Negatives of Rupee appreciation

Why in news?

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Rupee has appreciated around 6.1% against the dollar so far in 2017.

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What are the shortcomings?

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- It can cause damage in term of lost exports growth.
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- There might also be a fall in domestic production due to cheapening imports.
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- In the current year so far, a total of $31 billion of FPI flows have already come versus an outflow of $2.7 billion in the same period.
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- This is because interest rates are significantly higher in India.
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- So around 2/3rdof the FPI flows have been in the form of debt instruments like bonds and securities.
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- This rate is not slowing down in the near future as the US economy is not reflating at the expected pace.
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- In this case, FPIs benefit from both the higher interest rates as well as the appreciation of the rupee.
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- More the inflows, greater will be the appreciation.
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- This would make India a suitable place for carry trade.
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- A carry trade is a strategy in which an investor borrows money at a low interest rate in order to invest in an asset that is likely to provide a higher return.
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- It makes our exchange rate more volatile and also drains our forex.

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What has RBI done to tackle this?

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- RBI has purchased $20 billion, half each in the spot and forward markets.
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- RBI has tried to slow debt inflows by tightening norms for masala bonds.
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- The tenors were raised to 3-5 years and an interest rate cap was imposed.
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- RBI also said that each issue would be cleared by it.
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- SEBI reinforced this with a temporary ban on new issues.
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- RBI also tried to increase the maturity profile of FPI investments in G-Securities.
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What should be done?

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- There is no short-term solution to slowing, or reversing the rupee’s appreciation.
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- There should be sharper cuts in interest rates.
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- Inflows should be slowed down by promoting outward FDI.
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- The automatic hikes that were put in place for FPI positions in the bond market two years ago should be relooked to make it serve as a cap to debt inflows and the rupee’s appreciation.
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- Government has to create enough fiscal space to be able to service the resulting lower interest rates.
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- RBI has been using stronger rupee as an inflation-fighting tool.
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- It is time for RBI to shift the focus and estimate the damage caused by an appreciating rupee and to take necessary steps.

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Source: The Financial Express

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