

Rupee Depreciation: Cause, Impact and Future Prospects



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A B S T R A C T

The unexpected depreciation of rupee against US Dollar this year by over 25 percent has caused a great concern for the Government of India, RBI and corporates of India. On Aug 28, 2013 Indian rupee has touched historic low as 68.86 before recovering little in next few days. It appears that the rupee has entered into uncharted territory receding from where may be a long drawn hope and it seems not happening in short run. Some economist feels that the recent fall of rupee against US Dollar will help rupee to find its real value. Needless to say that apart from factors such inflation, crude oil, fiscal deficit the exchange rate is one of the most important determinants of country's relative level of economic condition.

Key Words: Capital flow, Forex, FII's, Inflation, Exchange rate.

Introduction:

For country like India, whose dependence on the import of crude oil and gold from the rest of world is to the extent of 75-80 percent of the total domestic requirement? Exchange rate risk also drives away foreign investors which in turn depreciates the local currency. Indian Rupee is currently caught in this vicious cycle; it will have to find a stable level to regain investors' confidence. The depreciating rupee has serious effects on the external debt figures of the nation. The total external debt has increased by Rs. 2286.8 billion to Rs16884.9 billion by the end of November 2012.

1. Factors that Pushed Rupee into the Well

1.1 Continued Global Uncertainty:

FII Investment - Financial Year

Financial Year	INR crores		
	Equity	Debt	Total
1992-93	13	0	13
1993-94	5,127	0	5,127
1994-95	4,796	0	4,796
1995-96	6,942	0	6,942
1996-97	8,546	29	8,575
1997-98	5,267	691	5,958
1998-99	-717	-867	-1,584
1999-00	9,670	453	10,122
2000-01	10,207	-273	9,933
2001-02	8,072	690	8,763
2002-03	2,527	162	2,689
2003-04	39,960	5,805	45,765
2004-05	44,123	1,759	45,881
2005-06	48,801	-7,334	41,467
2006-07	25,236	5,605	30,840
2007-08	53,404	12,775	66,179
2008-09	-47,706	1,895	-45,811
2009-10	110,221	32,438	142,658
2010-11	110,121	36,317	146,438
2011-12	43,738	49,988	93,726
2012-13*	140,033	28,334	168,367
Total	628,377	168,467	796,844

* As on March 31, 2013

Source: www.x-rate.com

Any outward flow of currency or decrease in investment will put a downward pressure on exchange rate. This Global uncertainty has adversely impacted the domestic factors (current and capital account etc.) and caused the depreciation of rupee. In the below table FII's contribution is unpredicted and does not follow the uniform direction and that ultimately lead to depreciation of rupee.

See Table 1

1.2 Current Account Deficit:

While a country like China will be more than happy with a depreciating currency, the same doesn't apply for India. China exports more than it imports, thus a depreciating currency makes its exports cheaper in the International market, in turn making China more competitive. India on the other hand does not enjoy this luxury, mainly because of increasing demand of oil, which constitutes a major portion of its import basket.

1.3 Capital Account Flow:

Deficit countries need capital flows and surplus countries generate capital outflows. India needs dollars to finance its current account deficit. Institutional investors investing in India are directly impacted by the global market uncertainty. In 2008 India had a net outflow of \$14 billion of FIIs and INR depreciated from 39 levels to 52 against dollar

1.4 Persistent Inflation:

This consistent high rate of inflation has hammered heavily on the exchange rates of the Indian currency compared to the most of the currencies of the world and has been termed as worst performing currency of the world. To tame the inflation, RBI has been initiating with the tight monetary policy and it has increased the policy rates thirteen times since March 2010 despite which the inflation is not coming down at comfort level of RBI i.e. 5-7 percent.

1.5 Interest Rate Difference:

Higher real interest rates generally attract foreign investment but due to slowdown in growth there is increasing pressure on RBI to decrease the policy rates. Under such conditions foreign investors tend to stay away from investing. This further affects the capital account flows of India and puts a depreciating pressure on the currency.

2. Impact of Rupee vs. USD

In the last two month July and August 2013 rupee has depreciated significantly. It is expected that it would continue the slide as many macro-economic factors not in favor of Indian Economy. The following are the factors which would slide down the rupee value in future.

2.1 Foreign Funds Outflow:

It is the major concern of Indian economy now because the global uncertainty and various economic crises like Europe sovereign debt problem, US economy problem etc. leads to search for the safe haven among the investor. They are quickly pulling out the money from Indian market and investing in any other safe investment like Gold or US Dollar.

2.2 Government Deficit is high:

The government finances are in a bad shape and the combined central and state government deficit has stubbornly stayed around 10 percent of GDP. It is high deficit and investor lost faith in the local economy.

2.3 Political Uncertainty and Corruption:

This is one of the major factors for any country to stabilize the economy. In India, last one year we are seeing of corruptions and there is no good news from the ruling party about the economic reforms and lot of agitation among the citizens including the veteran Gandhian Anna Hazare's campaign of fight for second freedom which took attention from global media.

3. The Way that Can Pull Rupee Out

3.1 Measures by RBI:

a. Forex Reserves:

RBI can sell forex reserves and buy Indian Rupees leading to demand for rupee. But using forex reserves poses risk also, as using them up in large quantities to prevent depreciation may result in a deterioration of confidence in the economy's ability to meet even its short-term external obligations. And not using reserves to prevent currency depreciation poses

the risk that the exchange rate will spiral out of control. Since both outcomes are undesirable, the appropriate policy response is to find a balance. Recent data shows that RBI had indeed intervened by selling forex reserves selectively to support Rupee.

b. Interest Rates:

The rationale is to prevent sudden capital outflows and ultimately lead to higher capital inflows. But India's interest rates are already higher than most countries. This was done to tame inflationary expectations. So further rising in interest rates would lead to lower growth level.

c. Attractive Investments Policy:

RBI can take steps to increase the supply of foreign currency by expanding market participation to support Rupee. RBI can increase the FII limit on investment in government and corporate debt instruments. It can invite long term FDI debt funds in infrastructure sector. The ceiling for External Commercial Borrowings can be enhanced to allow more ECB borrowings.

3.2 Remedies by Government:

Government should take some corrective and strict measures to bring FDI and create a healthy environment for economic growth. Key policy reforms that should be initiated includes rolling of Goods and Services Tax (GST), Direct Tax Code (DTC), FDI in aviation and retail, Companies Bill and diesel decontrol. Efforts should be made to invite FDI but much more needs to be done especially after the holdback of retail FDI and recent criticisms of policy paralysis.

Conclusion

The Indian Rupee has depreciated significantly against the US Dollar marking a new risk for Indian economy. Grim global economic outlook along with high inflation, widening current account deficit and FII outflows have contributed to this fall. RBI has responded with timely interventions by selling dollars intermittently. But in times of global uncertainty, investors prefer USD and Gold as a safe haven. To attract investments, RBI can ease capital controls by increasing the FII limit on investment in government and corporate debt instruments and introduce fostering instrument to increase the monetary flow. However, there are a lot of activities between cup and lips but strict decision can help to regain the shine of rupee.

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