India

What is the issue?

The US Dollar Index, which measures the greenback's exchange rate against 6 major global currencies, recently surpassed its 20-year high.

Why is the US dollar strengthening?

> *The US Dollar Index, also known as DXY, is used by traders seeking a measure of the value of USD against a basket of currencies used by US trade partners. The index will rise if the Dollar strengthens against these currencies and will fall if the Dollar weakens against these currencies.*

- **Consumer Price Inflation**- US consumer price inflation hit 8.6% in May 2022, its highest level since December 1981, driven by high energy and food prices.
- When inflation rises, interest rates in an economy generally catch up.
- This makes bond investments in the country more attractive, leading to higher demand for the currency.
- **US Federal Reserve's increase in rates**- Since March, the Fed has raised its policy rates by 150 basis points.
- When the Federal Reserve increases the federal funds rate, it typically increases interest rates throughout the economy, which tends to make the dollar stronger.
- **Western central banks raising the rates**- With Western central banks closing the tap to easy money and raising rates, the tidal wave of cheap global money originating from these countries, has suddenly begun to recede.
- This has led to sharp falls in risky assets, prompting a global flight to safety.
- As they withdraw from risky assets and repatriate their money back home, dollar demand surges, further strengthening the Dollar Index.

What does this mean for the India?

- **Imports**- India relies on dollar-denominated imports for over 85% of its crude oil requirements and imports more goods than it exports.
- Therefore, India's import bill usually shoots up when the dollar strengthens, increasing the local demand for dollars.
- **Widening deficit**- It will widen the deficit between its imports and exports.
- **Balance of payments crisis**- If this gap gets out of control, it can lead to a balance of payments crisis (though risks of this are low in the current context).
- **FPI pullouts**- Foreign Portfolio Investor (FPI) pullouts worsen the situation because this

further increases the domestic demand for dollars.
- **Depreciation of Indian rupee**- When the US dollar strengthens, the Indian rupee usually has no choice but to give in.
- Since the beginning of the year, the rupee has lost about 6% in value terms against the dollar.
- **Domestic inflation**- Many essential commodities and intermediate goods that India imports also get costlier, thus feeding into domestic inflation.
- **Remittance**- Indians who remit money in dollars to support relatives will need to shell out more.
- **Interest rate hike by RBI-** A fast-depreciating rupee can also force the RBI's hand in hiking interest rates more quickly or steeply than it originally intended.

How is the RBI handling this situation?

- When the rupee slides against the dollar, the RBI has two main weapons.
- **Interest rate hikes**- The RBI can put through sharp interest rate hikes in India, to make domestic bonds and gilts more attractive to foreign investors, so that they rethink their pullouts.
- **Usage of forex reserves**- RBI can use its large foreign exchange reserves, built up precisely for such contingencies, to intervene directly in the currency market.
    - So far this year, RBI is estimated to have spent over $40 billion out of its reserves to sell dollars and buy up rupees.
- It has also been taking sell positions in the dollar in the futures and forward markets.
- The main intent of RBI is to prevent shocks to the economy from a spell of unruly exchange rate volatility.
- **Predictions**- With the Russia-Ukraine conflict persisting, oil prices still on the boil, and no sign of relief on the FPI pullouts, most forecasters expect the rupee to slide further against the dollar in the coming months.
- However, such forecasts can change very quickly if the conflict ends, oil prices cool off, or FPIs suddenly begin to find value at lower levels in Indian equities.

References

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