

RESEARCH**BOB ECONOMICS RESEARCH | EXCHANGE RATE**

Imported inflation: Myth or reality?

SUMMARY**INDIA ECONOMICS: EXCHANGE RATE**

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research@bobcaps.in

EXCHANGE RATE

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Aditi Gupta

Economist

Dipanwita Mazumdar

Economist

These announcements along with anticipation of retaliatory tariffs and fears of a full-blown global trade war kept investors on edge. Wide gyrations were seen in almost all asset classes, with global currencies also depreciating to multi-year lows. INR also remained under pressure and tested new lows in successive sessions, ultimately depreciating to a record-low of 87.58/\$ on 6 Feb 2025, marking a ~4% depreciation in the exchange rate since the US elections.

Inflation and exchange rate: Apart from the external sector stability considerations, a sustained currency depreciation can also have implications for domestic macroeconomic stability. Traditional economic theory postulates a negative relation between inflation and exchange rate. This essentially means that a higher inflation exerts depreciation pressure on the exchange rate, and vice versa. This is based on the purchasing power parity principle. There also seems to be growing concern over the inflationary impact of a significant decline in the domestic exchange rate, also known as imported inflation. Emerging countries like India, which depend on imports either as intermediate inputs in the domestic manufacturing processes, or for direct consumption are particularly more susceptible to the risks emerging from a rapid depletion in the value of their currencies. This is because currency depreciation pushes up the price of imports, making inputs or imported goods more expensive. It is hence unsurprising that the recent bout of weakness in Rupee has led to serious concerns about its inflationary impact, especially at a time when the RBI has embarked on a long-awaited rate cut cycle, driven largely by a belief that the inflation outlook is much more comfortable.

To put this in perspective, India's headline inflation as measured by the CPI, has hovered at ~5.3% in the past 2 years, above the 4% target. This was driven largely by high food inflation which averaged about 7.5% in the same period.



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