Impossible task of taming the Rupee

Why in news?

In 2020, when the currencies of other emerging economies such as China, South Korea, Taiwan and the Philippines gained more than 5% against the US Dollar, the Rupee declined 2.3%

What are the reasons for Rupee's weakness?

- RBI's net purchasal of dollars amounting to $87.7 billion in 2020 had negative repercussions on domestic liquidity, inflation and quality of assets in the RBI balance sheet
- The rupee has been quite volatile in 2021, fluctuating in the range between 72 and 75 against the dollar
- Despite this, various factors point towards continued strength in emerging market currencies including the Rupee.

What apprehensions point towards increased strength in the rupee?

- US Federal Reserve's continuing bond purchases over the coming months and the promise of low interest rates until the end of 2022 will keep the dollar weak
- The US dollar index, which tracks the movement of the dollar against a basket of currencies, is in a structural downtrend since 2002 and might lead to rupee appreciation
- Strong portfolio and FDI flows into emerging economies is likely to continue as long as interest rates are low

What is RBI's dilemma?

- In intervening in the spot market for the rupee this year, due to the impact on system liquidity which is not only inflationary but also affects the interest rates

  The spot market is where financial instruments, such as commodities, currencies, and securities, are traded for immediate delivery

- Intervening in the forwards market might have negative impact of hurting corporates with hedging positions
- Sterilisation through open market operations is difficult currently, given the need for the RBI to support the government's large borrowing
- RBI's action of hiking CRR to absorb liquidity might burden the banks
- The fallout of Market Stabilisation due to additional supply of sovereign paper could attract more FPI inflows into debt
- Another negative fallout of excessive dollar purchases is the increase in low-yielding foreign currency assets on RBI's balance sheet

What options have been left out with RBI?

- Keeping the exchange rate under check, even with capital control and a pro-active monetary policy is the need of the hour although it is difficult
- A stronger rupee may not be so bad for the economy as it can help in reducing the imported inflation.

Source: Business Line

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