THE IMPINGEMENT OF DEVALUATION OF INDIAN RUPEEONINDIA'S ECONOMY

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Abstract:

India, one of the most emerging economies of the world, may face its worst financial crisis in decade if it fails to stem a slide in the rupee. The trend has changed drastically from 1947 as the value of rupee got depreciated from Rs.1/$ to all time low value of Rs.59.52 /$ in July2014. The major problems ascents when the people of the country are unaware of the reasons behind the devaluating currency. So with this paper an attempt has been made to give a general review behind the cause for downfall of the Indian currency. This study also focused on the history of Indian Rupee starting from 1947, to help one understand the root cause for the devaluation. This study also tried to convey the best possible remedies to curb this devaluation and imparted methodologies that a government should focus on.

Keywords:USD – United States Dollar, INR – Indian Rupee, BoP – Balance of Payment, EXIM – Export Import, CAD – Current Account Deficit, GDP – Gross Domestic Product

FIIs – Foreign Institutional Investors, FY13 – Fiscal Year 2013, RBI – Reserve Bank of India

FDI – Foreign Direct Investment

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Introduction:

“We invented money and we use it, yet we cannot understand its laws or control its actions. It has a life of its own.”
- Lionel Trilling, American literary critic.

The most concerning chapters for India over the last two years specifically over the last six months is weakening of Rupee against dollar. The value of dollar in rupee has increased from 45 to 68.825 in last two years. That is around 53%. In other words, value of rupee has depreciated by 53% (assuming inflation of dollar to be negligible). A common-man in this country is suffocated and besieged by triggered inflation due to depreciation in the Indian Rupee. Large chunks of goods are being imported to our country. As per fundamental laws of economics, if the demand of USD in INDIA will exceed its supply then its value will definitely increase and that of INR will come down. Due increased number of imported good in the country the demand has increased rapidly thereby devaluating Indian Rupee. The fall in the value of Indian rupee has several consequences which could have mixed effects on Indian economy. In this paper effort has been made to highlight the reasons and also attempts to study the real impacts of the devaluation of the Indian rupee

What is Devaluation of Currency?

Devaluation is used as a policy tool, when a country wants to reduce its trade deficit. The nation will be forced to devalue its currency if its market is too weak to justify the exchange rate. A currency's devaluation is the result of a nation's monetary policy. For example, suppose the exchange rate between rupee and dollar is Rs50= 1 $. If this exchange rate is fixed at Rs.55 = 1$ then it is called devaluation of rupee. Earlier Rs.50 could purchase a dollar and now more rupees (rs.5) are required to get a dollar. So the value of rupee in terms of dollar has declined.

Objectives of the study:

- To find out the root cause of this imbalance reviewing the History of Indian Rupee.
- To find out the impact on the economy and the possible steps taken by the government to handle the situation.

- To provide possible remedies to curb this situation.

Review of Literature

A review of all available related studies is quite indispensable to understand the basic concepts and theories pertaining to a research problem. In fact, a research gain a deep and perfect perception only from the experience gained in reviewing the publication closely related to the topic of interest. Hence a genuine attempt is made to review some of the outstanding studies related to the present research study

BatraN. K. et.al. [2]analysed the probable reasons and the impacts of depreciation of the rupee. Their study revealed the fact that, developing countries which don't allow currency prices to be determined by market forces. What happens is that they want to avoid financial crisis, for which they adopt policies to maintain a stable exchange rate to minimize exchange rate risk and save their gold (foreign currency) reserves. Restrictions placed are either trade barriers or financial. Financial restrictions are on flow of assets or money across border which is associated with policy of fixed exchange rate or managed exchange rate. The nation will be forced to devalue its currency if its market is too weak to justify the exchange rate. They have suggested Government should float overseas bonds to raise capital inflows

Kaur N et.al.[4] studied the effect of rupee depreciation on common man. They focussed change in pattern of spending and savings of people who are getting affected by rupee depreciation. Currency depreciation is severely affecting the economy of our country and eventually its residents are getting affected due to drastic change in their monthly budget. For stock market investors, things have turned worse. The fall in the value of Indian currency has several consequences which could have mixed effects on Indian economy and its residents. The study showed that after currency depreciation people are grappling with inflated prices of the commodities which they use in their day to day life and the change in their spending and savings trends, a falling rupee will pinch students who are planning to go abroad or are presently studying outside India.

MirchandaniA. [5]has investigated the various macroeconomic variables leading to acute variations in the exchange rate of a currency. The study concluded that Indian Rupee has shown

high volatility over the years. There are various probable reasons associated with it. India was receiving capital inflows even amidst continued global uncertainty in 2009-11 as its domestic outlook was positive. With domestic outlook also turning negative, Rupee depreciation was a natural outcome. Apart from lower capital inflows uncertainty over domestic economy has also made investors nervous over Indian economy which has further exaggerated depreciation pressures. Depreciation leads to Analysis of Macroeconomic Determinants of Exchange Rate Volatility in India 179 imports becoming costlier which is a worry for India as it meets most of its oil demand via imports. Apart from oil, prices of other imported commodities like metals, gold etc. will also rise pushing overall inflation higher. Even if prices of global oil and commodities decline, the Indian consumers might not benefit as depreciation will negate the impact. In present scenario without a more stable source of capital inflow, the Rupee is expected to remain highly volatile.

Exchange Rate Mechanism:

The Export and Import is also affected by the exchange rate. Devaluation can occur intentionally or it can be market driven. To understand this, let us first try to understand the determining factor of the exchange rate? Economies interacting with international economy can be classified on the basis of exchange rate policy of the country into three categories.

1. **Fixed Exchange rate:** The countries like Nepal and Bhutan with smaller economies follow this type of exchange rate regime. They peg their currency to some other more stable and prominent currency like US Dollar. The system is simple and provides stability to their economy. A large instability can be caused to the economy of these countries if their currency would have been market driven i.e. a sudden inflow or outflow of even a small amount of foreign capital will have a large impact on the exchange rate. Notable exception is China, which despite being large economy has its currency pegged to US Dollar.

2. **Floating (or free) Exchange Rate:** This exchange rate regime is followed by bigger and developed economies like US, UK, Japan etc. Here the exchange rate is determined by

the demand and supply of the currency. For example consider exchange rate of US Dollar versus Britain Pound. If US want to import something from Britain then it will have to pay in Pounds but it has only dollars with it, so US will have to buy Pound from the international currency market. This will tend to increase the demand of Pound and supply of Dollar. Thus the value of Pound vis a vis dollar will increase. Similarly if Britain Company is importing certain item from US, it will increase the value of dollar as compared to pound.

3. **Hybrid System:** Mostly mid-sized economy like INDIA practices this type of exchange rate regime. It allows exchange rate to float in the comfortable range. This regime offers Central Government to intervene in the currency market and control the exchange rate, if the market determined rate tries to breach this range.

The Root cause of devaluation of the Indian rupee (a Historical analysis)

From the year 1950 to 1973 Indian rupee was linked to British pound. But on 24th September 1975, the connection between Indian rupee and pound was broken. In 1975, India established a float exchange regime. And the effective rupee's rate is placed on a controlled, floating basis and linked to the basket of currencies.

Started at an exchange rate of Rs 4.00 in the 1950's, Rs 5.00 in the 60's and Rs 7.00 in the 70's, and Rs 8.00 in the 80's, these are the depreciation measure of Indian rupees before liberalizing of the economy. After the year 1980's current account deficits start to rise culminating into a BoP crisis in 1991, which causes the government to devaluate the Indian rupee against dollar and also it opened up the economy. This was followed by several reforms liberalizing the economy and exchange rate regime shifted from fixed to manage floating one. To understand the present scenario of the devaluation of the Indian rupee it is necessary to thoroughly understand the following two crisis that happen in the Indian history.

The 1966 crisis:

This is the year when as a developing economy it is expected that India would import more than it exports, Thus creating a balance of payments deficits since the 1950s. It resulted in the first

Major financial crisis the government faced. At that time inflation had caused Indian prices to become much higher than world prices at the pre-devaluation exchange rate, so later on when the exchange rate got fixed our country Experiences high inflation relative to other countries, as our country's goods become more expensive and foreign goods become cheaper relatively. Therefore, our exports decrease to a large extent and the imports increases rapidly. In the period between years 1950 to 1966, foreign aid was never greater than the total trade deficit of India except for the year 1958, which helped in the valuation of rupee until 1966. But in 1966, foreign aid was finally cut off and India was s told that it had to liberalise its restrictions on trade until foreign aid would again materialise. In the response to again materialise the foreign aid, Indian government devalued its currency and also bring the liberalisation in trade. But when it was seen that India still did not receiving foreign aid, government backed away from its commitment to liberalise its restriction on trade.

Another important factor that causes the further devaluation in 1966 is the s India's war with Pakistan in late 1965. In which the US and other countries which were friendly towards Pakistan, drew back their foreign aid to India, which resulted in the devaluation of Indian rupee.

The 1991 crisis:

In 1991 Indian government devaluated the rupee by 18 and 19 percent, and at the same time they also changed their s trade policy from its highly restrictive form to a system of freely tradable EXIM scrip's under which exporters are allowed to import 30% of the value of their total exports. This devaluation occurs as a consequence of all the reform efforts that had begun in the 1970s, when India relaxed restrictions on imported capital goods as part of its industrialisation plans. Then the Import Export policy of 1985-1988 replaed import quotas with tariffs.

Before 1991, there is a quantitative restriction on the India's trade barriers. But after 1991, government of India further lowers the tariffs on imports to further reduced the trade barriers, as after the post-liberalisation era, quantitative restrictions have not been significant. Thus due to all these in 1991 to avoid the financial crisis, it become necessary for the government to devaluate Indian rupee.

From March 1992 onwards government abolish the EXIM scrip system, And the dual exchange rate regime was established. Under this regime, the government allowed importers to pay for some imports with foreign exchange valued at free-market rates and other imports could be purchased with foreign exchange purchased at a government-mandated rate. And for the first time In March 1993 the government then unified the exchange rate and allowed the rupee to float. Thus From 1993 onward, managed floating exchange rate system was being followed, under which market forces ostensibly determine the exchange rate. S, but at the same time the Reserve Bank of India plays a significant role in determining the exchange rate by selecting a target rate and buying and Selling of foreign currency in order to meet the target.

The 2013 crisis

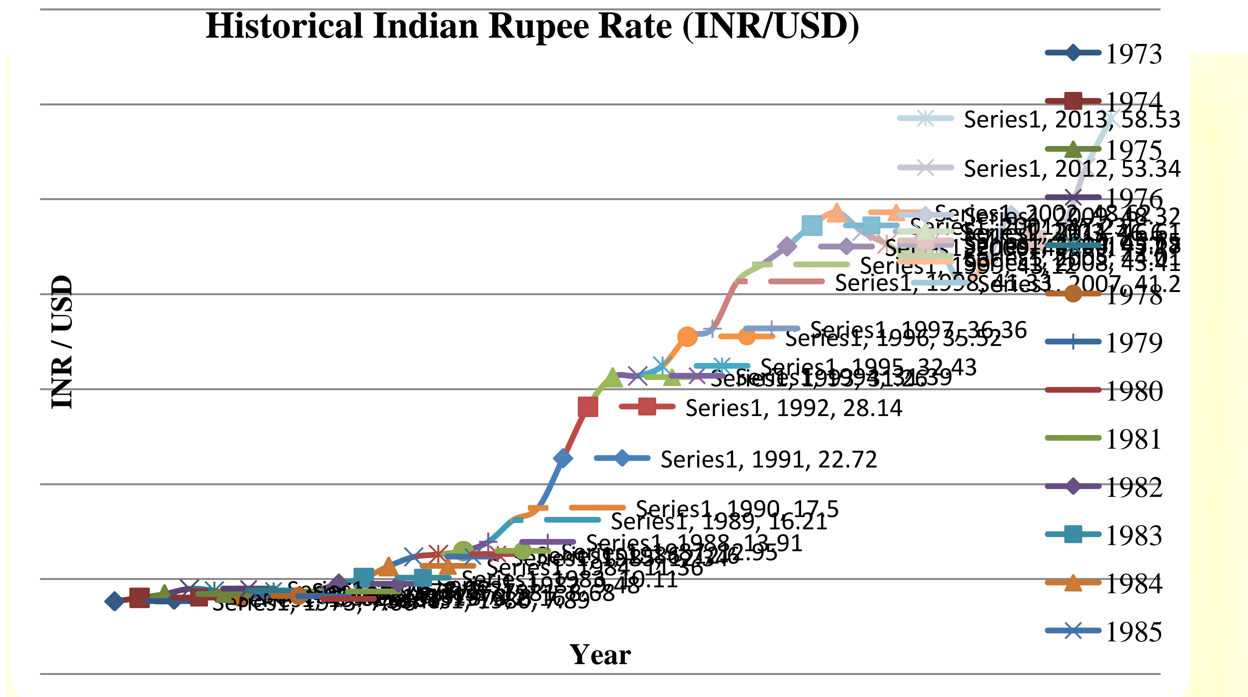
On 28th august 2013 the Indian rupee sank to a record low near 68.85 to the dollar, creating a history in the Indian economy history. The major cause for the falling rupee was the economy's high current account deficit, which was colliding with the Federal Reserve's signal to reduce monetary stimulus, which has already raised U.S. interest rates. The factors which aggravates India's current account deficit, were the Political factors, under which the government announced capital controls to keep residents from taking money from the country. Thus triggering Indians to take their money out of the country or convert it into gold, which requires buying it from foreign sources, which worsen the current account deficit. The high crude oil prices were also responsible for the current account deficit.

Table 1: A vast comparison of the Indian rupee fluctuation against the dollar

Historical Indian Rupee Rate (INR/USD)							
Year	**INR/USD**	**Year**	**INR/USD**	**Year**	**INR/USD**	**Year**	**INR/USD**
1973	7.66	1984	11.36	1995	32.43	2006	45.17
1974	8.03	1985	12.34	1996	35.52	2007	41.2
1975	8.41	1986	12.6	1997	36.36	2008	43.41
1976	8.97	1987	12.95	1998	41.33	2009	48.32
1977	8.77	1988	13.91	1999	43.12	2010	45.65
1978	8.2	1989	16.21	2000	45	2011	46.61
1979	8.16	1990	17.5	2001	47.23	2012	53.34

1980	7.89	1991	22.72	2002	48.62	2013	58.53
1981	8.68	1992	28.14	2003	46.6		
1982	9.48	1993	31.26	2004	45.28		
1983	10.11	1994	31.39	2005	44.01		

Source: http://www.forecast-chart.com/usd-indian-rupee.html



Reasons of Devaluation:

1. **Widening Current Account Deficit**

   One of the most important factors is the widening of CAD (Current Account Deficit). Current Account records all the trade (import-export), remittances, interests and earnings on investments made into outside countries. If the total inflow in the country exceeds the outflow then the country is having Current Account Surplus. But if the total inflow lags behind the outflow then the country is said to have Current Account Deficit. In the present scenario, India's current account deficit (CAD) narrowed sharply to $4.2 billion (0.9 per cent of gross domestic product (GDP)) in the third quarter of the current financial year from $31.9 billion (6.5 per cent of GDP) in the third quarter of 2012-13. This is also lower than $5.2 billion (1.2 per cent of GDP) in the second quarter of 2013-

14. This has greatly increased the demand for dollar and supply of rupee thereby causing a downfall in the rupee.

2. **Withdrawing by Foreign Institutional Investors**

Due to volatile nature of equity markets in India, there has been a dilemma for FIIs as to whether they should invest in India or not. If FIIs withdraws their investment from India then a huge loss in the inflows will be experienced by India, which will ultimately lead to devaluation of Indian Rupee. Widening of CAD due to large imports of Gold and Crude Oil in the country has weakened India position in international arena. Due to which FIIs have lost faith in the Indian economy and are withdrawing their money from the country thereby resulting in devaluation. In 1992 the Indian market for FIIs got a cumulative net investment of Rs.6.8 lakh crore (USD 145.7 Billion) in share and withdrew Rs.1.05 lakh core ($25 billion) from debt segment whereas the foreign investment inflow for the period 2012-2013 was declined to about 46,710 (US$ Million).

3. **Strengthening of Dollar:**

With the passage of time, the recovery of the US economy is taking place rapidly thereby strengthening US dollar against other currencies. As a result of which a lot of investors are fleeing away from the Indian market visualising better potential in the US market. Thus the strengthening of dollar is one of the major reasons of devaluation.

4. **Low Forex Reserve:**

India’s Forex Reserves are enough to cover imports of only seven months. Exchange rate can be controlled by manipulating forex reserves, but that requires a sufficient forex reserves with the government. Due to decline in forex reserves consistently in FY13, the government cannot liquidate its reserves thereby can’t intervene aggressively in determining the exchange rate. On BoP (Balance of Payment) basis, there was a net accretion of $19.1 billion to India’s foreign exchange reserves in the third quarter of 2013-14 as compared to a drawdown of $10.4 billion in the preceding quarter.

According to RBI the turnaround in export growth and decline in imports from July 2013 onwards led to a sharp reduction in the trade deficit to $116.9 billion in April-December 2013 from $150 billion in April-December 2012.

5. **Increasing Oil prices**

India being the second most populous country in the world, the consumption of oil is very high. Due to unavailability of sufficient sources of Crude oil in India to feed its population, India has to import large amount of Crude oil from other countries. But with the increasing price of the crude oil, India has to spend a lot to import oil in the country. In International Markets, prices for oil are quoted in dollars. With the increase in the demand of Oil, the demand of dollar is increasing thereby weakening the rupee further. The price of Crude oil rose drastically from 16.54 dollars/barrel in 1991 to 96.13 dollars/barrel in 2013. This has increased the demand of dollar which ultimately resulted in the devaluation of rupee.

Impact of rupee depreciation

1. **Impact on exports**

The domestic currency depreciation boosts the exports as because of the depreciation, exports become cheaper in international markets. The major sectors which tend to gain the benefit of rupee depreciation are leather goods, textiles, gems and jewellery and processed food products.

2. **Higher cost of imports**

Depreciation of the currency results in the higher cost of imports, as more money was needed to spend for the same product due to the current depreciated exchange rate. Higher cost of imports also results in the higher inflation as price of all the imported goods increases. Also due to the depreciation the price of the base metal such as aluminium, lead, nickel, iron and steel got increases thus it makes some of the capital intensive projects more expensive to execute.

3. **Increase in the foreign debt**

It also increases the cost of the dollar loans taken by companies, as the current exchange rate increases the company now has to pay more for dollar loan and thus it increases the foreign debt.

4. **Slow-down the overall economic growth**

It will also slow-down the overall economic growth by increasing the interest rate, that the government and the other companies needs to pay to the foreign countries and it also dissuade the flow of FIIs into the domestic country. Also the inflation caused by the depreciation reduces the buying power the common people which results in the slowing economic growth of the country and its overall GDP.

Remedies:

1. **Relaxation in the Foreign Direct Investment(FDI) limits**:
   The currency can be appreciated if the inflow is more in the country. One of the major ways to enhance inflows is by encouraging Foreign Companies to Invest in India. For the same the government should relax the limits for FDI, so that more FDI's can be attracted to invest in India. This will not only help in appreciating the currency but will also reduce the inflation in the country which is a major concern for every citizen.

2. **Encouraging Exports:**
   The widening of CAD can be restricted if the amount of outflow from the country can be increased compared with the inflows. The outflows can be increased if the exports can be raised. So government should encourage small scale industries to widen up their manufacturing range and should provide them with simple policies to export the goods in foreign country.

3. **Allocation of Coal Blocks:**
   India has abundance coal available in its core, even though it has to import a large quantity of coal from the foreign market. The major reason behind such a situation is that the government is not allocating coal blocks to the companies to extract coal. Due to this a large effect is seen in the Indian rupee. So government should carry out policies to allocate coal blocks so that at least in this field import can be saved.

Conclusion:

Due to awry in government decisions to curb the depreciation of Indian rupee from FY09 to FY12 without considering the future aspects, rupee reached its all-time low value to Rs.59.52/$ in June 2014 which impelled the government to take the matter seriously and implement stringent measures to stabilise the depreciation.

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