₹ slide: Dent on economic recovery prospects

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WHILE INDIAN ECONOMY has shown signs of recovery during the last quarters, the exchange rate has hit another blow. The rupee has breached the psychological barrier of 80 against the US dollar. The rupee was constantly under pressure ever since the Russia-Ukraine war started.

However, the recent sliding of the currency is attributed mainly to foreign investors who took their money out from Indian markets after the US Fed announced rate hikes. A depreciating rupee will hurt the prospects of recovery in domestic economy, which is already reeling under the Covid pandemic and Ukraine war crisis.

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Global currencies' exchange rate against dollar

Currency	June 01 2022	July 14 2022	% chg	App/Dep
Chinese yuan	6.6893	6.7383	0.73	Depreciated
Euro	1.0712	1.005	-6.18	Appreciated
Japanese yen	128.92	138	7.04	Depreciated
UK pound	1.259	1.1826	-6.07	Appreciated
Australian dollar	0.7168	0.6757	-5.73	Appreciated
Canadian dollar	1.2639	1.3138	3.95	Depreciated
Indian rupee	77.5554	79.871	2.99	Depreciated

Source: IMF

Rupee exchange rate against global currencies

Currency	June 01 2022	July 14 2022	% chg	App/Dep
Chinese yuan	11.580	11.817	2.05	Depreciated
Euro	83.082	80.008	-3.70	Appreciated
Japanese yen	60.010	57.610	-4.00	Appreciated
UK pound	97.616	94.613	-3.08	Appreciated
Australian dollar	55.600	53.960	-2.95	Appreciated
Canadian dollar	61.350	60.901	-0.73	Appreciated
US Dollar	77.555	79.871	2.99	Depreciated

Source: RBI

Rupee depreciation effects on exports and imports: What economic theory says

A depreciating currency is helpful in increasing the exports and controlling the imports. Currency depreciation increases the competitiveness of exports in the international markets by decreasing per unit price of exports in dollar terms.

On the other hand, imports become costlier, thereby decreasing domestic demands for imported products. The actual impact of a depreciating currency depends on the elasticity of exports and imports i.e. responsiveness of exports and imports demand to change in price. If imports are inelastic in nature, the depreciation may hurt exports and the economy at large. Let us understand this in the context of Indian economy.

High import dependence of Indian economy

Major import items for India consist of petroleum products, gold, coal, diamond, electronic integrated circuits, automatic data processing machines and palm oil. These products comprised almost half of India's total imports last fiscal year and in May 2022, the latest month for which trade data is available (see charts). For most of these products, India is significantly dependent on imports given lack of adequate domestic production.

For instance, India is the world's third-biggest oil consuming and importing nation with more than 85% dependency on imports to meet crude oil needs. Similarly, coal sector in India has witnessed demand-supply mismatches recently, resulting into substantial recourse to imports — more than 25% of the domestic consumption. For gold, imports made up 86% of India's total supply between 2016-2020, according to the report of the World Gold Council. For edible oils, India meets 55-60% of its need through imports. This high import dependence is likely to increase India's import bill in the face of sharply depreciating rupee.

How rupee is doing viz-a-viz other currencies

In order to understand if the current depreciation of rupee is more due to external factors or some weaknesses inside Indian economy, let us compare how Indian rupee is doing as compared to other major global currencies. If we compare changes in the exchange rates of major global currencies viz-a-viz US dollar during the last 45 days period (between June 1 and July 14, 2022), we found that the most depreciating currency against US dollar was Japanese yen, followed by Canadian dollar and Indian rupee. On the other hand, euro, pound sterling and Australian dollar appreciated against US dollar during this period (see chart). If we compare exchange rates of Indian rupee against all these currencies during the same period, we found that except for depreciating against the US dollar and Chinese yuan, Indian currency has appreciated against all major currencies during this period. This is an indication that the current slide in rupee is more to do with external factors and less attributed to any intrinsic weaknesses within the economy.

What lies ahead

Rate hikes are expected by the US Fed in coming days which will further accentuate foreign institutions outflows from India, thereby continuing depreciating pressure on Indian rupee. This will have unfavourable effects on Indian economy.

High dependence and inelastic nature of India's imports will result into import demand continuing to be around the same level in spite of high import prices. This is likely to increase import bills and put pressure on importers. The exports, though, will gain competitiveness after rupee depreciation, they may not see significant rise given subdued global demand and lack of purchasing power after the pandemic and Ukraine war. The export competitiveness may also see a reverse trend in import-dependent export industries, such as pharma and auto, due to high costs of imported inputs.

RBI move to allow international trade settlement in Indian rupee may provide some relief against the depreciating spree. However, the effects of this mechanism are likely to come into play in the long run and not immediately. Moreover, they will be dependent on availability of the foreign trade partners willing to settle their trade in rupee. The rupee depreciation will further aggravate inflationary pressure on Indian economy, particularly if there is no softening of crude oil prices in international markets. If crude oil remains more than \$100/barrel along with rupee trading around 80 against USD, domestic oil price hike will be inevitable. Therefore, considering the role of external factors in the present rupee fall, lets be prepared for hard times ahead.

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