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The Dynamics of Indian Rupee Depreciation: Causes, Impacts, and Policy Responses

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Abstract

The Indian rupee has experienced a gradual depreciation against the U.S. dollar over the past three decades. While currency depreciation is often perceived as a sign of economic weakness, the reality is more complex. This paper examines the factors responsible for the depreciation of the Indian rupee, compares the current situation with the 2013 "Taper Tantrum" episode, analyzes the role of the Reserve Bank of India (RBI), and evaluates the economic consequences of a weaker rupee. The study finds that India's current macroeconomic fundamentals remain relatively strong despite currency pressures.
Furthermore, moderate depreciation can improve export competitiveness and act as a shock absorber during periods of global uncertainty.
Keywords: Indian Rupee, Currency Depreciation, RBI, Exchange Rate, Current Account Deficit, Inflation, Exports

Introduction

The exchange rate of a country's currency serves as a crucial indicator of economic health and international competitiveness. In recent years, the Indian rupee has weakened against the U.S. dollar, crossing the ₹90 per dollar mark and reaching historic lows. This development has generated concerns regarding inflation, import costs, foreign investment, and overall economic stability.

However, currency depreciation is not necessarily synonymous with economic weakness. Many economists argue that controlled depreciation can support exports, improve trade competitiveness, and help economies absorb external shocks. This paper explores the causes, implications, and policy responses associated with the depreciation of the Indian rupee.

Historical Perspective: The 2013 Taper Tantrum

One of the most challenging periods for the Indian rupee occurred in 2013 during the U.S. Federal Reserve's announcement of reducing its quantitative easing program, popularly known as the "Taper Tantrum."
At that time:

* India's Current Account Deficit (CAD) stood at approximately 4.8% of GDP.
* Inflation was high.

* Economic growth was slowing.
* India was heavily dependent on foreign capital inflows.

As investors withdrew funds from emerging markets, the rupee lost nearly 20% of its value. India was grouped among the "Fragile Five" economies, reflecting concerns regarding its external vulnerability.
The current situation differs significantly from 2013. Inflation is comparatively controlled, foreign exchange reserves are stronger, service exports remain robust, and economic growth is healthier. Consequently, the present depreciation appears more manageable than the crisis-like conditions witnessed in 2013.

Long-Term Depreciation Trend of the Rupee

The depreciation of the Indian rupee is not a recent phenomenon. Since economic liberalization in 1991, the currency has followed a gradual downward trajectory.
Average Annual Depreciation
1990–2000: 9%
2000–2010: 6%
2010–2020: 5%
2020–2025: 4%

The rupee has moved from approximately ₹17 per U.S. dollar in 1991 to around ₹90 per dollar in 2025. This trend reflects structural factors such as inflation differentials, trade imbalances, and economic development patterns rather than temporary market disturbances.

Causes of Rupee Depreciation

Current Account Deficit (CAD)

The Current Account Deficit represents the gap between a country's imports and exports of goods and services. When imports grow faster than exports, demand for foreign currency increases, putting pressure on the domestic currency.

Recent increases in gold imports and energy imports have contributed significantly to India's CAD.

Global Economic Conditions

Several global factors have influenced the rupee's decline:
* Strong U.S. dollar appreciation
* Higher U.S. interest rates
* Global trade uncertainties
* Geopolitical tensions
* Changes in international capital flows

These developments encourage investors to move funds toward safer assets, particularly

U.S. financial markets.

Foreign Portfolio Investment (FPI) Outflows

When foreign investors sell Indian assets and repatriate funds, demand for dollars rises, causing downward pressure on the rupee.

Trade Deficit

India's persistent trade deficit, particularly due to energy imports, increases demand for foreign currency and contributes to rupee depreciation.

Measuring Currency Strength: Effective Exchange Rate

The strength of the rupee cannot be evaluated solely against the U.S. dollar because India trades with many countries.

Nominal Effective Exchange Rate (NEER)

The NEER measures the weighted average value of the rupee against the currencies of India's major trading partners.

The weights are assigned according to each country's share in India's foreign trade.

Real Effective Exchange Rate (REER)

The REER adjusts the NEER for inflation differences between India and its trading partners.

A decline in REER generally indicates improved export competitiveness, while an increase may suggest reduced competitiveness.

Recent declines in India's REER indicate an adjustment that supports exports rather than a simple erosion of purchasing power.

The Role of the Reserve Bank of India

Many observers interpret rupee depreciation as evidence that the RBI is failing to defend the currency. However, the RBI follows a managed-float exchange rate regime.

Under this framework:

* Market forces determine exchange rates.
* RBI intervenes only to prevent excessive volatility.
* RBI does not target a specific exchange rate level.

The objective is to ensure orderly market functioning rather than artificially maintain a particular currency value.

The RBI also utilizes:

* Foreign exchange reserves
* Forward contracts
* Market interventions

to smooth excessive fluctuations and maintain confidence in financial markets.

Economic Impact of Rupee Depreciation

Positive Effects

Export Competitiveness

A weaker rupee makes Indian products and services cheaper in international markets. Benefiting sectors include:

* Information Technology (IT)
* Pharmaceuticals
* Textiles
* Gems and Jewellery
* Agriculture

Export-oriented firms receive more rupees for every dollar earned, increasing profitability and investment capacity.

Shock Absorption

Currency depreciation acts as an economic shock absorber by helping domestic producers remain competitive during global economic slowdowns.

Negative Effects

Certain sectors face higher costs due to depreciation:

* Oil and Gas
* Aviation
* Electronics
* Automobile Manufacturing
* Overseas Education
* Foreign Travel

These sectors depend heavily on imported goods and services, making them vulnerable to rising exchange-rate costs.

Rupee Depreciation and Inflation

Currency depreciation often leads to imported inflation. However, India's situation is unique because the country produces a substantial portion of its food requirements domestically.

Major food items such as:

* Wheat
* Rice
* Pulses
* Milk
* Vegetables
* Sugar

are largely sourced within the country.
Research suggests that a 5% depreciation in the rupee adds only around 15–25 basis points to inflation. Therefore, moderate depreciation does not necessarily result in a significant increase in everyday consumer prices.

Foreign Exchange Reserves as a Currency Shield

India maintains substantial foreign exchange reserves, which act as a buffer against external shocks.

These reserves:

* Strengthen investor confidence.
* Reduce vulnerability to capital outflows.
* Provide the RBI with resources for intervention when necessary.

Combined with forward market positions, these reserves form an important safeguard against excessive exchange-rate volatility.

Future Outlook

Despite recent depreciation, India's economic fundamentals remain strong. Factors supporting long-term stability include:

* Robust economic growth
* Expanding service exports
* Large foreign exchange reserves
* Controlled inflation
* Structural reforms

While short-term volatility may continue due to global uncertainties and trade tensions, the rupee's gradual depreciation is more indicative of economic adjustment than financial instability.

Conclusion

The depreciation of the Indian rupee should not be viewed solely as a sign of economic weakness. Historical evidence suggests that the rupee has followed a long-term depreciation trend driven by structural economic factors. Unlike the 2013 Taper Tantrum, India today possesses stronger macroeconomic fundamentals, larger foreign exchange reserves, and greater resilience to external shocks.

A moderate and controlled depreciation can improve export competitiveness, support economic growth, and act as a stabilizing mechanism during periods of global uncertainty. Therefore, the current movement of the rupee reflects an economic adjustment process rather than a currency crisis.

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