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IMPLICATIONS OF DEPRECIATION OF INDIAN RUPEE

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ABSTRACT

Since moving to a market-determined exchange rate from 1999, the rupee has sank to a new low, the lowest in the history of Indian of having breached ₹ 68 to USD 1. Never in the past has the rupee fallen so much against the USD.

KEYWORDS :*history of Indian , foreign currency ,market-determined .*

INTRODUCTION :

Historical Perspective

A little before Independence the parity between USD and INR was 1 : 1, even at the time of the Independence, the exchange rate was USD 1 ₹ 5. However, that was the era of fixed exchange rate, of exchange rates determined by RBI India was then a 'closed' economy, so exchange rate really did not matter. Post-independence and over the years, India's problems mounted, of a rapidly increasing population, low growth, persistent high inflation, growing imports, but not able to earn foreign currency through exports and also as closed and regulated economy, no other avenues of foreign currency coming into India.

In such circumstances, the rupee was devalued especially after 1966 on number of occasions, to discourage imports and in a bid to increase exports and reign in the growing trade deficit. In fact trade deficit has become a structural problem of India, of not being able to 'earn' USD through exports to 'pay' for imports of goods.

IMPORTANCE OF THE STUDY

Towards Market Exchange Rate

The reforms initiated in 1991, only inherited current account deficit, even as it began to 'open' the economy, moving away from fixed or a pegged exchange rate in a calibrated manner, into a market-determined exchange rate since 1999. The demand and supply of USD in India began to determine exchange rate and not any more by RBI. As a market determined exchange rate there would always be movements in exchange rate based on a number of factors, such as levels of current account deficit, inflows and outflows of foreign currencies, influenced through policy environment and both domestic as well as global favourable/adverse developments.

Just as waves in the sea, sometimes going up and sometimes going down, is natural phenomenon, not restricting but allowing boats and ships to sail. The same is true for market-determined exchange rates, which will depreciate or appreciate depending on demand supply conditions and always be a variable, not possible to predict. An economy like a ship, it has to have the capability to move along the waves.

However, waves can get turbulent, forcing ships to drop anchor. This is the flip side of a market-determined exchange rate of a currency sliding against foreign currency, destabilizing economies and pushing them into a crisis-like situation. The present situation in India cannot be said to be crisis so far, but could be a well become one.

ANALYSIS OF THE STUDY

Why has the Rupee Depreciated so Steeply?

At first depreciation is a 'symptom' and not the problem. It is the result and culmination of multiple factors. As mentioned previously, India has chronic and persistent trade deficit leading to high current account deficit. It has ballooned in recent times due to high crude petroleum prices and also in imports of gold. A high deficit only implies greater demand for USD (to pay for imports) but not enough supply of USD (through exports), putting pressure on the rupee to depreciate. Once the rupee begins to depreciate, it further widens current account deficit, leading to further down slide of the rupee. At each stage the landing gets harder and harder.

This situation can still be addressed, through inflows in the capital account (refer to Chapter on Balance of Payment), through foreign investment, NRI deposits, External Commercial Borrowings by corporate and other such capital flows to cover current account deficit. This was happening in India till December 2012. The deficit was being met out of foreign currency coming as FDI, but more through FII (now referred as foreign portfolio investment or as FPI) and NRI deposit. Thus, making the rupee depreciate, just portfolio investment or as FPI) and NRI deposit. Thus, making the rupee depreciate, just like waves but not turbulent and volatile until May 2013.

The problems in capital account as far as India is concerned, is that it comprises more of reversible flows like FPI and NRI deposits and not through a relative stable flow as FDI. As a result in adverse circumstances, of reversal of such flows, the deficit gets exposed resulting in a steep depreciation of the rupee as it has happened since May 2013.

The reversal can be attributed to the Federal Reserve in the US announcing a gradual withdrawing from quantitative easing (QE) or abandoning its stance of following a loose monetary policy. This was done earlier through buy back of debt by the Federal Reserve to increase the supply of USD. US economy was beginning to recover in terms of turnaround in growth, even though marginal, but definite signs of recovery since beginning of 2013. Continuation of loose monetary policy would have become inflationary which could be a setback to recovery. This would have resulted in lesser supply of USD by Federal Reserve, affecting capital flows in all emerging economies including India.

Signs of revival of the US economy also lifted US stock markets, resulting in a quick withdrawal of FPI from Indian stock markets, an outgo of around USD 6 billion every months since May 2013. With both FDI as well as FPI easing, together with reversal of FPI, affected supply of USD, leading to sharp depreciation of USD.

At the same time, demand for USD increased arising out of domestic uncertainties; slowdown of growth, inflation, all putting fears of further depreciation, leading to greater free spin of rupee. This got further compounded with fears of increase in crude oil prices due to growing disturbances in West Asia.

With depreciation of the rupee becoming fairly certain, gave rise to speculation, both on shore and off shore through non-deliverables forward (NDF) contracts of rupee and USD. These are contracts which do not require delivery of foreign currency, but only booking of profits, of the difference between the contracted rate and the actual exchange rate on the contracted date on settlement. These contracts are in freer forex markets of Singapore and Dubai, outside regulatory control of RBI.

What are the Implications of Rupee Deprecation on the Indian Economy?

First, India's imports comprises of essential such as crude petroleum, machineries and fertilizers which become expensive raising their prices facilitating 'import' of inflation. Indian is very susceptible to a stubborn and sticky inflation. It hurts the masses in terms of across the board higher prices.

All imports become expensive including raw materials, goods and machineries which further push up domestic costs. It brings with it negative sentiments in the economy, makes investor cautious weary of investment and consumers' reducing spending in the economy. Thus, growth takes a down turn.

Negative sentiments and capital outflows impact the stock markets, which may not directly affect the common man but gets reflected as part of negative sentiment in the economy. It widens the current account deficit, which may require dipping into scarce foreign exchange reserves and their 'relative adequacy' could well become 'inadequate' if the deficit continues to widen. One cannot forget the situation of 1991 when India had no other recourse of meeting the deficit by pledging its official levels of gold and seeking commercial loan from international Monetary Fund (refer to Chapter on Multilateral Institutions.)

There are genuine concerns arising out of a depreciation currency of the domestic economy having larger faith in foreign rather than the domestic currency and as mentioned previously, the looming fears of currency crisis.

However, a depreciating rupee does make exports cheaper as the same dollar can now get more rupees. But exports are not only a function of prices but other aspects such as quality, ability to meet changing demands and preferences, global demand, efficient logistics, cargo-handling capacities, etc. Response to the historic depreciation of the rupee has, for the first time, tested how much Indian exports are sensitive to prices or can lower prices drive up exports from India. The impact cannot be immediate, of an overnight increase in exports but over a period of time. Many experts feel that the present depreciation is 'correction' and in the long run help India in achieving 'export (price) competitiveness'.

But definitely a slight depreciation can be considered good as long as it is gradual but not such a steep downslide in such a short span of time can destabilize the economy.

What has the Government/RBI Done to Stem the Slide of Rupee?

As a first step, the government went for compression in import of gold and silver and non-essential items by raising import duty levied on them to reduce their import and lower CAD. RBI on its part has taken a number of steps over the past few months are as follows:

(1)RBI has tightened liquidity by reduction liquidity adjustment facility (LAF) from ₹ 1,50,000 crores to ₹ 75,000 crores and raising the bank rate and marginal standing facility (MSF) to 300 bps over repo rate (presently 7.25 per cent) to 10.25 per cent to curb speculation on the rupee. The repo was not changed, as it was seen as a short term measure to stem the rupee volatility.
(2)'Sale' of Government of India securities through open market operations (OMO) o₹ 12,000 crores, but was unsuccessful as investors wanted a better return on the securities.
(3)Allowed public sector financial institutions to raise quasi-sovereign bonds to finance long-term

infrastructure.
(4)Liberalized ECB borrowings by private corporate sector.
(5)Permitted PSU oil companies to raise additional fund through ECBs and trade finance.
(6)Opening a separate window at RBI for oil marketing companies to finance import of crude petroleum.
(7)Liberalized non-resident (External) deposit/foreign currency non-resident deposit schemes to attract more and more NRI deposits.

(8)Imposed curbs on mercantilism in rupee forwards. Forwards square measure agreements to shop for or sell assets at a group worth and date.forward contracts reserved by foreign institutional investors, one off, couldn't be re-booked.
(9)Reduced the quantity of open positions dealers will maintain long. At present, a company’ s board is permissible to mend appropriate limits for numerous treasury functions with internet long open exchange positions and mixture gap limits. Impact of lowering the mercantilism limits would be immense as a result of bands wouldn't be able to keep speculative positions open for an extended time. The broad message the run is attempting to relinquish is that speculative tendencies have to be compelled to be restrained and real demand and provide ought to be allowed to additional the CURRENCY RATE.
(10)At gift, the run permits hedging of CURRENCY risks on the idea OF past performance (exports or import) for average 3 years. the corporate or unit may additionally take a hedge supported actual performance within the last twelvemonth . Now , for importers victimization the past performance facility , the power stands reduced to twenty five per cent of the limit, Importers, United Nations agency have used the power in more than the revised or reduced limit, square measure barred from creating more bookings. The run has created forward contracts reserved underneath the power would get on a totally deliverable basis. The exchange gains rising from the cancelling of contracts mustn't be passed on to the purchasers.
(11)All money and spot transactions by bands for shoppers are going to be performed for actual remittances/delivery solely . they can't be off or cash-settled.
(12)In an endeavor to regulate the result of currency spinoff deals by , the run prohibited rebooking

(13)Depending on the rupee volatility it has also sold USD from its forex reserves.
(14)Government is considering in directing the public sector banks to give commercial loans against household sector held gold, which would bring it in circulation, restraining imports.
(15)It has also reduced the ceiling of outward remittances from USD 2,00,000 to USD 75,000

Have These Measures Delivered?

It is quite evident that these measures have been unable to check the extreme rupee volatility. It is because these measures are aimed at witnessing rupee depreciation as a problem rather than witnessing it as a symptom. All measures are at compressing demand for USD, and that is wrong diagnosis. The problem is not of demand but of supply of foreign currency. Any demand compression only allows for leakages, like squeezing a balloon can never contain the balloon.

The answer has to come more in addressing supply side problems of augmenting supply of USD. This will take care of the demand and also stem rupee volatility.

Potential Solutions to the Symptom

As a first step, the government should go all out to push exports of goods and services, remove all bottlenecks to exports and provide logistics support. This is a ‘rare’ opportunity for Indian exports, as rupee has depreciated more sharply than currencies of other emerging economies, clearly making Indian goods and services, remove all bottlenecks to exports and provide logistics support. This is a 'rare' opportunity for Indian exports, as rupee has depreciated more sharply than currencies of other emerging economies, clearly making Indian goods and services virtually the cheapest globally. With US recovering and so also the euro zone means global markets would also be looking up. The exporters could not have asked for a better time than the present. The response both by the government as well as the exporters has to be 'quick'.

All government departments dealing with exports should be directed to cut red-tapism and provide fast clearances wherever required to facilitate faster and quicker exports. Banks should be mandated to provide liberal funding for exports.

All pending FDI proposals with the foreign investment promotion board (FIPB) should be fast tracked and cleared expeditiously. Further, FDI norms should be further liberalized to attract more FDI. All efforts have to be made to get Indian back on the growth trajectory. Speed up investment by the government, expedite investments proposals held up in bureaucratic red-tapism. Initiate government level reforms non-controversial and easy to implement. It is not about 'bold reforms' but 'quick reforms'.

Government has done well to restrict non-essential imports to reduce CAD. As a further step, India could import more from Iran where it has 'rupee payment agreement'. India could also flag the issue of trade deficit with China, of India importing more form China than what it exports. Reducing trade deficit with China (USD 39 billion) would also ease the pressure on CAD.

It could also be the time for India to go for 'full' convertibility of the rupee, as it would encourage inflows. Outflows may not be a worry at this stage as USD has become expensive. Convertibility would also surfacing of the underground USD into money market augmenting supply of USD.

CONCLUSION:

These are difficult times for the Indian rupee, but not questioning inherent strengths which are still fundamentally strong and cannot be said as a crisis as being reported in the media, the press and even some analysts. There is a definite unwarranted pessimism. The levels of savings, availability of resources for investment, levels of forex reserves and potential domestic demand are all strong factors of India.

It is time for a collective action of reversing the negative sentiments and restoring the faith back on the Indian Economy, through appropriate mix of policies, shaking of the political and bureaucratic lethargy and re-bouncing on high growth path with a stable rupee.

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