

Sabse Bada Rupaiya

The Indian rupee has grown stronger. We keep hearing and reading about this in media. Now, what does all this talk mean? Let's make an attempt in understanding the dynamics behind this news.

Buyers of dollars now have to shell out fewer rupees to buy one unit of a dollar. If they had to pay Rs 43 to buy one dollar earlier, they can now get the same dollar for Rs 42 ie they are getting it for a rupee less. This is what is meant by 'rise in the value' of the rupee in recent months

As the rupee becomes stronger compared to the US dollar, the cost of all the imported goods and services fall down.

Remember that India imports three-fourths of its oil. As the value of dollar goes down importing oil becomes cheaper. Since oil prices are directly related to rise in prices of other goods and commodities in India, their prices will also fall down.

But how can the rupee strengthening in value against the dollar bring about these changes and what exactly does it mean?

To understand this let us look at some basic concepts.

Exchange rate, foreign-exchange rate, forex rate or FX

Rate all are one and same thing. It measures the currency's worth of the in terms of another currency. For example an exchange rate of 120 Japanese yen (JPY, ¥) to the United States dollar (USD, \$) means that JPY 120 is worth the same as USD 1.

The foreign exchange market is one of the largest markets in the world. By some estimates, about 2 trillion USD worth of currency changes hands every day.

Quotations

An exchange rate quotation is given by stating the number of units of a price currency that can be bought in terms of 1 unit currency (also called base currency). For example, in a quotation that says the USD/EUR exchange rate is 1.2 (USD per EUR), the **price** currency is USD and the **unit** currency is EUR. It is known as price currency because it is the price that has to be paid for every unit currency.

Direct Quotation

Quotes using a country's home currency as the price currency (e.g., Rs 41 = \$1 in the India) are known as direct quotation or price quotation and are used by most countries.

→ direct quotation: 1 foreign currency unit = x home currency units

Indirect Quotation

Quotes using a country's home currency as the unit currency (e.g., .02439= Rs1 in the India) are known as indirect quotation or quantity quotation and are used in British newspapers and are also common in Australia, New Zealand and Canada.

→ indirect quotation: 1 home currency unit = x foreign currency units

Relationship between strength of the currency and exchange rate

Note that, using direct quotation, if the home currency is strengthening (i.e., appreciating, or becoming more valuable) then the exchange rate number decreases.

Conversely if the foreign currency is strengthening, the exchange rate number increases and the home currency is depreciating.

In direct quotation as used in India the strength of home currency is inversely proportional to the exchange rate. The higher the strength of the home currency the lower will be the exchange rate. As we all know the exchange rate has reduced from Rs 44 levels to Rs 40 levels. But the strength of the home currency is said to be increasing in this period.



Free or Floating Rate

A floating exchange rate, by contrast, means that the exchange rate is determined in the foreign exchange markets by the forces of demand and supply. The exchange rate changes from day to day as market forces shift.

Fixed or Pegged

Simply put in the fixed rate policy, the government chooses the official exchange rate: say 1 dollar equals 25 rupees. All official exchange of currency has to take place at this fixed rate.). A fixed exchange rate is often associated with strict controls on the use of foreign exchange. It also sees the rise of black markets as individuals try to avoid the official exchange rate. Individuals do it because they think the government-fixed exchange rate gives them less value for their dollars. The black market, hypothetically, can give more than Rs 25 to a dollar.

India followed a fixed exchange rate policy before liberalization (pre-1991)

Hybrid or Dirty Float

In practice, many countries including India now have a hybrid system called 'dirty float'. This is basically a floating rate where the government intervenes from time to time, trying to nudge the exchange rate in one direction or the other

Interest rate parity concept

Interest rate parity (IRP) states that an appreciation or depreciation of one currency against another currency might be neutralized by a change in the interest rate differential. If Indian interest rates exceed US interest rates then the Indian rupee should depreciate against the USD by an amount that prevents arbitrage.

However IRP showed no proof of working after 1990s. Contrary to the theory, currencies with high interest rates characteristically appreciated rather than depreciated. This happened because

1. Foreign exchange chased the higher yielding currency leading to appreciation of the currency.
2. The gov did not intervene in the forex market as that would have led to increased liquidity leading to increase in inflation.
3. This led to appreciation of the currency.

This is what we are seeing in the Indian context today.

Balance of payments model concept

This model holds that a foreign exchange rate must be at its equilibrium level - the rate which produces a stable current account balance. A nation with a trade deficit will experience reduction in its foreign exchange reserves which ultimately lowers (depreciates) the value of its currency. The cheaper currency renders the nation's goods (exports) more affordable in the global market place while making imports more expensive. After an intermediate period, imports are forced down and exports rise, thus stabilizing the trade balance and the currency towards equilibrium.

Fluctuations in exchange rates

A market based exchange rate will change whenever the values of either of the two component currencies change. A currency will tend to become more valuable whenever demand for it is greater than the available supply. It will become less valuable whenever demand is less than available supply.

The demand for money is highly correlated to the country's level of business activity, gross domestic product (GDP), and employment levels. The more people there are out of work, the less the public as a whole will spend on goods and services. Central banks typically have little difficulty adjusting the available money supply to accommodate changes in the demand for money due to business transactions.

A currency will tend to lose value, relative to other currencies

1. If the country's level of inflation is relatively higher
2. If the country's level of output is expected to decline
3. If a country is troubled by political uncertainty. For example, when Russian President Vladimir Putin dismissed his Government on February 24, 2004, the price of the ruble dropped.

The Indian context

So in the Indian context, what are the forces that have been affecting exchange rate movements? What, in particular, has been causing the rupee to rise in value in recent months?

The most important factor, probably, is how attractive a country's economy is to foreign investors. Every time a foreign bank or company wants to invest in India — whether it is by buying shares or opening a factory — it will need to buy rupees. This will increase the demand for rupees in the foreign exchange markets, which will mean the rupee, will rise in value.

This is exactly what has been happening in India recently as it has become one of the fastest growing economies in the world. Multinational corporations are eager to get a slice of the action. In the financial year 2006-2007, India received \$16 billion dollars in foreign direct investment; this is about three times the previous year's figure.

Another important factor is the interest rate in different countries. If Indian interest rates rise relative to other countries, Indian interest-bearing products become more attractive; this will once again increase demand for the rupee.

For instance, if the rate of interest in the US is only 4 per cent on bank deposits and a fixed deposit in India fetches, say, 10 per cent, the 6 per cent difference between the interest rates of these two countries will attract foreign investors to India.

In India, the Reserve Bank of India has been raising interest rates in recent months as a way of fighting inflation; this has played a role in the rising value of the rupee.

So what is the impact of a rising rupee on different sectors of the economy?

In a nutshell, exporters are hurt and importers celebrate.

The logic is simple: suppose an exporter earns \$1 million in foreign exchange. At an exchange rate of 47 rupees to the dollar, this is worth Rs. 4.7 crores while at a rate of 43 rupees it's only worth Rs. 4.3 crores.

This is why stocks of export-intensive technology firms like Infosys have performed relatively poorly in recent weeks. Firms in the textile sector have also been hurt. Both the information technology and the textile sector are export-driven and are hurt whenever the rupee's value increases.

The reason is they get less rupees for the dollars they earn through exports.

The opposite is true for companies with large imports. A stronger rupee means their import bill will fall in rupee terms. In India, the single biggest import is crude oil, and the rising rupee has seen stock market gains for oil marketing companies like IOC and HPCL in recent weeks.

If a barrel of oil cost \$ 40, it would cost Rs. 1720 if the exchange rate were Rs 43 per dollar. This would reduce to Rs 1,680 if the rupee appreciates by just Rs1 to Rs 42.

UNDERSTANDING

This saving directly goes into the net profit kitty of oil marketing companies.

The rising rupee also has a direct impact on consumers who will face lower prices in rupees for imported goods or travelling abroad. For instance a typical weeklong trip abroad costing, say, \$1000 (or Rs 42,000; \$1 = Rs 42) will be cheaper because of the rise of the rupee in the last six months. The same trip would have earlier cost Rs 44,000 (assuming \$1 = Rs 44).

So what's likely to happen to the rupee in the future?

No one can say for sure as exchange rates are notoriously unpredictable. If the rupee rises significantly, you could see the

RBI intervening in the markets and selling rupees in order to lower its value.

As of now, it is not doing this, allowing the rupee to increase in value.

However, if India remains an attractive investment destination, the rupee is unlikely to drop significantly from its current level as foreign investments will come pouring in.

But if it does 'rise in value' further then you and I will be able to buy that imported watch, the latest laptop and of course, oil at much cheaper rates than we are doing now.

USD-Rupee Exchange Cycle



RBI- Intervention

The demand for the rupee causes appreciation in its value. If RBI weighs the pros and cons of the situation and feels that the negative impact on exports outweighs the positive impact on imports, it intervenes by buying the excess dollars in the system, thus creating demand for the dollar. This leads to depreciation of the rupee thereby stabilizing its value again. Another consequence of this step is infusion of INR in the banking system. This leads to increase in liquidity which in turn can stoke inflation in the system

