DEPRECIATION OF RUPEE AND ITS EFFECTS

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ABSTRACT

Rupee depreciation refers to the fall of the value of home currency against the foreign currency caused by the demand for foreign currency exceeding its supply in the market at a given point of time. Presently rupee has been continuing with its downward trend since a couple of months. Moving from bad to worse, the Indian currency hit new all time low of 68.85 three weeks ago. In such a situation one has to pay more than before to get units of foreign currency. This fall takes place in the market and on its own. Market determined exchange rate serves the purpose of aligning the domestic economy with the world economy was the price route. As consequences the domestic price gets linked up with that of the world price. With the liberalization, globalization and privatization policy of the Indian economy in recent years, imports are bound to increase the lessening of restrictions on imports and lowering of tariff on imports which the economic reform implies, an increase in imports has in fact taken place. Taking cognizance of the adverse impact the ongoing slowdown has had on the Indian economy, the Prime Minister's economic advisory council on Friday scaled down its GDP projection for the current fiscal to a more realistic 5.3 per cent from 6.4 per cent estimated earlier[1].

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[1] The Hindu, sep 14,2013,p 16

India got her independence from British rule on Aug 15, 1947.At that time Indian rupee was linked to the British pound and its value was at par with the American dollar. There was no foreign borrowing on India's balance of payments sheet. To finance welfare and development activities, especially with the introduction of the five year plans, the government started external borrowings. This required the devaluation of the rupee. After independence, Indian chooses to adopt a fixed rate currency regime. The rupee was pegged at 4.79 against a dollar between 1948 and 1966. India faced a serious balance of payment crisis in 1991 and was forced to sharply devalue its currency. The country was in the grip of high inflation, low growth and the foreign reserves were not even worth to meet three weeks of imports. Under this situation, the currency was devalued to 17.90 against a dollar.

India being a developing economy with high inflation, depreciation of the currency is quite natural. Depreciation of rupee is good, so long as it is not volatile. A random depreciation that we have seen in the last few months is bad and it has hurt the economy. Right from the beginning of the year 2013, the value of rupee has been depreciating.

High growth coupled with a market driven exchange rate bears well for the economy. However, when growth falters and macroeconomic parameters start appearing vulnerable, one of the first casualties is the exchange rate. Presently, there is no clarity on whether we have seen the worst of the storm or it is just the beginning. The problems are manifold. Persistent high inflation and fiscal deficit, increasing subsidies, faltering exports and slowing industrial production pointing towards an economy, which is moderating in growth. Monetary policy has so far been ineffective in reversing the inflation trajectory. Fiscal stimulus appears non-existent, especially when the government has added to the subsidy bill by giving a go ahead to the food security bill. In this weakened environment, the rupee has depreciated by close to 20%in the past few months.

Secondly, the extent of volatility in the global economy has not helped. Besides the euro zone crisis, the downgrade of the US economy has let to flight of capital in order to boost the US home economy. The US dollar has become scare and unlike its peers, India needs to attract sufficient foreign funds to close the fiscal and current account gap. The fact that a weakening of the Indian economy has happened at the same time as a global debt crisis has elevated the exchange problem.

The appreciation in the US dollar has led to the decrease in the value of Indian rupee; the value of US dollar has been rising over since the Chairman of the U.S Federal Reserve, Mr. Ben Bernanke has announced on May 22nd that an end was in sight to the federal reserve's policy of quantitative easing i.e., the policy of keeping down U.S. interest rates by injecting liquidity into the system. Bernanke's announcement made speculators shift funds to the U.S. where the interest rates are expected to rise, and this has reduced the value of all other currencies, including the Indian rupee (and even of gold), vis-a-vis the U.S. dollar[2] . This has hit not only the emerging markets and assets of India but also of other countries like Thailand, Brazil, South Africa, Indonesia, Russia, China and other developing countries. Just as in other countries, the foreign institutional investors have also started withdrawing their investments in the Indian bond market. With growing concern for increasing risks in the global investment, massive redemptions through the global exchange traded funds are taking place. This has further initiated the selling by the FIIs in the equity market of India leading to depreciation in the Indian rupee. The Reserve bank of India does not wish to intervene and control this depreciation as it is initiated by global factors that are beyond the control of RBI. Moreover, the trade deficit of India has also not escalated further decreasing any hope of appreciation in Indian rupee in near future.

Meanwhile the Indian economy, like any bank facing a run on its resources, is under intense pressure. This is aggravated because our banking sector is both small and undercapitalized and not well configured to take on rapid outflows of this nature. The rupee, like the currency of any country now a day's, is underpinned by the working economy and its fundamentals .and all parameters of these assessments are also very weak at present. Indian officials and central bankers say their economy is only one of several emerging markets that are suffering from the flight of investors back towards the US, where the prospect of an end to the Federal Reserve's ultra-easy monetary policies has made dollar assets more attractive.

EFFECTS OF DEPRECIATION OF RUPEE

1. Automated devaluation brought on by the rupee makes some asset classes attractive; there may be slight recovery because of arbitrage opportunities and bottom fishing.

[2] People's Democracy,vol.xxxvii,No.27, 7 July 2013.

2. Students who are studying abroad will bear the brunt most owing to depreciating rupee expenses incurred towards the university/college fee as that of living will shoot up, thereby spelling a huge burden on the students.
3. Forex reserves could fall putting pressure on rupee.
4. Buying imported stuff will become a very costly affair. You will have to shell out extra on imported goods. For instance if you bought a product valued USD 1,you paid around Rs.54(three months ago) but you will now have to shell out close to Rs 65 for the same product. Trade deficit will widen because of costlier imports, worsening the current account deficit.
5. Exports are unable to leverage the weak rupee fast enough given the speed of its descent. In fact many exporters are caught out because of fixed price contracts in rupees wherein they cannot get the benefits of its rapid fall. The balance of payments is tilting sharply against U.S.
6. Global rating agencies will revise our rating downwards to "junk" status, making international borrowing difficult and even more expensive.
7. Spending on any kind of foreign exchange denominated spending will increase, apart from spending on discretionary goods.
8. Capital inflow will slow or reverse.
9. In case of weak demand companies may not be able to pass on higher input costs.
10. The government and the RBI have issued a series of measure in recent days designed to reduce the current account deficit and bolster the rupee, including increases in the import duty on gold. The end of duty exemptions of outward direct investment by Indian companies and individuals.
11. Fuel price will keep petroleum subsidy in check, but fertilizers subsidy will rise.
12. The depreciating rupee will surely be a dampener if you are planning your holiday abroad. Your travel charges as well as hotel charges will escalate drastically, let alone shopping and other miscellaneous spending activity.

The finance ministry has argued that this sharp decline in the rupee is "no reason to panic". Its representatives have suggested that this is happening because most currencies have depreciated relative to the U.S. dollar ever since Ben Bernanke, the head of the united stated Federal

Reserve, indicated a possible decline in the monetary policy of “quantitative easing” that had encouraged capital to move away from the U.S. in search of higher returns in other currency assets. But this is simply not true. First of all, the rupee had declined even when the U.S monetary policy was at its most lax and when countries such as Brazil had complained about the currency wars generated by the U.S. quantitative easing.

Further, recent trends indicate a significant worsening of both trade and current accounts. Both exports and imports actually declined in 2012-13 compared with the previous year, but even so the trade deficit still increased by nearly 4 per cent, or more than $7 billion. In April 2013, exports were 2 per cent higher than in April 2012 but imports were 11 per cent higher and non oil imports were 15 per cent more. So the trade deficit increased by more than 26 per cent in April 2013 compared with the previous year [3], and external debt rose 13 per cent over dollar 345.5 and is now stood at dollar 390billion[4].

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What is more important is, the increasing costs of imports can also affect exports, thereby wiping out any global cost advantage accruing from the devaluation. For example, important export sectors such as gems and jeweler, automobiles, machinery and chemicals are all very import dependent, and their rising costs could nullify the impact of the devaluation on their ability to sell more cheaply in export markets. This is made worse by the fact that in the current depressed global trade context, buyers are able to renegotiate contracts once the exchange rate has changed. Indeed, many global buyers even in sectors such as garments and leather goods now insist on contracts and invoicing in rupee terms. This allows them to benefit completely from rupee

[3] Finance ministry, Monthly economic report for April 2013.

[4] The Hindu,7th sep 2013,p 13

depreciation, while the local producers are forced to bear the rising domestic costs. This means that the falling rupee need not generate any significant increase in exports as may be hoped.

CAUSES OF RUPEE DEPRECIATION

Among the following reasons, Strengthening of dollar index overseas, strong importers demand and continuous capital outflows coupled with widening current account deficit which almost touched 3.8 per cent of the GDP has put pressure on the rupee[5].

1. Bearish bets in offshore markets, key cause of the rupee's recent harrowing plunge[6].
2. One of the most obvious reasons why the current depreciation is not to be welcomed is the effect on domestic living standards. There are several ways in which the falling rupee immediately has an inflationary impact, one of the most important of which is the price of energy. Since the misguided decontrol of oil prices, it is not only the globally traded price of fuel but also the exchange rate that determines domestic oil prices. Both Durable consumer goods such as automobiles, white goods and electronic items and non durable goods such as soaps and toiletries are all likely to become more expensive. And, of course, food inflation the most worrying aspect of recent price movements is likely to go up as well.
3. The fact that private fixed investment did not increase at the same pace is perhaps because a large portion of the credit was diverted by Indian companies to what would appear to be an asset bubble-in land, shares of companies and other speculative assets. The clamour by corporate lobbies that interest rates be lowered has no respect for economic logic, given the state of the country's external balances. They fail to appreciate that the era of cheap credit fuelled growth is well and truly over[7].
4. As per the data reported, FIIs are showing some disinterest I Indian markets lately. Sluggish economy and recovery in stock markets of developed economies like U.S. and Japan are believed to be the key reasons. Since FIIs inflows have played important role in keeping rupee at current levels, an intense selling activity by them does not augur well for the near term direction of the rupee.

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[6] The Hindu ,sep 27,2013,p 17

[7] The Hindu ,sep 17,2013,p 10

5. Consistently high inflation has resulted into Indian goods becoming expensive in the global markets, thus making it less competitive, especially when compared to goods from china. Thus, rupee may have hardly any support by way of higher exports. Lastly, gold imports, another key reason why the deficit is high and rupee under pressure, may not slow down in a hurry.
6. The value of rupee follows the simple demand and supply rule of economics. If the demand for the dollar in India is more than its supply, dollar appreciates and rupee depreciates. Similarly, when the supply of dollars in India increases its demand, the value of dollar decreases in terms of rupees.
7. The central banks of euro zone and Japan are printing excessive money due to which their currency is devalued. On the other hand, U.S. Federal Reserve has shown signs to end their stimulus. Hence, making the US dollar stronger against the other currencies including the Indian rupee, at least in the short term.
8. Oil price is one of the most important factors that put stress on the Indian rupee. India is in the unhappy situation where it has to import a bulk of its oil requirements to satisfy local demand, which is rising year on year. In international markets, prices of oil are quoted in dollars. Therefore, as the domestic demand for oil increases or the price of oil increases in the international market, the demand for dollars also increases to pay for suppliers from whom we import oil. This, increase in demand for dollar weakens the rupee further.
9. Our equity market has been volatile for some time now. So, the FIIs are in a dilemma whether to invest in India or not. Even though they have brought in record inflows to the country in this year chances are there that, they may be thinking of taking their money out of the equity market which might again results in fewer inflows of dollars in India. Therefore, decrease in supply and increase in demand of dollars results in the weakening of the rupee against the dollar.

On the investment front steady decline in GDP growth, constant and continuing contractions in industrial output, spiraling inflation, growing instance of financial corruption, policy confusions etc. do not help in portraying India as a favored investment destination. It is here that the government has a very crucial role to play. In reality the only role the government has played till date is to try and correct certain policy nuances (FDI regulations etc.) but has done precious little to address the concerns of the domestic economy.

The government would do better if it were to concentrate mainly on the domestic economy. Foreign investment is a consequence of good domestic growth and not a consequence of domestic fiscal and regulatory policy alone. The fiscal and domestic policy regimes come secondary-primarily it is the fundamentals of the Indian economy, which will attract foreign investment and thereby help the rupee in regaining some value. The government has targeted a CAD of 3.7 percent of GDP, or USD 70 billion, in the current financial year. India's CAD, which indicates the excess of imports of goods, services and transfers over exports, touched a record 4.8 percent of GDP, or USD 88.2 billion, in 2012-13. The CAD has widened due to increasing imports, especially of commodities such as oil and gold.

CONCLUSION

Currency depreciation affects everyone in the economy because it feeds directly and indirectly into general inflation, which is a continuing problem even as output growth decelerates, and therefore hits common people hard. There are several ways in which the falling rupee immediately has an inflationary impact, one of the most important of which is the price of energy. Since the misguided decontrol of oil prices, it is not only the globally traded price of fuel but also the exchange rate that determines domestic oil prices. Going by the way the economies in the euro zone and the US have been behaving, it would be naïve to expect that the export earnings would be contributing significantly to foreign exchange inflows in the near future. The government should concentrate on correcting the economic fundamentals rather than indulge in soap operas in a run up to the election. A better coordination with RBI is required rather than blame game and the new RBI governor Raguram Rajan should be wary of replicating the Anglophone model which has spread so much devastation across the world[8]. Keeping apart the differences the political parties should come together in fixing the problem and getting back the investors confidence.

[8] The Hindu, sep 14,2013.p.8