Depreciation of Rupee: Causes, Consequences & Policies for Insulation

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Abstract

India, the third largest economy in the world on the basis of Purchasing Power Parity (PPP) and it is growing invincibly despite challenges like large population and lack of basic facilities. Above that the rupee is under stress as the value of rupee is consistently depleting because overseas investors are demanding less of Indian rupee. The exchange rate between the Indian Rupee and the US Dollar has touched Rs. 73.43 which means for acquiring one dollar, Rs. 73.43 has to be paid. Historically, on 15th August 1947, one dollar was equal to one rupee. But over the years, the rupee has been consistently depreciated against the dollar due to dwindling macroeconomic factors. In April 2020, the rupee touched its all-time low value- Rs. 76.87 and more than 10 percent of loss of its value in recent years have been observed and it is the currency which is worst performing. The consistent decrease in the value of Indian currency may impact the Indian economy in negative ways. As further increase in depreciation increases the costs of imports. Since Indian economy is heavily dependent on imports such as oil, gems, iron, fertilizers, organic chemicals, gold & technical apparatus, this is a great cause of concern. Hence the stability in Indian Rupee is of prime importance to the Reserve Bank of India (RBI). The Indian economy is a mixed economy where the central bank regulates to stabilize the inflation rate and the exchange rate volatility. This paper reviews the probable causes for this negative performance of the rupee and policy initiatives by the regulatory authority to curb the downfall. It has also made effort to capture the scale of actions taken by the Reserve Bank Management in volatility episodes.

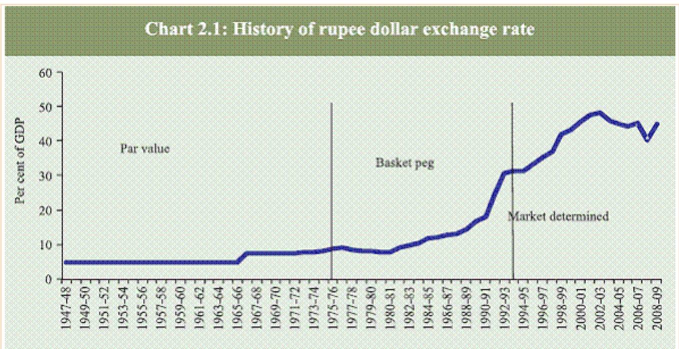
***Keywords**: Rupee Depreciation, Economic Impact, Policy Initiatives.*

Introduction

India, being one of Asia's largest countries has witnessed many fiscal and monetary challenges. One of the major issues is consistent fall in the worth of Indian currency causing the depletion of foreign reserves & Special drawing rights. Foreign reserves are critical to an economy for international transactions. Also, the depreciation of Indian rupee against hard currencies evades the acceptance of rupee in the international market. Since India is an import dependent nation, foreign reserves are bought and sold using Indian rupee to pay for imports. Decrease in rupee value makes the import more costly and thus affect the current account deficit in Balance of Payments (BoP).

The Balance of Payment had also been consistently in deficit implying that the government had to resort to borrowing of hard currencies. The first currency devaluation took place due to first major financial crisis the government faced in 1966. The inflation narrowed Indian and international prices further. During 1991, there was aggresive downward pressure on the value of the rupee from the international currency market, therefore India was faced with depleting foreign reserves that necessitated devaluation. During the same year 1991 India faced a Balance of Payment crisis which was huge in scale. As a part of intervention, Indian government decided to let the Indian rupee free float and determine its value using market forces. Indian rupee had been following a managed float system of exchange rates. The value of Indian currency is decided by market forces of demand and supply, but the Reserve Bank of India has been vested with the power to intervene in case of extreme volatility.

Figure 1



Source: Reserve Bank of India publication.

According to the historical data, Figure 1. Is showing the past relationship between Rupee & US Dollar from 1947-2009. The graph reflects the stability in the exchange rate till 1966. The increase in exchange rate from 1966-76 was caused by the Reserve Bank of India's decision to devalue after Indo- Pakistan War 1965. The period of 1976- 93 was full of volatility as domestic banks were allowed to do intraday trading in foreign exchange market and the rupee was pegged with a basket of hard currencies. In1993 Balance of Payment crisis after-effects started reflecting in the economy. The RBI then decided to allow the market forces to determine the price of Indian rupee in foreign markets.

Depreciation of Rupee with respect to other currencies is also evident through data. The data implies that during 2008-18 Rupee had been continuously underperforming against USD, Canadian Dollar (CAD), Chinese Yuan & Euro. This shows that the rupee oscillations are spontaneous and volatile. The Indian Exports and imports value also gets affected by the decreasing trend. This is causing the imports to be costlier and the exports to become cheaper. India trades with major economies and its business gets adversely affected. In 2020, the exchange rate of INR and Euro is Rs.86.25 and in 2001 it was Rs. 42.25. This depreciation has caused Indian imports to be costly by twice and exports value have become half. The Europe Union is the major trading partner of India, accounting for about €80 billion trade of goods in 2019 or 11.1% of Indian trade in totality, which is at par with the USA and surpassing to China (10.7%). European Union is also the second-largest center for Indian exports (over 14% of the total) after USA. Rank of India in the EU's largest trading partner is tenth, accounting for 1.9% of EU total trade in goods during 2019, which is behind the major trading partners like USA (15.2%), China (13.8%) and the UK (12.6%). Hence it is crucial for India to limit the exposure of Indian rupee to sustain global business.

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Objectives of the Study

- **To study the probable causes of depreciation of Indian rupee in the foreign market.**
- **To understand the consequences of depreciation of rupee on economy.**
- **To learn about the policy initiatives taken to curb the downfall.**

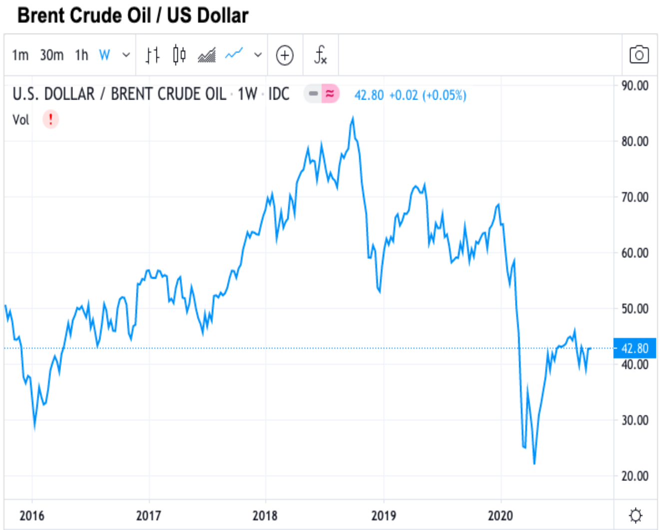
Probable Causes of Depreciation of Indian Rupee and Their Impact.

The Indian currency is under performing not only against the US dollar, but also against other hard currencies. Hence it is imperative to know the probable reasons behind the under-performance to predict the growth of the Indian economy. A host of reasons have been identified in terms of macroeconomic & political factors leading such deterioration.

1. Oil Prices Escalation & Undwindled Demand

India fulfills its crude oil demand via imports from Iraq, Iran, Saudi Arabia, USA, West Africa, South America & others in foreign currency prominently US dollar. It is the third largest importer of oil. India imported around 228.6 million tonnes oil worth US$ 120 billion in 2018-19. The upsurge in oil demand in its price hurt the Indian economy as the oil accounts for a substantial portion of India's total imports. The imports of goods are computed in current account (CAD) in balance of Payments. The Current Account balance of India mostly stays in deficit which indicates that the imports of India are in excess of its exports. However, the current account did register a surplus of $0.6 Billion in 4Q FY20 (0.1% of Gross Domestic Products) against the deficit of $ 2.6 Billion in 3Q of FY2020.

The surplus was due to a lower trade deficit of $35 Billion with rise in oil demand worth $34 billion. The further rise in price level will put pressure on Indian rupee in a downward direction. With expectations of slow global growth in 2020 due to pandemic- Covid-19, from the International Monetary Fund, it is imperative that rupee is going to depreciate further as the economy stands with low growth and dwindled oil demand. Crude oil prices movements act as an indicator to determine changes in rupee movements. In April 2020, when the rupee hit its lowest - Rs. 76.87 against dollar, Crude oil price movement was a critical factor behind it.



Source-moneycontrol.com

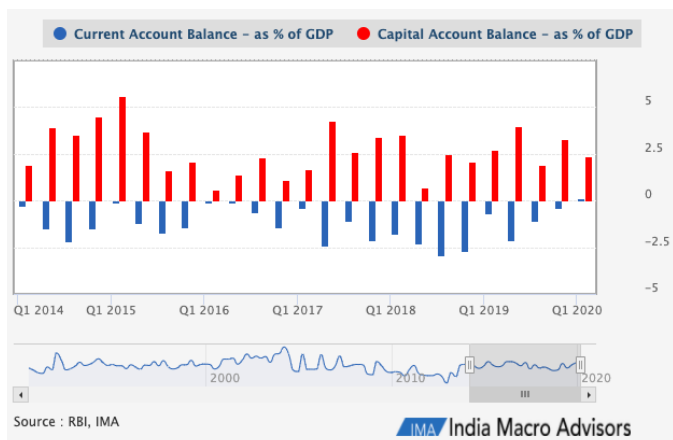
2. Aggravating Currency & Trade Wars

When a country is engaged in manipulating the exchange rate of the currency or other economic instruments to achieve its own economic or political aspirations, it is called a Currency War. It has been witnessed in the past that such wars happened frequently and incur 'Beggar thy Neighbor' policy. As accepted by the World Bank and Indian Monetary Fund, Indian currency is perceived to be undervalued to almost 33% of its "Purchasing Power Parity" value Or the US $ is overvalued. Despite continuous trade deficit for four decades, United States has succeeded in maintaining a high value of USD since it has the tag of Global Currency. It is unfeasible to trade across borders without dollars. Before the 2008 Global Financial crisis the Gold price at that time was $ 400 per ounce. Today it is $ 1731 per ounce. Therefore US $ has depreciated in these years. Yet, in terms of Yuan & Rupee, USD has not depreciated. Aggravation in such war practices hinders the economic cycle and brings disruption in the global growth trajectory. Such trade wars & currency wars are used for strategic purposes & are often used as a catalyst for political gain. Disruption in trade leads to slower exchange of goods and services and in turn affects the aggregate demand. The Indian economy trades heavily and if any of the currencies participates in such practices, Rupee trade may deteriorate and be depreciated.

3. Undue Goading Due to Interest Rate & Prevaricating Outflow of Capital Money

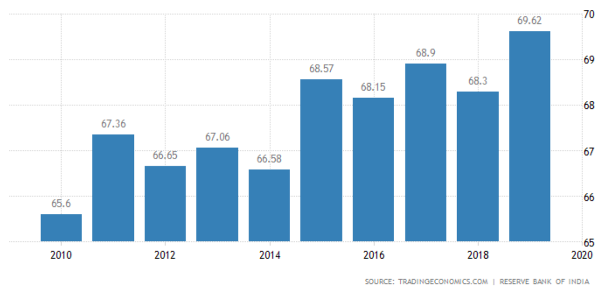
Higher Interest rates attract foreign investors and create demand for the currency in which investments are made. Such upsurge in demand leads to appreciation of the currency. As long as India is providing higher rates of interest in investments, the rupee is expected to gain value. In India, the Reserve Bank of India is responsible for interest rates decisions. In the past 5 years, the interest rate has been lowered from 6.8 % to 4 % in 2020 by the RBI to revive credit policy of the banks and India's domestic demands. Low interest rates help in increasing money supply and indicate that the economy is on a productive trajectory. However, the lower interest rates dissuade foreign investors who indulge in diluting their holdings of hot money and create more supply of Indian rupee. More supply of Indian rupee is leading to depreciation of currency and outflow of capital investments. On the other hand, countries like the US have an interest rate around 0.25 % in 2020 which is way lower than that of India. Hence, Foreign investors do get attracted to India to park their funds but a continuous under performance of a currency invites suspicion on the country's macroeconomic stability.

Actual	Previous	Highest	Lowest	Dates	Unit	Frequency
4.00	4.00	14.50	4.00	2000 - 2020	percent	Daily



4. Unbridled Increase in Government & Foreign Debt Amount

Indian government's debt to GDP ratio in 2010 was 65.6 % which was higher when compared to that of China - 33.5 %. Indian government relies on debt from bilateral trade, IMF loans, export credit facilities & commercial borrowings. The government debt is close to 70% of its GDP in 2020, implies that the government needs to ensure funds availability to be able to pay back the investors with adequate returns. The past data showed that valuation gains occur due to the appreciation of US dollar against Indian rupee. The loan value enlarges as the rupee further depreciates leaving less of foreign reserves in a country basket. Two worrisome causes are - first, the raising of interest rates in other nations which may attract the potential & existing investors to park their funds in other markets. This outflow of money may cause more Rupee to be dumped and further depreciate it. The second cause of concern is the unexpected downfall of rupee. The loan amount will have to be paid by shelling out more rupees than past estimates.



Actual	Previous	Highest	Lowest	Dates	Unit	Frequency
69.62	68.30	83.23	47.94	1980 - 2019	percent	Yearly

5. Underachievement of Current & Capital Accounts in BOP.

The Current account recorded a surplus in decades. In 2020 Current account of India stood at $0.6 Billion positive balance. First time the exports rose against imports value. On the surface it looks positive, but it primarily reflects India's economic slowdown, India had actually lowered its import demand of non- crude oil and other gems & precious metals during the period. Causing the surplus in Current account in Balance of Payments. Meanwhile partial capital account convertibility has been insulating Indian economy from sudden evasion of funds.

Policy Initiatives to Stabilize Exchange Rate

Reserve Bank of India (RBI), the central bank of India is responsible to control monetary fluctuations including foreign exchange rates volatility in India. The RBI undertakes this objective by modifying policy rate according to the prevailing macroeconomic conditions. The following are key actions taken to curb the downfall of rupee depreciation.

I. Modification In Policy Rate.

The Policy rate is a monetary policy instrument used by the Reserve bank of India to combat inflation & control money supply. The RBI if increases its policy rate, the higher rate attracts inflow of capital investments and results in surge in rupee demand. The hike in interest rate also help in controlling inflation & depreciation. It puts upward pressure on the exchange rate and hence helpful. However, in the year 202o, the Repo rate is fixed at 4%, which is lower in comparison to past rates. This was decided in order to revive the economy. So, the monetary authority has to take a stance using trade-off.

II. Export Promotion & Import Substitution

The exports of India have to be in excess to its imports to have current account surplus. The country is working relentlessly towards promoting its exports. Government schemes like Make in India, friendly policies for SEZs are used by government to boost exports. The exports of both goods and services is expected to enlarge by improving total factor productivity (TFP) growth and scaled FDI flows. For imports, other alternatives to oil are also being thought of. The country if produces goods & services in lines with its import requirements, the imports demand would be substituted by domestically produced goods & services. Items like gold are heavily imported in India, schemes like Gold bonds & ETFs are introduced to substitute its physical demand up to certain extent.

III. Dealing with Transactions Related Bottlenecks

The rupee witnessed a sharp turnaround in the past owing to the measures taken by the RBI related to transaction process namely the interchange the window for attracting FCNR and increasing of foreign credit limit of banks. The action to open special US dollar swap window for oil imports helped in mitigating a major bundle of demand of foreign currency. These initiatives understood the market sentiments, which got reflected in the sharp turnaround made by the rupee from September 2014 onwards. Also, empirically it is known that ECBs and NRI deposits are interest sensitive, though policy interventions by authorities required which tend to reduce interest rate sensitivity. Thus, monetary policy needs to address the that debt flows like External Commercial Borrowings and NRI deposits are impacted both by interest rate as well as exchange rate movements, while sensitivity of capital flows like FII and FDI is relatively less to interest rate changes (RBI).

IV. Internationalisation of Indian Rupee

Besides these measures, the RBI intends to promote transactions in rupee in order to help it become an internationally acceptable currency like US $. Same way China is also aggressively internationalizing its currency by using bilateral swap arrangements.

Former Governor Raghuram Rajan emphasized on the following in regard to internationalization of the rupee: "As our trade is going to expand, we will push for more settlement in rupees as currency. This also has second meaning that we will have to open up our financial markets more for those who receive rupees to invest back in the market. We intend to continue the path of liberalization at gradual pace''

V. Levying Custom Duties on Imports

The Ministry of Finance levy customs duties on imports and additional taxes on certain products including precious metals like gold & Platinum. Such actions help in directing the money flow towards asset generation in a country over heavy investments in only precious metals. This measure also protects the domestic market and insulates the domestic business of India. Because of this the imports do become expensive but consequently only non-essential import items feel its impact and leave the market for betterment.

Conclusion

The Indian rupee consistent depreciation has been a cause of great concern since India is an import dependent nation. The probable causes identified in this paper include rise in oil prices and constant demand. India imported crude oil at an increased price costing about $120 billion in 2018-19 due to the absence of alternate sources of energy. The crude oil is in huge demand in India and the commodity is itself inelastic as it has no close substitute. To curb this dependence on crude oil, India has initiated International Solar Alliance as a measure and is now focusing on developing energy. The other notable reasons for downward pressure on rupee are trade wars among developed economies for strategic gains and prevaricating outflow of capital money in other overseas attractive investments. India provides better rate of return in investments, but other developed economies are providing enough incentives to redirect the FDI towards them. The Reserve Bank of India & Government of India have been actively involved in order to stabilize the volatility in the foreign exchange market through many ways. One such measure is use of policy rate, India monetary policy committee responsible for deciding policy rate, promotes growth and tries to take a stance best suited for the economy. Export promotion, import substitution, simplifying and elimination of bottlenecks are other measures to curb the consistent downfall. The policies are also advocating to internationalize Indian rupee. The Indian rupee is trying to create its space among hard currencies like US Dollar, Euro, Pound & Yen. Since India is fastest developing country hence it has the potential to attract huge foreign investments for economic development and control rupee depreciation.

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