

Rupee Depreciation and Impact on the Economy

(Dr. Nikhil Saket, Senior Assistant Secretary, ICAI, New Delhi)

Introduction

Depreciation refers to a fall in the value of the domestic currency which is caused by the demand for foreign currency exceeding its supply in the market. 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 those of the world price. With the liberalizations and globalization of the 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. Again with trade having become an important element of the new strategy of growth.

India got freedom from British rule on Aug 15, 1947. At that time the 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 sheet. To finance welfare and development activities, especially with the introduction of the Five-Year Plan in 1951, the government started external borrowings. This required the devaluation of the rupee.- After independence, Indian choose 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 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. Currently, 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 point 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 hasn't helped. Besides the Eurozone crisis, the downgrade of the US economy has led to flight of capital in order to boost the US home economy. The US dollar has become scarce 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 ever since the US Federal Reserve has announced quantitative easing. This has hit not only the emerging markets and assets of India but also of other countries like Thailand, Brazil and Indonesia. Just as in other countries, the foreign institutional investors (FIIs) have also started withdrawing their investments in the Indian bond market. With growing concern for increasing risks in the global environment, massive redemptions through the global exchange traded funds (ETFs) 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 close 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 under-capitalised and not well configured to take on rapid outflows of this nature. The rupee, like the currency of any country nowadays, 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. The Historical Evolution of rupee can be traced from the chart given below.

How the Rupee Crumbled



Source : The Times of India, New Delhi dated 14th June 2013

Effect of Depreciation

- Trade deficit will widen because of costlier imports, worsening the current account deficit.
- Fuel price will keep petroleum subsidy in check, but fertilizer subsidy will rise.
- Spending on any kind of foreign exchange denominated spending will increase.
- Capital inflow will slow or reverse.
- Spending on discretionary goods will increase.
- Forex reserves could fall putting pressure on rupee.
- In case of weak demand companies may not be able to pass on higher inputs costs.
- The government and the RBI have issued a series of measures 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 for flat screen televisions brought in by airline passengers and restrictions on outward direct investment by Indian companies and individuals.
- 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 us.
- The Indian stock- market will take a hiding as opposed to a beating.
- Global rating agencies will revise our rating downwards to “Junk” status, making international borrowing difficult and even more expensive.
- If the automated devaluation brought on by the rupee makes some asset classes attractive, there may be slight recovery because of arbitrage opportunities and bottom-fishing.

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 States 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 (Finance Ministry, Monthly Economic Report for April 2013).

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.

What is more, 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 jewellery, 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 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.

Reason

- One of the more 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.
- As per the data reported, FIIs (Foreign Institutional investors) are showing some disinterest in Indian markets lately. Sluggish economy and recovery in stock markets of developed economies like US 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.
- 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.
- 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.
- The central banks of Eurozone and Japan are printing excessive money due to which their currency is devalued. On the other hand, US Fed 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.

- Oil price is one of the most important factors that puts 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 our suppliers from whom we import oil. This, increase in demand for dollar weakens the rupee further.
- Our equity market has been volatile for some time now. So, the FII's 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 they may be thinking of taking their money out of the equity market which might again results in less inflow 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 favoured 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 majorly 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:

The rupee's decline 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 naive to expect that the export earnings would be contributing significantly to foreign exchange inflows in the near future. The govt should concentrate on correcting the economic fundamentals rather than indulge in soap operas in a run up to the election. A better co-ordination with RBI is required rather than blame game. Apart from all the political parties should come together in fixing the problem and getting back the investors confidence.