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Title of the topic: "Understanding Currency Fluctuations"

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A) Introduction

During their monsoon trek, Arun and Neha paused to catch their breath at a scenic viewpoint.
"This trek was worth every step," Arun said, enjoying the mist-covered hills.
"Absolutely! Next on my list is a trek in Nepal," Neha replied excitedly.
"That's on my list too! Arun replied - I was thinking of a US trip later this year, but with the rupee weakening against the dollar, I'm not sure my budget will hold."
Neha nodded. "It's not just travel. I was planning to buy a new iPhone, but that seems to be getting more expensive as well."
"Interesting... I never thought the value of the rupee could affect both travel costs and gadgets. I always thought exchange rates only mattered to people who trade in foreign currencies."Arun remarked.
"It does—and much more," said Neha. "Currency movements influence imports, exports, inflation, company profits, stock markets, and even our investments."
Arun smiled. "Looks like I need to understand the currency fluctuates before planning my next anything!"

Currency fluctuations may seem like just another business headline, but they influence far more than international travel or imported products. From the prices we pay to the performance of businesses and financial markets, currency fluctuations have a widespread impact on our everyday lives and that decision that we intend to take. Understanding what drives these fluctuations and how they affect the economy and investments can help us make better financial decisions.

B) Decoding Currency Fluctuations

Currency fluctuation refers to the continuous change in the value of one currency relative to another. These changes determine how much a unit of your local currency, such as the **Indian Rupee (INR),** is worth when exchanged for any foreign currency like the **US Dollar (USD).** Exchange rates fluctuate every day due to changes in demand and supply in the foreign exchange market.

Two key terms associated with currency fluctuations are:

- Appreciation: When a currency increases in value relative to another currency, meaning less of the domestic currency is required to purchase the same amount of foreign currency. For eg: Current exchange rate: 1 USD = 98 INR, this means 1 US Dollar can buy 98 Indian Rupees. Now, after 6 months, suppose the exchange rate becomes: 1 USD = 95 INR. Then we can say that in this case, the INR has appreciated against the USD, since now 1 Dollar can buy only 95 Rupees compared to 98 Rupees earlier.

- Depreciation: When a currency loses value relative to another currency, meaning more of the domestic currency is required to purchase the same amount of foreign currency. For eg: Current exchange rate: 1 USD = 98 INR, this means 1 US Dollar can buy 98 Indian Rupees. Now, after 6 months, suppose the exchange rate reaches: 1 USD = 100 INR. Then we can say that in this case, the INR has depreciated against the USD, since now 1 Dollar can buy 100 Rupees compared to 98 Rupees earlier.

  Currency fluctuations are a natural feature of the global foreign exchange market and play a crucial role in international trade, investments, tourism, inflation, and overall economic growth. For businesses engaged in international trade, particularly importers and exporters, even small movements in exchange rates influence costs, revenues, profit margins, and pricing decisions a whole lot.

C) Factors Contributing to Currency Fluctuations

The following are some of the influential factors that are significant to consider when understanding how any currency fluctuates:

- **Inflation:** Countries with higher inflation generally experience a decline in the value of their currency, as rising prices reduce purchasing power and make the currency less attractive to investors.

- **Interest Rates:** Higher interest rates tend to attract foreign investors seeking better returns, increasing demand for the country's currency and strengthening its value.

- **International Trade:** Importers and exporters closely monitor these economic indicators, as changes in exchange rates directly affect the competitiveness of exports and the cost of imported raw materials and finished goods.

- **Business Cycles:** During periods of economic growth, a country's currency often strengthens due to higher investment and consumer confidence. Conversely, recessions can weaken the currency as economic activity slows.

- **Political Stability:** Stable governments and predictable policies enhance investor confidence, strengthening the currency. In contrast, political uncertainty or instability can reduce demand for the country's currency and weaken its value.

- **Government Debt:** Excessive public debt may raise concerns about inflation and a country's ability to repay its obligations, discouraging foreign investment and putting downward pressure on the currency.

- **Current Account Deficit**: A country that imports more than it exports requires more foreign currency to pay for imports. This increased demand for foreign currency can weaken the domestic currency over time.

D) Why Must We Know About Currency Fluctuations?

Understanding currency fluctuations helps individuals, businesses, and investors make informed financial decisions. Exchange rate movements influence the cost of imports and exports, business profitability, inflation, investment returns, and stock market performance. For businesses, monitoring currency trends supports pricing, budgeting, and risk management. Investors can better assess market opportunities and manage currency-related risks, while policymakers use exchange rate movements to formulate monetary and trade policies. In today's interconnected global economy, understanding currency fluctuations is essential for effective financial planning and sound economic decision-making.

E) Impact of Currency Fluctuations on the Indian Economy

Currency fluctuations can have both positive and negative effects on the Indian economy. Some of which are:

- **Higher Import Costs:** Importers face higher costs for raw materials, machinery, crude oil, and other inputs, which can reduce profit margins unless these costs are passed on to customers. India imports a significant share of crude oil, machinery, and electronic components. A weaker rupee makes these imports more expensive, increasing costs for industries such as aviation, automobiles, paints, and power.

- **Higher Inflation:** Costlier imports of crude oil, edible oils, fertilisers, and electronic components due to a weaker rupee often lead to higher prices for goods and services, contributing to inflation.

- **Boost to Exports:** A weaker rupee generally benefits exporters by increasing the rupee value of foreign earnings, improving profitability and global price competitiveness. Export-oriented sectors such as IT services, pharmaceuticals, and speciality chemicals benefit from a weaker rupee, as they earn more rupees for every dollar of export revenue, improving profitability.

- **Economic Growth:** A moderate depreciation can improve export competitiveness and support economic growth. However, a sharp or prolonged depreciation may increase the import bill, widen the trade deficit, and slow GDP growth.

- **Foreign Investment:** A weaker rupee reduces returns for Foreign Institutional Investors (FIIs) in their home currency, which may lead to capital outflows, reduced capital inflows, and increased market volatility.

- **Interest Rates and Government Finances:** Rising inflation caused by a weaker rupee may prompt the Reserve Bank of India to increase interest rates, thereby affecting consumption and investment. At the same time, higher import costs—particularly for crude oil and fertilisers—can increase the government's subsidy burden and fiscal pressure.

Thus, the above reasons shed a light on why it is important for one to be aware of currency fluctuations and its impact.

F) Currency Fluctuation Impact on the Indian Equity Markets

Currency fluctuations influence the Indian stock market by affecting corporate earnings, investor sentiment, and foreign investment flows. The impact, however, varies across sectors.

As mentioned before, export-oriented industries generally benefit from a weaker rupee, as foreign earnings translate into higher revenues in rupee terms. Improved profitability often boosts investor confidence, leading to a rise in the share prices of these companies.

On the other hand, import-dependent industries face higher input costs when the rupee depreciates, which can reduce profitability. Lower profit margins may reduce investor confidence, putting downward pressure on their stock prices.

Foreign Institutional Investors (FIIs) are also influenced by exchange rate movements. A weakening rupee reduces their returns when converted into foreign currencies. This may trigger capital outflows, increase market volatility and put pressure on broader market indices.

Overall, the stock market responds not only to the direction of the rupee but also to the reasons behind its movement. For instance, if the rupee depreciates due to global economic uncertainty, investors may become risk-averse, leading to a broader market decline even though export-oriented companies benefit.

G) Managing the Impact of Currency Fluctuations on Investment Portfolios

Currency movements can influence investment returns, particularly for portfolios with exposure to export-oriented, import-dependent, or international investments. While exchange rate movements cannot be controlled, businesses involved in international trade often manage currency risk through hedging instruments such as forward contracts, options, and currency swaps to protect themselves against adverse exchange rate movements. Investors, on the other hand, primarily rely on diversification and prudent portfolio management. Some common strategies include:

- **Diversify Across Sectors:** Maintain a balanced portfolio by investing in export-oriented, import-dependent, and domestic-focused companies. This helps reduce the impact of currency movements on overall portfolio performance.

- **Include International Investments:** Investing in global equity or debt funds provides geographical diversification and can act as a natural hedge against domestic currency depreciation.

- **Consider Currency-Hedged Funds or ETFs:** Some international funds offer "currency-hedged" versions. These investment products reduce the effect of exchange rate fluctuations on returns, making them suitable for investors seeking international exposure with lower currency risk.

- **Adopt a Long-Term Investment Approach:** Currency movements are often temporary. Staying invested over the long term can help smooth out the impact of short-term exchange rate volatility.

By combining diversification with a long-term investment approach, investors can better manage currency risk while building a balanced and resilient portfolio.

Sources: *SSL Research Centre, StoneX*

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