Need for Rupee Depreciation

What is the issue?

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- The rupee has strengthened 4.3% this year and is trading at around 65 per dollar.
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- Despite the short term gains of increasing rupee value, it poses some risks for export-dependent sectors.
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What are the causes for rupee appreciation?

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- Positive growth prospects among major economies created expectations that the rupee would appreciate.
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- This encouraged capital inflows, particularly into the equity market.
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- This was with the expectation that any rupee appreciation would also result in a proportionate increase in return on investment.
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- Further, relaxation in the capital account and lack of intervention by the RBI in regulating foreign capital inflows are also the reasons.
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- Mostly short-term in nature, these capital flows have played a major role in strengthening the rupee.
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What are the concerns?

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- **Exports** - A higher currency makes a country's exports more expensive and

imports cheaper.
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- Resultantly, the strengthening rupee is hurting exporters' competitiveness and earnings.
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- This has the potential to create volatility in the external sector of the economy.
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- **Employment** - Many export-dependent industries such as gems and jewellery, textiles, leather and agricultural products are labour-intensive.
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- Also, the supply chain of export industries involves millions of SMEs.
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- Therefore, a rising rupee and decreasing exports would be unfavourable for employment opportunities as well.
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- **Services sector** - This is also negatively affected, when export earnings are foreign currency-dominated.
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- Evidently, in recent years software export, where India has dominated, is experiencing lower profit margins
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Why is export-led growth important?

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- An export-led growth strategy with appropriate structural reforms (like liberalisation and an open economy) results in sustained productivity-led growth.
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- This is because exports promote better resource allocation, efficient management, and technology exchanges.
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- Evidently, China followed an export-led growth strategy and increased its participation in global value chains.
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- It also led to the expansion of tradable and manufacturing sectors as well as creation of jobs and growth pick up.
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What are the challenges to rupee depreciation?

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- Among various structural reforms, one of the prime reasons for the success of China’s export-led growth was an under-valued exchange rate.
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- However, there are some limitations and challenges for India in employing this strategy.
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- The high fiscal deficit and high debt to GDP ratio give the RBI little space to allow the rupee to depreciate by intervening in the forex market.
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- Doing so also has the risk of leading to a higher inflation.
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- Inflation is a politically sensitive subject and, moreover, RBI has been favouring a stronger rupee to achieve its inflation targeting mandate.
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- Because, as a general rule, there is an inverse relationship between inflation and exchange rate of a country.
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- Lower inflation lead to increasing purchasing power relative to other currencies and thus in turn lead to an increase in currency value.
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What lies ahead?

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- A rising rupee is not a bad thing as it has helped contain inflation through cheap imports.
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- Also, companies that have foreign currency-denominated debt have been benefitted by rising rupee.
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- However, the strategy may not be right to sustain growth in the long run.
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- Ensuring a productivity-led growth by pursuing structural reforms across sectors could reduce the inflation concern of rupee depreciation.
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- The government and the RBI should step in to correct the mis-alignment in the exchange rate and allow the rupee to depreciate to move towards its true value.
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Source: Business Standard

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