

Rupee and Dollar

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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.
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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.
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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.
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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.
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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.

