CHANGES IN INDIAN RUPEE AND ITS CURRENT ACCOUNT DEFICIT

Uma C Swadimath[1],

Prasanna B Joshi[2]

Dr. R Venkataraman[3]

ABSTRACT

International trade payments are made on the basis of exchange rate. Exchange rate is the rate at which one currency is exchanged for another. Exchange rate reflects on the trade balances of that particular economy. Many countries are facing this currency crisis and India is no different. India is currently facing an exchange rate crisis resulting in rupee depreciation. Exchange rate affects balance of payments. As a matter of fact, balance of payments is an important indicator of a country's trade balance. The present paper is an attempt to understand the causes for fluctuations in the exchange rate and its impact in India. Variations in exchange rates affects not just trade but also investments into the country. The depreciation of rupee against the dollar has resulted in current account deficit. This is because of huge imports of crude oil and gold. Foreign investments in the country have been adversely affected due to depreciating in the value of rupee. This paper also tries to study the measures undertaken both by the fiscal and monetary authorities to combat the exchange rate crisis.

Keywords: Exchange rate, rupee depreciation, fiscal and monetary policies, current account deficit (CAD).

---

1. Uma C Swadimath, Associate Professor, Centre for Management Studies, Presidency College, Bangalore & Research Scholar, Department of Studies in Economics and Co-operation, University of Mysore, Mysore
2. Prasanna B Joshi, Assistant Professor and Head, Department of Economics, Rani Parvati Devi College, Rani Channamma University, Belgaum
3. Dr. R Venkataraman, Professor, Centre for Management Studies, Presidency College, Bangalore

I INTRODUCTION

In this era of modern globalization, each country has trade prospects amongst different countries. A country's growth and development world wide reflects . on its balance of payments.

International monetary payments takes place on the basis of an exchange rate where one currency is traded for another. India is facing an adverse balance of payments due to a current account deficit thus resulting in depreciation in the value of rupee. It has been observed that huge imports of crude oil has resulted in a deficit in the balance of payments and more demand for dollar reserves has resulted in depreciation of rupee. As international business in today's context is quite uncertain, fluctuations in the rate of exchange can be attributed as one of the risk factors, due to which it results in deficit in trade balance. Huge imports are a concern factor for the monetary and fiscal policies respectively. Risk in the exchange rate arises due to unexpected changes in the prices of currencies between any two countries. Adequate finance being the life line of any commercial economic activity, crisis in the financial system or exchange rate does have an impact on the productivity and efficiency of prime economic sectors namely the manufacturing and service sectors. A volatile exchange rate very much affects international trade. Exchange rate determines aggregate demand. The present paper is an attempt to study the causes of changes in the value of Indian rupee and measures undertaken to battle this crisis as this is one of the challenges for the policy makers in India.

II OBJECTIVES OF THE STUDY

a) To understand the causes for depreciation of rupee
b) To study the impact of rupee depreciation.
c) To study the measures undertaken to control current account deficit.

II (a) The causes for depreciation of rupee

Exchange rate refers to the rate at which one currency is exchanged for another currency when international trade takes place between countries. In other words, exchange rate is the price paid in the home currency in terms of foreign currency.

As Aristotle has rightly pointed out that no country can remain in isolation economically, justifying the fact that no country is self sufficient due to scarcity of resources. Therefore, every country tries to gain in terms of comparative advantage resulting in cross border trade transactions. The trade of commodities and services between countries takes place on the basis of conversion of one foreign currency to another called as the exchange rate. The world has constantly being witnessing fluctuations in the exchange rate and India is not new to this kind of volatility.

Economic factors such as inflation rate, interest rates and balance of payments have been varying since last two decades thus causing volatility in the exchange rate. Of late, convertibility of current account, more liberalized trade reforms, advancement in technology, foreign investment, speculation in stock and currency markets, globalization trends due to expansion of markets, more consumerism and trade balances have all led to exchange rate fluctuations. The European sovereign debt crisis can be attributed to factors such as globalization of finance, trade imbalances, fiscal debts, slow economic growth, high spending and trying to bail out sick industries.

In India the rupee was made convertible on current account, partially in 1992 and fully in 1993 under the Liberalized Exchange Rate Management System(LERMS).

The reasons for depreciation in the value of rupee can be attributed to the following factors.

- **Current Account Deficit (CAD):** This is the main cause for fall in the value of rupee. Current account deficit is due to a disequilibrium or deficit in the balance of payments. Balance of payments indicates the value of traded commodities and services. It has two types of accounts namely capital account and current account. Capital account refers to short term and long term investments in foreign countries and Government loans. Current account includes imports and exports of both commodities and services. Current account depends on merchandise exports and imports ie the sale of goods to other countries and invisible exports and imports. The Government's liberalized exim policy in 1991 resulted in huge imports because of the economic objective to attain rapid industrialization. This in turn led to the import of capital goods, import of technology, machinery and technical manpower in the year 2005-06. Increase in the burden of interest payments and huge import of gold led to weakening of the rupee. Gold imports is the main cause for rise in the import bill. In 2006-07, India witnessed large trade deficits to the extent of 65 billion US dollars and current account deficit was as high as 10 billion US dollars. Higher gold imports and slowdown in exports were the main factors in pushing current account deficit (CAD) to a record high of 4.8 per cent of gross domestic product (GDP) or 88.2 billion US dollars. in 2012-13. The export value was due to the price effect, where some countries increased their productivity resulting in the slow growth of export demand. the falling rupee can be seen on the rising import bill. India imports close to 70% of its net fuel requirements. This means the companies importing oil have to shell out more rupees for the same dollar invoices.

- **Fiscal Deficit**: When the Government's revenue or income through taxation falls short in meeting its expenditure on development projects causes a deficit. This leads to inflation and fall in the value of rupee.
- **Huge imports:** Rising imports, crude oil and dollar prices have led to trade imbalances. The trade deficit which was 10.3 billion dollars in the month of June, 2012 increased to 15.5 billion dollars in July 2012. Due to depreciation of currency, domestic price of crude oil has become more costlier. Increase in import prices of essential commodities such as crude oil, fertilizer, pulses, edible oils, coal and other industrial raw materials are bound to increase the prices of the final goods. Thereby making it costlier for the consumers and hence inflation might be pushed up further.
- **Speculations in the capital markets:** An increase in the dollar rates, importers started hedging and exporters were holding dollar reserves. There was an inflow of dollars by foreign institutional investors (FIIs) in 2011 and when they started to pull out dollars from Indian markets , this led to a demand for dollars. Risk Aversion on part of Currency Investors, which has caused the Demand for the US Dollar to go up world over.

TABLE 1: Shows net investments by foreign institutional investors (FIIs) and exchange rate in the 2012

2012	FII Net Investments (In crores)	Average exchange rate
January	26,328.90	51.2
February	35,227.90	49.2
March	1,792.50	50.4
April	-4,896.60	51.78
May	3,222	54.39
June	4,066.70	55.99

Source: Security and Exchange Board of India (SEBI)

- **External Debt:** The reason for deficit is also due to huge external borrowings. According to Reserve Bank of India, the external debt was to the extent of 317 billion US dollars.The NRI deposits and multilateral borrowings accounted for about 20 per cent of the increase in total external debt.

TABLE 2 : Shows the variations in the exchange rate in terms of Indian rupees per US dollars from 1947 till 2013.

Year	Exchange rate (INR per US $)
1947	1
1948 - 1966	4.79
1966	7.50
1975	8.39
1980	7.86
1985	12.38
1990	17.01
1995	32.47
2000	43.50
2005 (Jan)	43.47
2006 (Jan)	45.19
2007 (Jan)	39.42
2008 (October)	48.88
2009 (October)	46.37
2010 (January 22)	46.21
2011 (April)	44.17
2011 (September 21)	48.24
2011 (November 17)	55.39
2012 (June 22)	57.15
2013 (May 15)	54.73
2013 (Sep 12)	70.36
2013 (Sep 16)	62.83
2013 (Sep 28)	61.98

Source: RBI

II (b) Impact of rupee depreciation

Impact of exchange rate volatility is related to higher transaction costs and exchange rate fluctuations are measured on a day to day basis. The trend of falling rupee against US dollars has has made traders and corporates to trade in other foreign currencies to mitigate their losses in the rupee/dollar exchange. The traded currencies are Euro, Pound Sterling, Japanese Yen, Swiss franc, etc. The export sector stands to gain against rupee depreciation.

The depreciating rupee has further added pressure as domestically India is facing a situation of high prices because of weak monsoon escalating food prices and fuel prices. India being an import intensive country, a high and continuous deficits in its trade balances, domestic costs will increase due to rupee depreciation.

The rupee depreciation affects the industrial sector by increasing costs on products like oil, imported coal, metals and minerals, imported industrial intermediate products. Thus the value in the fall of rupee has not only made imports expensive but also has increased cost of production and affecting profits adversely.

A depreciating rupee is not only impacting the import bill, it has also affected the cost of borrowings for the corporate sector. It was found that the Indian companies have borrowed 29 billion US dollars in foreign currencies through ECBs (External Commercial Borrowing) and FCCBs (Foreign Currency Convertible Bonds). But on a positive note, exports have gained particularly information technology (IT) services being the main components of commercial services exports in India. Export oriented industries have gained in their foreign exchange earnings and textiles sectors has also benefitted from the falling rupee.

(c) The measures undertaken to control current account deficit.

Combating the exchange rate crisis and depreciation in rupee which has resulted in inflationary situations in the country has become a cause of concern for policy makers in India. One of the ways to battle this deficit crisis is to encourage the flow of capital through investments in various sectors.

Monetary measures include controlling inflationary pressure in the country by regulating the supply of money aiming at reducing imports. It is quite likely that the central bank will hike its monetary tools including bank rate, cash reserve ratio (CRR) and statutory liquidity ratio (SLR).

Imports have to be reduced and exports to be promoted thereby enabling a reduction in the deficit of balance of payments particularly in the current account. The Reserve Bank raised the repo rate by 25 basis points to 7.5% to control inflationary pressure in the economy. The central bank has imposed regulations in the month of September where the non banking finance companies (NBFCs) are prevented from extending gold loans without proof of ownership for any loans involving more than 20 grams of gold. Retail investors cannot buy gold coins from banks and also purchase from their credit cards. A transaction tax of 0.01 per cent was imposed on non-agricultural futures contracts including precious metals. India's biggest jewellers' association asked members to stop selling gold bars and coins, and the import duty on gold was raised to 10 percent.

Fiscal measures: India is the largest consumer of gold in the world and huge gold imports being the cause for a major deficit in the current account, the Government of India has increased the import duty on this yellow metal and other precious metals. The Government has imposed strict measures against the import of gold by raising the import duty. The Government is very keen that the economy will come out of this crisis and bounce back in terms of growth and development. The Government in order to reduce current account deficit which is 88 billion US dollars is hopeful to reducing it to 70 billion US dollars this year. The Finance Ministry to reduce the current account deficit (CAD) wants to raise revenue by asking the department of telecommunications to auction 3G spectrum. The Government can take initiatives which encourage and increase the flow of foreign investments into India. Three recent steps taken by the Government be it the pension fund FDI limit or the increase in the investment limit investors in Government security and corporate bonds are the steps in the right direction. The Government can make investments attractive and invites long term FDI debt funds. Government has to make the flow of foreign direct investment (FDI) more attractive in potential areas which contributes to economic growth.

III FINDINGS OF THE STUDY

- The Reserve Bank of India (RBI) has increased the FII limit on investment in Government and corporate debt instruments and introduced higher ceilings in external commercial borrowings (ECBs) to control exchange rate.
- Due to an alarming current account deficit, the finance ministry in India announced a hike in import duty on gold thereby discouraging the purchase of physical gold.
- The steps taken by the Government to curtail gold imports has reduced and there is a fall in the imports by 18.1 % and exports have increased by 11.15% in September 2013.
- Crude oil imports declined by 6% to 13.19 billion US dollars and this brings some good news for solving the deficit in trade balances. But the inflation rate has increased to 6.46% in September against 6.1% in August due to a rise in food prices.

IV CONCLUSIONS OF THE STUDY

Fluctuations in the exchange rate and current account deficit has posed a major challenge to the Government in attaining economic stability in terms of growth and development. The Government should focus more on exports that may result in inflow of foreign exchange reserves into the economy. To reduce the deficit in balance of payments, foreign investments should be made attractive and emphasized. No doubt, the 3 steps taken by the Government be it the pension fund FDI limit or the increase in the investment limit investors in Government security and corporate bonds are the steps in the right direction.

Though India is one of the fastest growing Asian economies next to China but depreciation in the value of the currency benefits more to China than India as its exports are more unlike India. Therefore, this fact necessitates that India should focus, emphasize and promote more export oriented products and help in reducing current account deficit, controlling the value of Indian rupee in international business community.

.

REFERENCES

1. Exchange rate volatility & growth in small open economies at the EMU periphery (2007) –Gunther Schnable – Working paper series-No. 773/July 2007, ISSN 1725-2806(online)
2. Exchange rate slide- what impact is it having (2012)-Associated Chambers of Commerce & Industry of India (Assocham),(www.assocham.org)
3. Exchange rate volatility & trade: A literature survey-Ozturk, Ilhan-International Journal of Applied Econometrics & Quantitative Studies-Volume 3-1 (2006)
4. Fall of rupee: causes, impact & role of RBI-Avant Garde- IIT Kanpur MBA monthly e-newsletter (February 2012)
5. Finance Minister wants to raise revenue through 3G auctions to tame CAD-Thomas K Thomas, The Hindu-Business line newspaper-page no.1 RNI No. 55320/94 dated 15th October 2013
6. Impact of rupee appreciation on India's export-with special focus on labour intensive sectors- Annual report(2007-2008), Department of commerce & industry, Govt. of India
7. Impact of exchange rate movements on exports: An analysis of Indian non-financial sector firms-Yin-Wong Cheung & Rajeswari Sengupta-Maximilians University's Centre for Economic Studies & the Ifo institute -CESIFO Working paper no. 4214-category 7: monetary policy & international finance (April 2013)(www.cesifo.org/wp)
8. International finance-Maurice D Levi-McGraw-Hill, Inc.(1996)
9. Indian Financial Management- Vikas Publishing House Pvt.Ltd. Pg. no.14.5 (1998)
10. International Business-texts & cases- P Subba Rao, Himalaya publishing house, page no. 358-359 ISBN:978-93-5024-101-1, 2nd edition,(2008)
11. Macro economic causes of exchange rates volatility-Claudio Morana, International Centre for Economic Research(ICER)-working paper series-(working paper no.8/2007),(April 2007)
12. Productivity trends in Indian banking in the post reform period-experiences, issues & future challenges-Dr. K C Chakraborty, Deputy Governor, RBI at FIBAC 2013, (Augsust 2013)
13. Real exchange rate volatility & Malaysian exports to its major trading partners- Hook L S & Boon T H (Working paper 6-University Pradyut, Malaysia (2000)
14. RBI report, the currency & finance report RBI (2007) (www.rbi.org.in)
15. Rupee depreciation-Industry impact-Krithika Subramanian, Care ratings (Professional risk opinion) (January 2012)
16. Rupee exchange depreciation: Impact analysis(2012)-Associated Chambers of Commerce & Industry of India (Assocham),(www.assocham.org)
17. Structural factors affecting exchange rate volatility: A cross-section study-Jorge Canales, Kriljenko & Karl Habermeier, (IMF working paper no. Wp/04/147-Monetary & financial systems department) (August 2004)
18. Gold -The new rules for investing- Rajalakshmi Sivam, Investment world-Business line newspaper page no.11- volume 20 no.286 dated 5th October 2013