



**Anand Wadadekar**

# Understanding 'Dollar Rupee Relation'

**SIMPLY 5**

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## About 'Exchange Rate' of a currency:

The exchange rate of the currency of a country in relation to the currency of another country depends on the comparative trade advantages and economic strengths of the countries.

If one US dollar is equal to 45 rupees, it simply means that in the US, if a dollar fetches 45 oranges while in India, a rupee would fetch only one orange of equivalent size and quality.

Just like any other commodity, the currency of any economy is based on dynamics of supply and demand, and its value depends on trading in currency exchanges all over the world. Higher the demand for a currency on an exchange, the stronger it becomes and vice versa. However, for currencies like INR which are not traded on exchanges, the value depends on capital inflows in the country.



## Appreciation & Depreciation of currency:

A currency appreciates means its value has increased in relation to another currency. A currency depreciates means its value has decreased in relation to another currency. Eg. If 1 \$ costs Rs 45 and if it now costs Rs 44, this means rupee has appreciated in its value (i.e. instead of Rs 45 you will get 1 \$ in Rs 44, this also means the dollar has weakened). Similarly, if 1 \$ costs Rs 45 and if it now costs Rs 46, this means rupee has depreciated in its value (i.e. instead of Rs 45 you will get 1 \$ in Rs 46, this also means the dollar has strengthened).

## Why do currency values fluctuate?

There are many participants in any foreign exchange market. These entities -- like banks, corporations, brokers, even individuals -- buy and sell currencies everyday.

Here too the universal economic law of demand and supply is applicable: when there are more buyers for a currency than sellers, its exchange rate rises. Similarly, when there are more sellers of a particular currency than buyers, its exchange rate

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*The views are personal*



will fall. This does not mean people no longer want money; it only means that people prefer to keep their wealth in some other form or another currency.

### Scenario before occurrence of the current financial crises:

We were witnessing a surge of dollar-inflows into India due reasons like strong economic fundamentals and favourable business atmosphere, etc. These dollar inflows can be in the form of Foreign Direct Investment, portfolio inflows (foreign investment in equity), External Commercial Borrowings by Indian companies abroad and remittances to India by Non-Resident Indians. Since the Indian economy and the Indian stock markets have been on a roll, the capital inflows to India has been pretty strong which has primarily led to the appreciation in value of rupee. This huge influx caused a significant demand supply gap between the dollar and the rupee. Going by the laws of demand & supply, the rate of the rupee vis-à-vis the dollar, rises.

Due to this exporters were placed at a disadvantage with a rising rupee, since the dollar became weaker. Thus a dollar which fetched Rs. 48 about two years ago today fetched only Rs. 44 eating into the profit margins of exporters (since they earned less on their exports).

At the same time, importers benefit (since they need to pay less for their imports), but our economy was at a stage where we first needed to build our dollar reserves to meet our import payments and so the exporters' woes were needed to be tackled first.

The Reserve Bank of India (RBI), as the central bank of India, which oversees the foreign exchange (forex) management of this country quite often intervened to ensure that the rupee was adequately propped at a particular rate. This was done to ensure that there are no sudden currency shocks, to protect exporters and importers and above all, to ensure the feeling of 'national pride,' which is attached to a stable and healthy currency.

When the RBI intervened to keep the rupee at some weak value, it had to buy the dollar inflows from exporters, from NRIs, from foreign direct investors, from companies that borrow abroad. In any case the sellers of dollars need rupees to conduct their businesses here. The RBI buys or sells dollars via state-run banks to prevent excessive volatility in the forex market and avoid any sharp appreciation or depreciation in the currency. When the RBI purchases foreign currency inflows, the domestic monetary base or money supply or both



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rises since for every dollar the RBI buys from the market, an equivalent amount of rupees gets injected into the system, adding to excess money in the system or the liquidity overhang. When the RBI buys dollars, it pays for them using freshly printed rupee notes. This leads to greater money supply, higher credit growth and inflation.

And precisely, here comes the catch. As RBI sells more rupees, the money supply increases which means too much money chasing same (or less) number of goods, thereby leading to inflation. So in effect one act of RBI creates another problem. In other words, when the RBI buys dollars from the Indian market, it simultaneously pumps rupees into the currency markets, creating the risk of inflationary pressures. The RBI typically controls the appreciation

by manipulating demand-supply dynamics of currency market. It purchases dollars (to create more demand for dollar) and sells rupees (to increase supply of INR, thereby decreasing its value).

To contain inflationary pressures, the RBI adopts a measure termed as 'sterile intervention.' Under this measure, the RBI sells Government of India bonds in the market. With the sale of these bonds, the rupee, which had flowed into the market for buying dollars, is once again sucked out of the market. When the RBI buys dollar-denominated assets, (to create demand for dollars and reduce supply of rupee) it sells rupee-denominated securities to suck the rupees back. But when the RBI has to suck out a whole lot of rupees back, it has to raise rupee interest rates, the Repo rate (the interest rate at which commercial banks borrow for short term from RBI) and the Cash Reserve Ratio (CRR).

This is how the RBI protects the dollar-rupee exchange rates and yet, manages to contain inflation.

### Scenario after occurrence of the financial crises:

The sub-prime crises, bankruptcy, sale, restructuring and merger of some of the world's largest financial institutions caused cataclysmic disruptions in the international stocks and money markets. Imprudent financial decisions, fed by greed and bad luck, have seen global financial markets collapse.

The current financial crises that shook the global financial markets has seen unprecedented bailouts and infusion of dollars into the US economy at a cost of many an emerging market, from where funds have been pulled out to flow back into America.

India, which was till recently having huge capital dollar inflows, now is experiencing flow of dollars outside the country due to selling of more Indian shares than bought (to the tune of over \$9 billion), thereby making dollars scarce in India and reduced demand for rupees, simultaneously, as there is increased demand for dollars due to spurt in crude oil prices and the dipped capital inflows.

The dollar prices fell by some considerable amount with respect to most of the currencies. Here in India the rupee rose to around 40-41 a dollar from around the 45 rupees a dollar. There is a lot of panic among the exporters because a weak dollar adversely affects the exporters, especially in the services sector who have all their expenditure in rupees and earnings in dollar.

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Example: Consider a firm; say 'K software' that has a profit margin of 5 %. Now 'K software' bags a contract of 100,000 USD from a big US based firm when the dollar Rupee exchange rate is 45 Rs a dollar. So the profit of 'K software' would be 5 % of 100,000 i.e. USD 5k (= 225k Rs at the exchange rate of 45Rs= 1USD) and expenditure which is in Rupees as USD 95k i.e. 4275k Rupees. Therefore, 'K software' goes ahead with its project and when the project is completed the dollar gets weak and trades at 40 Rupees a dollar. Now 'K software' has already spent 4275k and now despite getting the

promised 100,000 USD they get only 4000K rupees and end up, in effect, paying 275k for developing the software. So weakening of dollar is detrimental for the exporters.

To explain it with another example; Say that exchange rate is US 1 \$ = 50 INR. If an exporter X earns US \$ 1000 by exporting his goods/services to US, his earnings in Rupee terms is Rs. 50,000. If the Rupee appreciates to US 1 \$ = 40 INR, then in rupee terms the earnings of exporter will be Rs. 40,000. A fall in earnings despite the exports being constant. But the exporter who is based in India has to spend in INR in India; he has less money at his disposal constraining his further growth by way of limiting his investment capacity.

Importers on the other hand have to pay less to import the same thing suppose you buy a 100\$ iPod now you will have to shell out just around 4k instead of the earlier 4.5k. This is one of the reasons why all those Oil economies which are primarily the importers maintain very high exchange rates by regulating their currencies.

#### Reverse of what was happening before the crises:

Therefore, where the RBI was sucking out the excess liquidity from the system caused due to huge capital dollar inflows, it is now compelled to reverse its stance and infuse liquidity back into the system. Where previously the CRR was hiked, RBI now reduced the CRR, repo rate and adopted to increase the reverse repo rate (the interest rate at which RBI borrows for short term from the commercial banks), since there is shortage of money supply in the system and therefore reduced credit in the market.

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