Exchange rate stability desirable? Not really, data shows

It remains to be seen whether the RBI will show greater tolerance for exchange rate under Governor Sanjay Malhotra

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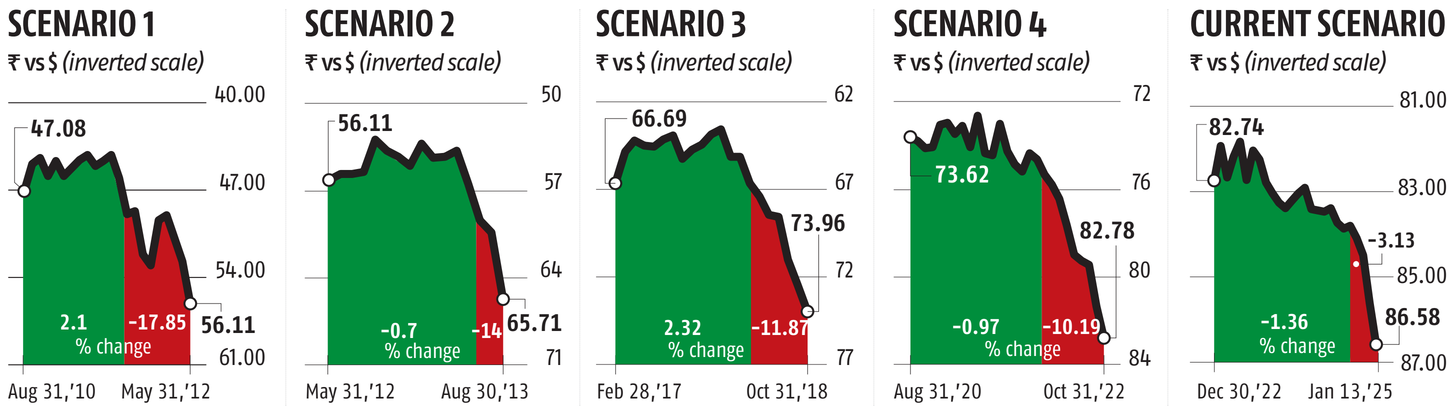
THE RUPEE STORY



Compiled by BS Research Bureau   Source: Bloomberg

MANOJIT SAHA
Mumbai, 13 January

The recent depreciation of the rupee along with sharp fall in the country's foreign exchange (FX) reserves has sparked a debate whether stability of the exchange rate is necessary and desirable.

The rupee was one of the least volatile currencies among peers for almost two years before the current downward pressure started in September after the US Federal Reserve lowered interest rate.

There is empirical evidence in the last 15 years, which suggests a period of stability of the rupee is followed by extreme volatility.

For example, between August 2010 and August 2011, the rupee traded in a tight range and strengthened 2.1 per cent, which was followed by 17.85 per cent depreciation in the next nine months.

Similar trend is evident for the period starting 2023 till August 2024. The rupee came under pressure following the war in Europe, which started in February 2022, resulting in a depreciation of over 10 per cent that very year.

In 2023, the central bank kept a tight leash on the exchange rate, allowing it to depreciate by only 0.6 per cent.

The tight leash continued till August 2024. Between January-August 2024, the currency depreciated only 1.36 per cent. It took 478 days for the Indian unit to touch 84 a dollar, from 83.

Between September and now, the currency has depreciated over 3 per cent. The rupee has hit new closing lows in 21 out of 30 trading days in December and January so far.

"A flexible exchange rate acts as a first line of defence against variation in external conditions and prevents economic imbalances from accumulating over time. Excessive volatility is also undesirable as it can prove disruptive to corporate planning and detrimental to foreign portfolio flows," said Abhay Gupta, Asia FX/rates strategist, BofA Global Research.

"For this reason, particularly in emerging markets, central banks do have to step in once in a while to rebalance FX demand-supply. However, it is difficult to justify the very tight trading ranges that we saw in USD-INR over the last few years, which have resulted in larger variation in INR's valuation on trade-weighted terms and on real terms," Gupta said.

Data shows that in October, the Reserve Bank of India (RBI) sold $37.8 billion while it purchased $27.5 billion to manage the exchange rate.

The RBI had always maintained that its intervention in the FX market is aimed at curbing excess volatility and that it does not target any level or a range of the exchange rate.

"Yes, there has been a tight leash on the rupee for a sustained period of time. The implication of keeping the volatility overtly low is that it may give rise to some sort of complacency regarding hedging activity, etc. This may also result in the currency becoming overly rich (overvalued). We do not know if there is a shift in policy. All we can see is visibly the currency is weakening, which perhaps indicates a loosening stance," said Mitul Kotecha, head of FX & EM Macro Strategy, Asia, Barclays.

The real effective exchange rate (REER) of the Indian rupee increased to 108.14 in November 2024 from 107.20 in October 2024. This means the rupee appreciated by 0.9 per cent month-on-month (M-o-M) in November.

REER, which represents the inflation-adjusted, trade-weighted average value of a currency against its trading partners, is often used as an indicator of external competitiveness.

Is there a change in strategy so far as the exchange rate intervention policy of the RBI is concerned? Has the central bank, under new governor Sanjay Malhotra, become more tolerant with the currency's depreciation?

"Though the RBI has been maintaining the rupee in a tight range, former RBI Governor Shaktikanta Das has repeatedly said that there is no exchange rate target and that the central bank intervenes to tackle volatility. The question we get now is if there is a change in policy under the new governor. Though it is quite hard to determine that, anecdotally, a faster pace of depreciation of the rupee, which we have seen of late, perhaps indicates a shift under the new governor. But we don't know that, there is no real indication to suggest a shift," Kotecha said.

Currency watchers said the recent depreciation is also due to global factors, including the stance of the Fed and Donald Trump winning the US election.

"On markets, rupee traders have been keen to assess the new governor's view on the currency. Recent INR price action points to a higher tolerance for a weaker exchange rate, demonstrated by the over 2 per cent fall since late December compared to the nearly flat performance in Q1-Q3 of FY25," said Radhika Rao, executive director and senior economist, DBS Bank.

"However, the pace of depreciation cannot be attributed solely to the change in leadership but also to a shift in the global environment, which has introduced tradeoffs between the cost of strong intervention and its economic impact. A rapid appreciation in the dollar has magnified the misalignment, increasing the need to ease the grip on the rupee," Rao added.

Another strategy, which may turn counterproductive, is ballooning short positions in the forward markets.

"Short forward book had increased to $59 bn as of end-November, according to data. We believe such large short forward liabilities acted counterproductively by raising market concerns on the sustainability of the RBI's FX policy," Gupta said.

"That skewed the risk-reward for INR positioning as potential unwinding of these shorts limited the downside of USD-INR. A confluence of factors, like slowing growth, foreign direct investment (FDI) and wider trade deficits further fuelled these concerns and led to larger depreciation in the INR than would have been seen otherwise," he said.

The forward book was marginally negative till the end of FY24. The outstanding book was positive till February and expanded in FY25.

"Over the past months, there has been a shift in RBI invention – increasingly being done with forwards and NDF (non-deliverable forward)," Kotecha said.

"Since the forward book has expanded the dollar deficit, the rupee has come under pressure with FX reserve loss. The question now is how to manage the forward book, will it be rolled over, or will it be allowed to mature," Kotecha added.

The jury is still out if there is a change in the FX intervention strategy under Malhotra.

Falling rupee drags down forex kitty

Continued weakening in the rupee against the dollar has weighed on the country's forex reserves.

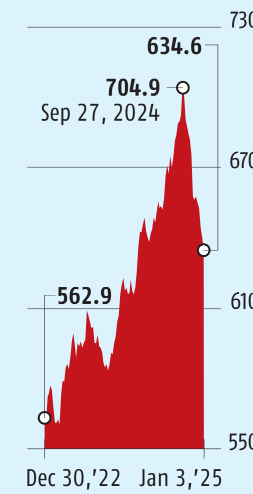
The domestic currency has depreciated 3.1 per cent since September 2024. In the same vein, India's forex kitty has depleted by $70 billion from an all time high of $705 billion in the fortnight ended September 27, 2024.

The RBI has been intervening to slow down the steep fall of rupee.

After showing resilience against the dollar for almost two years, it turned to be the worst performing Asian currency on Monday, falling 0.7 per cent, and worst in January after Philippines peso. **BS REPORTER**

STEEP FALL

Forex reserves ($ bn)



MAJOR ASIAN CURRENCIES AGAINST $

	Jan 13, 2025	% change YTD	% change 1-day
Indian rupee	86.58	-1.12	-0.70
Philippines peso	58.70	-1.23	-0.57
Taiwan dollar	33.12	-0.99	-0.44
Thai baht	34.80	-1.29	-0.32
Malaysian ringgit	4.51	-0.85	-0.28
Singapore dollar	1.37	-0.61	-0.19
Bangladesh taka	121.68	-1.72	-0.18
Vietnam dong	25,397.00	0.35	-0.10
China renminbi	7.33	-0.45	0.01
Hong Kong dollar	7.79	-0.23	0.02
South Korean won	1,471.08	0.51	0.18
Japanese yen	157.31	-0.07	0.27

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