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The Rising Rupee and the Crouching Federal Reserve

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When it comes to discussing the implications of any policy reversal, we often evaluate the pros and cons – the advantages and the disadvantages. When it comes to the change in the value of the currency, we have one more dimension to face: the ugly side.

India's foreign exchange reserves [have been on the rise](#) since late December 2017. They reached a new high for the fourth straight week ending January 19, 2018: \$414.8 billion, up from \$413.8 billion of the week ending January 12, 2018.

A year ago, at the end of January 2017, the reserves stood at \$361.6 billion.

Rising reserves lead to appreciation of the rupee. The rupee rose from Rs 67.48 per US dollar in January-end 2017 to Rs 64.01 on January 12, 2018. It was still rising. On January 29, it was Rs 63.67.

If we express the exchange rate in the reverse way, the Indian rupee's journey is clear. One rupee was worth 1.48 cents in end January 2017; it was 1.56 cents on January 12, 2018; and now on January 29, 2018 it is 1.57 cents. The trend is upward. What are the implications of this?

Three sides of appreciation

The Good: If the rupee appreciates against world currencies, it signifies strengthening of the currency. Politicians would be happy that the country's growing strength is duly reflected in the rising value of the rupee. Foreigners would now have to shell out more of their US dollar or British pound, for paying in rupees for the same quantity of Indian goods and services they purchased last month.

The Indian consumer would also be happy that prices of imported consumer goods would fall in rupee terms. Indian manufacturers, too, would welcome the appreciation of the rupee, as rupee prices of imported capital goods, machinery, petroleum crude and other raw materials and intermediate goods would duly decline. The purchasing power of one Indian rupee goes up with currency appreciation.

The Bad: Export earnings would be decreasing. Indian exports would become more expensive to foreigners. Overseas importers of India's limited range of goods and services, as well as foreign tourists to India will be hit hard. The competitiveness of India's exports is dented with the appreciation of the rupee. So, the exports would have to decline; and exporters would be at a disadvantage.

The Ugly: India's export manufacturing sector is especially labour-intensive. Most labour-intensive exports – such as clothing, processed consumer goods, including food and condiments – eagerly consumed by expatriates overseas and handicrafts and the like will be greatly affected. Any exporter seeing a decline in overseas sales following the appreciation of the rupee, now has concerns as to how to cut costs: the immediate avenue is the wage component. Effects on employment in general will be adverse, if the backward linkages of export industries to farm and rural sector are stronger.

Reasons behind India's currency appreciation or depreciation

India switched onto a market-determined exchange rate regime in 1993, though still a managed float, just as most economies all over the world intervene from time to time to reduce volatility in their exchange rates. In keeping with liberalised capital movements with the rest of the world, the market forces now encompass supply and demand for goods and services and capital as well. Capital flows in search of higher returns either from long-term investment (equity) or debt; or short-term gains by way of investment in bonds and shares due to favourable interest rate differential.

India's economic reforms in the mid-1990s have increasingly allowed foreign direct investment and encouraged foreigners to participate in the domestic investment and services operation. Second, sound economic policies such as targeting low fiscal deficit, low inflation and, above all, an exchange rate regime relatively free of stringent exchange controls on capital movements, have thus made India a desirable destination for investment.

More importantly, in recent years, after the onset of the Great Recession since 2008, interest rate differentials between the rich economies, which have deliberately kept their interest rates low and the emerging economies, including India, with higher interest rates, have worked to the advantage of India.

Financial capital inflows have grown enormously in recent days. The delay in the often professed but postponed return to normalisation of interest rate policy in the US may eventually end by August 2018. The US economy is picking up growth with President Donald Trump's "America First" policies of reduction in corporate taxes to foster domestic investment and rising protectionism.

So, until then, India may continue to be benefited by interest differential and the hot moneys would continue to flow in. We all know only FDI inflows add to real sector – hot moneys vanish in no time. They only enlarge financial bubbles until the interest rate differential disappears.

Foreign exchange reserves and exchange rates					
	Foreign Exchange Reserves US\$ billion	Nominal Market Exch Rate Rs/US\$	Nominal Market Exch Rate US\$/Rs	Trade weighted NEER Index (2004-05 =100)	Export weighted NEER Index 2004-05 =100
2015(ave))	360.2	64.15	0.0156	74.8	74.7
2016 9(ave)	370.0	67.19	0.0149	74.7	76.4
2017 end Jan	361.6	67.48	0.0148	75.1	76.9
2017 end Apr	372.7	64.31	0.0155	78.8	80.7
2017 end July	378.7	64.32	0.0155	77.6	79.4
2017 end Oct	398.8	64.96	0.0154	76.3	78.3
2017 end Dec	404.9	63.46	0.0158	77.2	79.2
2018 Jan 8	411.5	64.48	0.0155	NA	NA
2018 Jan 12	413.8	64.01	0.0156	NA	NA
2018 Jan 29	414.8	63.67	0.0157	NA	NA

Source: RBI Monthly Bulletin 2015 to 2018 Monthly Issues

The Table above presents data (2015-17) on foreign reserves and nominal exchange rates (Rs/US\$ and US\$/Rs). Further, the table also presents two indices of nominal effective exchange rate (NEER) where the exchange rate is defined as units of foreign currency per one unit of rupee: (i) one index by using the trade (exports and imports) with 36 countries as weights; and (ii) another index using exports to each of 36 major countries as weights.

The two NEER indices, so calculated with both trade and exports as weights, are also rising.

Booming currency trade

According to Bloomberg, the Indian rupee returned the highest yield among its Asian peers. The currency trade involves selling a certain currency with a relatively low interest rate and using the funds to purchase a different currency yielding a higher interest rate. Indian rupee trade gave the highest interest return at 6.37%. Bloomberg also recorded the rupee appreciation as a close 6% against the US dollar.

The appreciation of the rupee is generally attributed to three developments. One, the early recovery in growth after the two domestic shocks of demonetisation of late 2016 and disruption due to introduction of Goods and Services Tax (GST) regime in July 2017. Two, credible RBI policy. And three, continued economic reforms.

Of course, the unsaid thing is the operating influence of interest rate differential in India's favour – inducing financial capital inflows – which do not add to investment or employment.

Role of RBI

Turning to RBI policy, one could raise some legitimate questions. How about RBI intervention? Has it intervened on previous occasions? Would not RBI intervene for stopping the rupee appreciation and helping exporters?

The answers to the first two are in the affirmative. The RBI did intervene previously and has been intervening for controlling volatility in exchange rate changes. RBI does not target any specific level of exchange rate.

By targeting only at inflation: 4% within an allowable band of plus or minus 2% variation as its mandated goal, it does influence real exchange rate, which is more relevant for maintaining the competitiveness of exports than nominal exchange rate.

Real exchange rate is the product of nominal exchange rate and the domestic price index relative to foreign price index. Given the nominal rate, a fall in domestic price level relative to foreign price level would amount to fall in real exchange rate, which promotes export competitiveness.

No doubt, in the past exporters clamoured for halting or even reducing the exchange rate appreciation. The RBI intervention was not for weakening the currency to favour exporters, but for reducing the volatility in currency fluctuations. The RBI purchased foreign currency and sold rupees in return; by so doing, it reversed the effects of adding to money supply by selling bonds for mopping up excess money supply.

The procedure is known as sterilisation. The RBI may consider it when appropriate.

At present, all central banks including RBI are awaiting the likely US Fed interest rate policy change in the near future. Indication of any change in the monetary policy stance would be known after the latest US Federal reserve meeting this week.

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