# Rupee and Dollar

Posted at: 24/12/2024

## Rupee and Dollar: The Changing Landscape

**Context: The Indian rupee has weakened against the US dollar, crossing the 85 mark. In April, the exchange rate was around 83, and a decade ago, it stood at approximately 61. This steady decline in the rupee's value relative to the dollar highlights persistent economic challenges and shifts in global financial dynamics.**

---

### Understanding Exchange Rates

1. **What Are Exchange Rates?**
    - The exchange rate determines how many **rupees** are needed to buy one unit of a foreign currency.
    - For international transactions—such as purchasing an **American car** or booking a **Swiss vacation**—Indian rupees must be exchanged for foreign currencies like the **US dollar** or **euro**.
2. **How Are Exchange Rates Determined?**
    - Exchange rates are influenced by the **demand** and **supply** of currencies in global markets.
    - **When demand for the US dollar exceeds demand for the Indian rupee, the dollar strengthens, making it costlier.**

---

### Factors Influencing Exchange Rates

1. **Trade in Goods**
    - **Higher imports** from the **US** than exports to the **US** create greater demand for dollars, leading to the rupee's weakening.
2. **Trade in Services**
    - Increased purchases of **US services** (e.g., **tourism**) by Indians also drive up dollar demand, contributing to rupee depreciation.
3. **Investments**

    - **If Americans invest more in India than Indians invest in the US**, the rupee strengthens due to higher demand.
    - Conversely, reduced foreign investments in India weaken the rupee.

---

**Key Factors Impacting the Rupee's Demand**

- **Trade Restrictions**: **Tariffs** or **bans** on Indian goods reduce the demand for rupees, weakening its value.
- **Inflation Differences**: **High inflation** in India compared to the US erodes the rupee's purchasing power and deters investors.

---

## Current Developments: The Falling Rupee

- **Recent Decline**: The rupee has slid to **85.11** against the US dollar, driven more by a strengthening dollar than by a weakening rupee.
- **Mixed Performance**: While the rupee has depreciated against the dollar, it has appreciated against other major currencies like the **euro**, **pound**, and **yen**.

### Global Factors Driving Dollar Strength

- **US policies** such as potential **import tariffs**, **deportations**, and **tax cuts** have boosted inflation expectations.
- The **US Federal Reserve's tight monetary policies** have resulted in **higher bond yields**, further strengthening the dollar.

---

## Impact of the Falling Rupee

### Negative Effects

1. **Rising Inflation**
    - **India imports nearly 80%** of its **crude oil** needs, and a weaker rupee makes imports costlier.
    - These higher costs cascade through the **value chain**, increasing input costs across industries.
2. **Widening Current Account Deficit (CAD)**
    - Costlier imports exacerbate the **trade deficit**, putting additional pressure on the exchange rate.

### Positive Effects

1. **Boost to Remittances**

    - A weaker rupee makes **remittances** from overseas more attractive for recipients in India.

2. **Export Competitiveness**

    - **Indian exporters** benefit from a weaker rupee, as their goods become cheaper internationally, provided they do not heavily rely on imported raw materials.

---

## Policy Recommendations for India

1. Focus on the rupee's **effective exchange rate** against a basket of currencies, rather than solely against the **US dollar**.
2. **Avoid defending the rupee through interest rate adjustments**; instead, base rate decisions on domestic inflation trends.
3. Address **fiscal** and **current account deficits**, adhere to **inflation targets**, and reinforce confidence in India's **growth potential** to ensure macroeconomic stability.

---

## Conclusion

The rupee's depreciation against the dollar is a multifaceted challenge influenced by global and domestic factors. **While it brings certain advantages like increased remittances and export competitiveness**, the negative impacts on **inflation** and **trade deficits** cannot be ignored. By focusing on sound macroeconomic policies and strengthening structural fundamentals, India can mitigate the adverse effects and build a more resilient economy.