Rupee Appreciation & Depreciation

What is rupee appreciation & depreciation?

- Exchange rate is the price of foreign currency (USD, Yen, Euro, Pound etc) in terms of domestic currency (rupee) i.e. amount of domestic currency needed to buy one unit of foreign currency.
- Currently price of 1$ = ₹ 53.74, which means 1$ can be purchased in exchange of ₹ 54.
- Exchange rate tells us the value of domestic currency in relation to one unit of foreign currency. 1$ is worth ₹ 53.74.
- Rupee prices keep fluctuating all the time. Sometimes we need more rupees to buy one unit of foreign currency and sometimes we need fewer rupees to buy one unit of foreign currency.
- This change in rupee price is known as rupee appreciation or depreciation.
- Rupee appreciation is when value of rupee increases (becomes expensive) and fewer rupees can buy one unit of foreign currency. This is also known as strengthening of rupee as now INR is worth more than foreign currency.
- Suppose exchange rate changes to 1$ = ₹ 50, we say rupee has appreciated as 1$ can buy fewer INR.
- Rupee depreciation is when rupee value decreases (becomes less expensive) and more rupees can buy one unit of foreign currency. This is also known as weakening of rupee as now INR worth is less than foreign currency.
- If exchange rate changes to 1$ = ₹ 55, we say rupee has depreciated as 1$ can buy more INR.
- Currency price is always stated in relation to another currency. So when one currency appreciates the other currency depreciates.
- Chart below shows daily exchange rates of rupee per unit of various foreign currencies like USD, Pound, Euro, and Yen.

*The exchange rate for Japanese Yen is in Rupees per 100 Yen.*
What causes currency to appreciate or depreciate?

- Like any commodity whose price is determined by its demand and supply, currency price is also determined by demand and supply of that currency in the international market.
- When supply of a country’s currency increases, value of currency falls as more currency is required to purchase another currency causing currency to depreciate. Reverse holds true when demand for a currency increases.
- Demand for a country’s currency comes from its export of goods and services and foreign investment in the country.
- Supply for a country’s currency comes from its imports of goods and services and its investments in other countries.
- Major factors which cause currency to appreciate or depreciate are current account deficit/surplus, capital account flows, interest rate and inflation.
- **Current account deficit** is when imports are higher than exports. When a country imports more, it needs to pay in foreign currency, causing the country’s currency to depreciate as demand of its currency decreases. Reverse holds true in case of current account surplus.
- Chart below shows India’s current account quarterly data and rupee movement from 2000 till December 2012.

![Chart showing India's current account quarterly data and rupee movement from 2000 till December 2012.](chart)

- From above chart, we can see that rupee has depreciated with increase in current account deficit.
- During 2002-2004, when India saw current account surplus, rupee has appreciated from ₹ 48.8 to ₹ 43.58.
- From 2011 with increasing deficit, rupee has depreciated from ₹ 49 to ₹ 54.7 (as on December 2012).

- **Capital account flows** - Current account deficit is funded by capital flows and current account surplus generate capital outflows (invest in other countries). When there is capital inflows in the country, demand for the currency increases leading to currency appreciation. Capital outflow causes the country’s currency to depreciate as supply of its currency decreases and demand for foreign currency increases.
- Chart below shows India’s quarterly capital account flows and rupee movement from March 2000 to December 2012.

- From above chart, we can see with increase in capital flow, rupee has appreciated.
- **Interest Rate** - A country with high interest rate attracts foreign investors to take advantage of the arbitrage opportunity arising from low interest rates in their country. Thus demand for the country’s currency increases, resulting in appreciation in the value of the currency.
- Chart below shows movement between repo rate and rupee.

- **Inflation** - High inflation in a country impacts the country’s exports as goods become expensive for other countries resulting decreased demand for the currency and hence depreciating currency value.
- Chart below shows monthly inflation and rupee price change\(^1\) from April 2006 till March 2013.

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\(^1\) Rupee change is monthly price change and negative change means rupee has appreciated and positive change means rupee has depreciated.