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Why is the Indian rupee falling against the US dollar?

Like any other trade in life, the relative value of one currency against another depends on which is demanded more. If Indians demand more US dollar than Americans demand the Indian rupee, the exchange rate will tilt in favour of the US dollar

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New Delhi | Updated: December 22, 2024 16:02 IST

5 min read

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The value of each currency relative to another currency is called the exchange rate. These values can stay the same over time but more often than not they keep changing. (File)

The Indian rupee's exchange rate against the US dollar has breached the 85 mark. In other words, one would have to pay Rs 85 to buy $1. In April, this "exchange rate" was around 83 and a decade ago, when Prime Minister Narendra Modi took charge, it was around 61. As such, the rupee has been weakening in value relative to the dollar. To be sure, this is a long-term trend as CHART 1 shows.

Chart 1

What is the exchange rate?

Typically, we buy goods (such as a pizza or a car) and services (such as a haircut or a hotel stay in a hill station) using our money — the Indian rupee. But there are many things where we need things from outside the country — say an American-made car or Swiss vacation or indeed, crude oil. For all such goods and services we might have to first buy the US (dollar) or Swiss currency (euro) using our domestic currency before we buy the final item. The rate at which one can swap between currencies is the exchange rate. In other words, how many rupees would buy you a dollar or a euro.

In such a market — also referred to as the currency market — each currency is like a commodity itself. The value of each currency relative to another currency is called the exchange rate. These values can stay the same over time but more often than not they keep changing.

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What determines the exchange rate?

Like any other trade in life, the relative value of one currency against another depends on which is demanded more. If Indians demand more US dollar than Americans demand the Indian rupee, the exchange rate will tilt in favour of the US dollar; that is, the US dollar will become relatively more precious, more valuable, and more costly. If this situation keeps repeating every day, such a trend will

become stronger and the rupee will keep losing value relative to the US dollar. This movement will show up in the form of the rupee's exchange rate **weakening against the dollar**.

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But what factors determine the demand for rupee vis a vis dollar?

There are several factors that can affect the demand for currencies.

One big component of demand comes from trade of goods. For the sake of simplicity, imagine a world where there are only two countries — India and the US. If India imports more goods from the US than what it exports to the US, then the demand for US dollar will outstrip the demand for Indian rupee. This, in turn, will make the US dollar gain strength against the rupee and its exchange rate versus the rupee will appreciate. Put differently, the rupee's exchange rate relative to the dollar will weaken. As a result, more rupees will be required to buy a single US dollar.

The other big component is trade in services. If Indians buy more US services — say tourism — than Americans buy Indian services, then again, demand for dollar will

outstrip the demand for rupee, and rupee will weaken.

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The third component is investments. If Americans invest in India more than Indians invest in the US, then the demand for rupee will outstrip the dollar and rupee will appreciate against the dollar.

These are the three main ways in which the exchange rate can change.

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But what factors affect these three kinds of demands?

Of course, there are several factors that can affect these three demands.

Suppose the US decides that it will not allow Indian imports. In such a scenario, the demand for Indian rupees will plummet. After all, if the Americans can't buy Indian goods, why would they go to the currency market to buy Indian rupees?

End result: rupee will weaken. Something similar is expected to happen if, as President-elect Donald Trump has promised, the US slaps high tariffs against Indian goods, making them so costly that no one in America will buy them.

Similarly, imagine a scenario where both India and the US are experiencing high inflation. By definition, inflation eats away the value of a currency because an inflation of 5% means that whatever one could buy for Rs 100 in first year, requires Rs 105 to buy in the second year.

Now imagine that in five years time, the US reduces its inflation to zero while in India it stays at 6%. This would mean that if an American decides to invest in the Indian stock market thinking that Indian companies/shares give an annual return of 10%, he or she would end up getting only 4% real return because six out of those 10% would be eaten up by inflation. On the other hand, the US stock market might give a return of just 5% but since inflation is at 0%, the final return would be 5%.

In such a scenario, an investor may not make any fresh investments into India; worse still, he or she may actually pull out money from India and invest it back in the US. Both these actions will reduce the demand for rupees relative to the dollar and the rupee will weaken against the dollar. Again, something similar is happening at present as the investors pull out money from India.

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First uploaded on: 21-12-2024 at 08:12 IST

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