Understanding Rupee Depreciation

What is the issue?

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- The recent slide in the rupee's value is particularly steep.
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- However, it is to be noted that it is part of a longer process of decline and requires holistic measures.
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What are the recent developments?

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- The recent depreciation of the rupee worries those who need to buy foreign exchange.
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- It has also caused panic in the stock markets, the decline in which partly reflects the exit of foreign investors.
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- This, in turn, further contributes to the rupee's fall. Click here to know more.
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- It causes further trouble for companies that borrowed heavily in foreign currency, encouraged by lower interest rates abroad.
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- It adds to domestic inflationary pressures that are already rising with higher global oil prices.
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How has the depreciation trend been?

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- The period of the global financial crisis in 2008 witnessed rupee depreciation like many other emerging market currencies.
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- But this was relatively small and the recovery of the rupee was also relatively rapid.
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- Thereafter, the currency was relatively stable in nominal terms until late 2011.
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- From then on, it started declining relative to the US dollar once again.
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- It culminated in a particularly sharp decline in the middle of 2013.
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- This is famously referred to as the “taper tantrum” which afflicted all emerging markets.
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- It happened when the US Federal Reserve hinted that the Fed might soon start tapering off the extraordinary liquidity creation measures.
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- [Notably, the Quantitative Easing had marked the recovery strategy after the global crisis of 2008.]
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- Now, vis-à-vis the US dollar, the rupee is worth only around half of its value in January 2008.
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- This is a remarkably rapid nominal depreciation in just over a decade.
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What happened thereafter?

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- Despite some slight recovery thereafter, the decline in the rupee’s value became a major political talking point.
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- The performance of the currency from 2014 has not been so favourable.
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- The rupee-dollar exchange rate had been deteriorating for the previous two years from the most recent sharp decline since January 2018.
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How was growth then?

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- Despite the above, in this period, there were not much external headwinds to slow down the economic growth.
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- Evidently, the Indian economy was one of the major beneficiaries of low global oil prices.
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- It provided a windfall gain to the government since it did not pass on these declines to domestic consumers.
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- India was also a major recipient of portfolio capital inflows.
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- Also, more domestic companies took on external commercial debt.
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- Foreign exchange reserves also increased but the country continued to run a current account deficit.
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- So this was essentially based on short-term capital inflows.
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- Such a method of building up forex reserves is not sustainable or desirable.
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- Nevertheless, the significant level of reserves acts as a protection against capital flight and consequent rapid depreciation.
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Can open market operations address depreciation?

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- Open market operations (OMO) refer to the buying and selling of government securities in the open market.
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- This is primarily to expand or contract the amount of money in the banking system, to control liquidity.
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- It is argued that open market operations by the RBI could operate to stabilise exchange rates.
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- It is said to prevent excessive appreciation as well as protect against sharp depreciation.

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- However, previous episodes of currency volatility do not provide clear signals on the effects of OMOs.

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- Once market expectations have turned adverse, no amount of OMOs and no level of forex reserves had been “enough”.

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- Indeed, the very running down of reserves in the process of such intervention can further erode trust in the currency and undermine its value.

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- Thus OMOs are only more suitable in the “good times”, when it is necessary to prevent excessive appreciation of the currency.

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What are the other measures?

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- Given the above, a wider range of measures is required to tackle the depreciation crisis.

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- It makes more sense for policies to address the current account deficit.

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- E.g. controls on gold imports beyond those required for jewellery exports

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- On the other hand, capital account measures could seek to prevent outflows through transaction taxes.

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Source: BusinessLine

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