Devaluation of Indian Currency in Indian Economy: Causes and Effects

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Abstract
Today, in many countries, especially the developing ones, the weakening of their currency i.e. the decrease or depreciation of their own currency in terms of foreign currencies has become a central growth issue. These currency changes can have an expansionary or contractionary effect on economic growth. Many development organizations like International Monetary Fund (IMF) support the idea of devaluation of currency as one means of economic growth besides the financial aid and loans to their member countries for the development of domestic firms. It will increase competitiveness of firms and increase the production of domestic products and output. However, some researchers focusing on developing countries (Krugman & Taylor, 1978) shed light on the negative effect of devaluation on output. Despite ambiguous results from empirical studies devaluation of currency has been used as a growth strategy by many developing countries. Even though the study focuses on India, the results from my study can hopefully be used when evaluating the growth effects of currency devaluations in other developing countries.

Key Word: Devaluation, Economic Growth, Currency.

Introduction

Historically, from 1973 until 2011 the USD/ INR exchange averaged 30.32 reaching an historical high of 52.84 in December of 2011 and a record low of 7.19 in March of 1973. India may face its worst financial crisis in decades if it fails to stem a slide in the rupee, leaving the central bank with a difficult choice over how to make the best use of its limited reserves to maintain the confidence of foreign investors. The fall in the value of Indian rupee has several consequences which could have mixed effects on Indian economy.

The rupee has plunged to an all-time low against the dollar and its fall has become a subject for debate. The usual discussions on the fall of the rupee bring up macro economics matters such as slow economic growth, huge current account deficit, rising imports etc. At the time of independence when India had no foreign borrowings the rupee was at par with the dollar. With the introduction of the 5 years plan and the subsequent requirements for foreign investments the dollar slowly rose. In 1985, after the Bofors scam, which toppled Rajiv Gandhi's government, the dollar was equal to 12.35 rupees and since the economic liberalization in 1991, there was a sharp devaluation of rupee and the rupee had dropped to Rs. 24.5 against a Dollar. The dawn of the third millennium gave a further worsened the condition rupee against dollar and the rupee has hit an all time low of Rs. 65.42 against a dollar on the 22nd of August 2013. Indian economists are trying hard to chalk out a strategy to counterbalance the falling value of rupee but it seems the attempts are futile.

Meaning of Devaluation and its implications

Devaluation means a fall in the value of domestic currency in terms of foreign currency/currencies. For example, suppose the exchange rate between rupee and dollar is Rs 25= 1 $. If this exchange rate is fixed at Rs. 30 = 1$ then it is called devaluation of rupee. Earlier Rs. 25 could purchase a dollar and now more rupees (Rs.30) are required to get a dollar. So the value of rupee in terms of dollar has declined.

Implications of Devaluation

a) It helps to boost exports

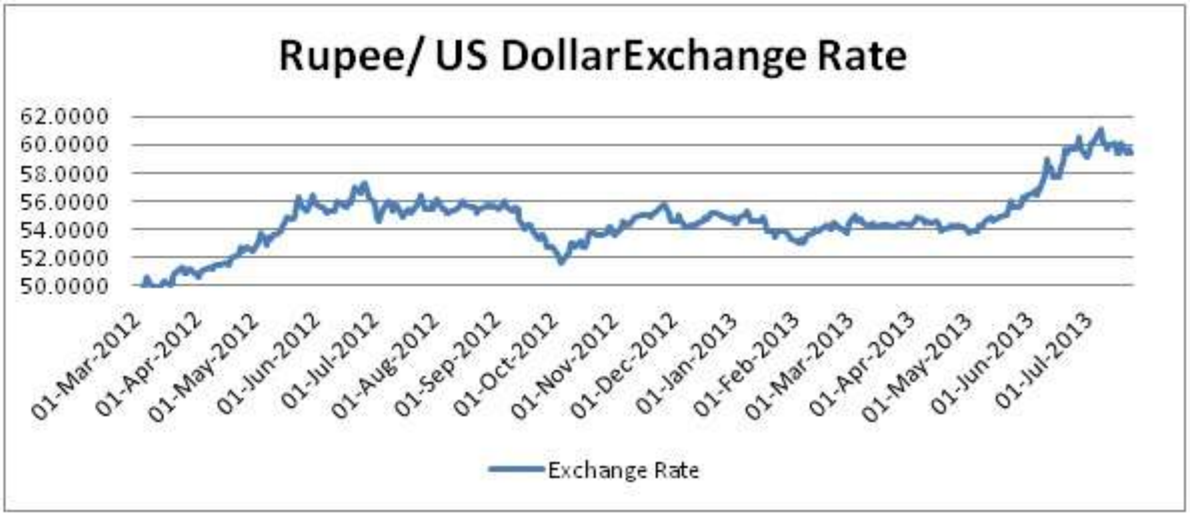
b) It will lead to higher cost of imported goods and make some of the capital extensive projects more expensive to execute

c) It will increase cost of dollar loans taken by companies and increase foreign debt

d) It will slow down the overall economic growth by increasing the interest rates and dissuade flow of FII's.

Comparison of Rupee and Dollar

Persistent rupee depreciation has adversely impacted the profitability of various industries, widened the current account deficit and has also fuelled inflation that has adversely impacted the common man. It is also undermining the government and RBI's effort to bring economy back to growth trajectory. Depreciation of currency has become a major concern for both Ministry of Finance and Reserve Bank of India. If certain important steps are not taken than fall in the value of rupee will have some serious impact on the long term growth prospects of the country.



Current Economic Scenario

After a promising start to the decade in 2010-11 with achievement like GDP growth of 8.4 per cent, bringing down fiscal deficit to 4.7 per cent from 6.4 of GDP in 2009-10, as well as containing current account deficit to 2.6 per cent from 2.8 per cent in 2009-10. GDP growth decelerated sharply to a nine year low of 6.5 per cent during 2011-12.

The slowdown was reflected in all sectors of the economy but the industrial sector suffered the sharpest deceleration which decelerated to 2.9 per cent during 2011-12 from 8.2 per cent in 2010-11. The centre's finances for 2011-12 experienced considerable slippage as key deficit indicators turned out to be much higher than budgeted due to shortfall in tax revenues and overshooting of expenditure. The gross fiscal deficit (GFD)-GDP ratio moved up to 5.8 per cent in 2011-12 compared to the budgeted ratio of 4.6 per cent. The substantial increase in subsidies during 2011-12 on account of high crude oil prices further impacted the deficit of the Government.

The year 2011-12, especially the second half, was characterised by a burgeoning current account deficit (CAD), subdued equity inflows, depletion of foreign exchange reserves, rising external debt and deteriorating international investment position. Inflation remained elevated at over 9 per cent in the first eight months of 2011-12, before softening moderately in December and remained sticky in the range of 6.9-7.7 percent.

Economy in 2012-13

GDP Growth Profile: According to the first advance estimates of national income for the year 2012-13 of the Central Statistics Office (CSO), the Indian economy is expected to grow at its slowest pace in a decade at a mere 5 per cent in 2012-13, on the back of dismal performance by the farm, manufacturing and services sectors, The estimate is lower than the 6.2 per cent growth clocked in 2011-12 and is the lowest since 2002-03, when the economy grew by 4 per cent only According to the CSO s' advance estimates, the growth in agriculture and allied activities are likely to lowered to 1.8 per cent in 2012-13, compared to 3.6 per cent in 2011-12 and manufacturing growth is also expected to drop to 1.9 per cent in this fiscal, from 2.7 per cent achieved during the last year. Services sector, including finance, insurance, real estate and business services are likely to grow by 8.6 per cent during this fiscal, against 11.7 per cent in the last fiscal. Meanwhile, mining and quarrying is likely to be slightly better at 0.4 per cent, compared to a negative growth of 0.6 per cent a year ago. Growth in construction is also likely to be 5.9 per cent in 2012-13, against 5.6 per cent last year.

Per Capita Income

The per capita income at current price during 2012-13 is estimated to be Rs. 68,747 as compared to Rs. 61,564 during 2011-12. India's per capita income, a gauge for measuring living standard, is estimated to have gone up by 11.7 per cent to Rs. 5729 per month in 2012-134.

Agriculture: In the advance estimate of GDP for 2012-13, the CSO had pegged farm growth at a three-year low of 1.8 per cent against last year's 3.6 per cent. Production of foodgrain is expected to decline by 2.8 per cent as compared to the growth of 5.2 per cent in the previous year.

Industry: Industrial growth has remained subdued since July 2011 due to weak global demand, weak supply linkages, high import costs, and sluggish investment activities. During 2012-13 (April to November), industrial growth slowed to 1.0 per cent. The Industrial sector was mainly affected by the contraction in the output of capital goods and the mining sector. Excluding capital goods, the growth rate of overall IIP during April to November 2012 was 3.0 per cent. The slowdown in consumption demand has affected the growth of motor vehicles, food products and apparel industries.

The subdued growth of the core industries has remained a drag on industrial production. Policy uncertainties in areas such as iron ore and coal mining have adversely affected the output of the steel and power industries. The recent initiatives taken by the government for the allocation of new coal blocks and commencement of production from Coal India Limited (CIL)'s new coalfields are expected to boost coal output going forward. However, in the interim, constraints in infrastructure sector remain

Inflation

The inflation decelerated to 7.7 per cent in first half of (April-September) of 2012-13. WPI inflation was 8.07 per cent in September 2012, which was 8.01 per cent in August 2012. It has fallen to 7.32 per cent in October 2012, 7.24 per cent in November, 7.18 per cent December 201217 and stood at 6.62 (provisional) for the month of January 2013.

Exchange Rate

Slowdown in net capital inflows coupled with pressure in trade account balance strained the exchange rate leading to depreciation of Rupee from Rs. 52.7 (per USD) at end-September 2012 to Rs. 54.5 at end-November 2012. Pressure on Rupee continued in December and it closed at Rs. 54.8 at end-December 2012. As on January 23, 2013, the rupee showed lower depreciation over end-March 2012 compared to other major emerging market developing economies (EMDEs) like Brazil, South Africa and Argentina.

Foreign Investment Inflow

Foreign Direct Investment (FDI): FDI have declined during 2012-13 for the period April to December of the current fiscal, the inflows have been $16,946 million which were $29, 277 million during April to December 2011.

Foreign Institutional Investors (FII): During 2012-13 (upto January 23, 2013), FII's made net investments of Rs. 1,190 billion in the capital market compared with that of Rs. 520 billion during the corresponding period in the previous year

Major Causes for Depreciation of Rupee

Here is a detailed analysis of the factors that have caused depreciation of Indian rupee, possible effects of it on different sectors and industries, policy measures taken by RBI to arrest the fall of rupee and effects of these measures on the economic outlook of the country.

1. Strong Dollar

In the past two years, demand of dollar has increased significantly. This increase in demand can be attributed to increased confidence of investors in US economy. A marked improvement has been observed in US labor market and US equities have also performed well. Also, with euro zone still in crisis, investors prefer Dollar over Euro. Investors are opting for capital preservation rather than capital appreciation. This increase in demand of dollar has resulted in its appreciation vis-à-vis other countries.

2. Crude price

Price of crude is one of the major factors that have contributed to depreciation of rupees. India is one of the major importers of crude oil. Increase in demand of oil all over the world combined with its shortage resulting from the political uncertainties in Arab countries, has lead to increase in price of oil. Rising crude price (Figure 2), on the other hand, has resulted in a higher demand of dollar since crude oil is quoted in dollars. This rising demand of dollar in turn has weakened the Indian rupee. It might be the case that Indian economy is at the initial stage of J-curve effect with respect to the demand of oil but till the effect reaches its maturity, rupee is expected to depreciate further.

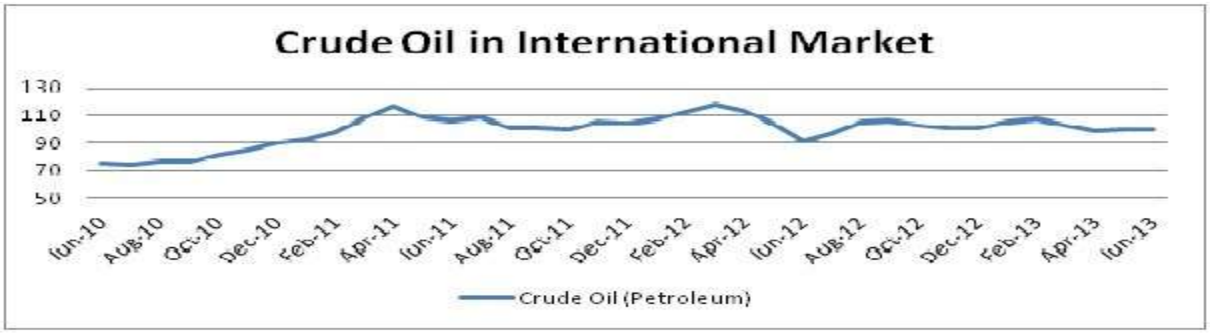


Figure 2

3. Decline in Investor Confidence

India has witnessed a massive decline in investor confidence. Overseas investors have pulled out a massive Rs 44,162 crores from the Indian capital market in the month of June, 2013 itself. The efforts by the Ministry of Finance to infuse confidence in foreign investors have so far failed miserably. Declining FII and weakening currency actually results in a vicious cycle. FII outflow results in currency depreciation and currency depreciation, on the other hand makes it less attractive for the investors to invest in the currency.

4. Import-Export Mismatch

India for long has been facing an import-export mismatch; imports far exceed exports resulting into a persistent current account deficit. This in turn leads to another vicious circle. Persistent CAD leads to currency depreciation; depreciated currency further increases the price of imports which in turn further adds to the current account deficit. Figure 3 depicts the widening current account deficit to GDP ratio since 2004-2005. As we can see that this ratio has continually been increasing and it is expected to increase further this financial year. As of June, 2013 India's current account deficit already stands at staggering $ -18.1 B.

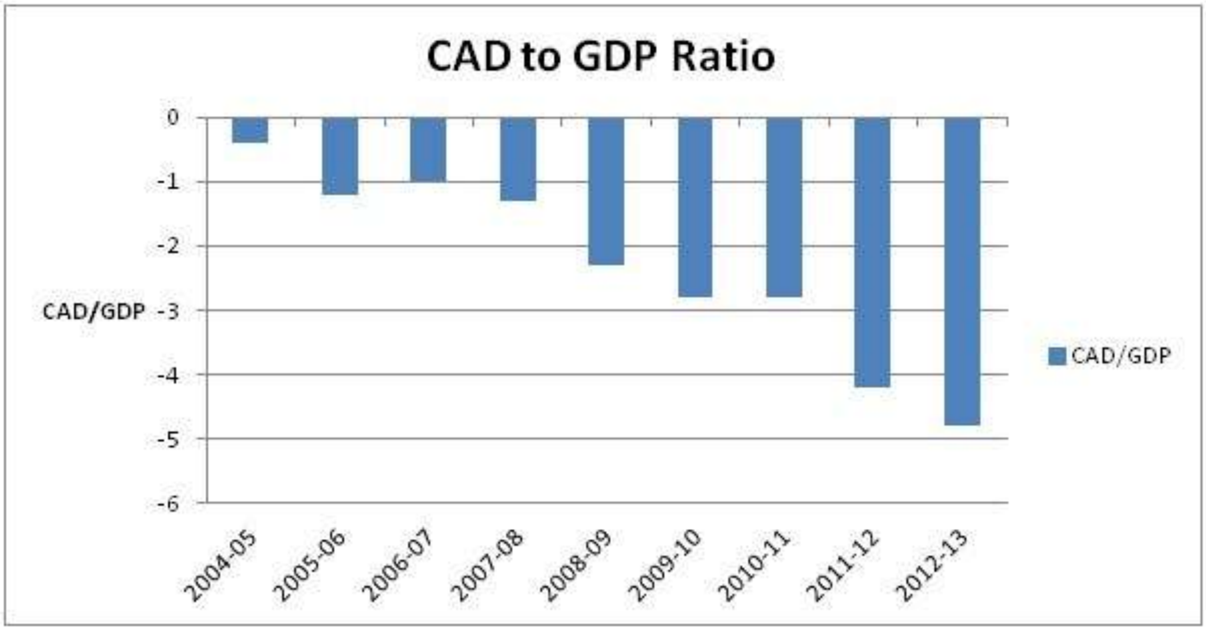


Figure 3

5. Current Account Deficit (CAD)

CAD is considered to be the key factor behind the steep volatility of rupee against dollar. CAD occurs when the total import of goods and services of a country is greater than the total export goods and services thus making India a debtor to the rest of the world. India's current account averaged a deficit worth 1.5 billion USD since 1947 until 2013. In the first quarter of 2013 the CAD was 18.1 billion and at present it has gone up over 20 billion. This has hit hard on the rupee.

Strengthening of Dollar In the last six months the dollar has strengthened by 3.52 percent with the strengthening of the US economy. The dollar has been rising on signs of growing economic momentum and talk of an early end to the Fed's stimulus effort. This is something which is beyond the control of the Indian Government and it is hampering the recovery of the rupee.

6. Insufficient inflow of FDIs and outflow of the foreign investments

The downfall in the Indian economy has worsened the situation and the government is unable to generate heavy capital inflows. Despite all the government effort to allow Foreign Direct Investment (FDI), there hasn't been significant FDI inflow. The US federation has withdrawn some of its bond buying programmes resulting in a sudden outflow of money that in return has left India far behind in the race Foreign investors has been pulling out of the Indian economy. The month of May has seen a record outflow of foreign investments of Rs. 44162 crore. With the giants like Posco pulling out of its Rs. 30000 crore steel plant project in Karnataka followed by Arcelor Mittal pulling out of its Rs. 50,000 crore project in Odisha due to delays and land acquisition delays. This has shrunk the total inflow of capital in India. Indian investors have been spending more abroad than foreign investors have been spending in India. This has led to the further deficit of current account.

7. Rising Imports

The rising import bill is one of major concern and is has hindered the government effort to tackle the falling rupee. Oil accounts for 35% of the total imports and gold 11% on India's current bill. There has been a heavy demand for the greenback from the exporters of oil, the most prolific buyers of dollar in the world market, thus pushing rupee lower. In the gulf countries, the dealing of oil is done in dollars, i.e, if India has to purchase oil, it has to pay in dollars, so for this India needs purchase dollars from USA in exchange of gold. This has led to the further devaluation of the rupee. Also, the sliding prices of gold have triggered the government to lower the imports of gold, thereby increasing the Current Account Deficit (CAD) and concurrently weighing heavy on the currency.

8. Poor Economic Growth

The Gross Domestic Product (GDP) has hit its lowest patch in the last 10 years. With fall of the GDP to 4.8%, it had significant effect on the stock markets and the falling rupee. The manufacturing, mining and the agricultural sector has faltered and investors have become cautious of investing in India.

The central government has unravelled a multipronged strategy to bring about an increment in the inflow of dollars and limit the outflow to compensate for the sliding value of rupee. A planned increase in import duty has been exercised to shore up the decrement in rupee.

Adverse impact of weakening of rupee can be witnessed on various sectors and across various segments of Indian Economy.

1. External Debt

India external debt as on June, 2013 stands at about $390 billion . And most of the debt is dominated in foreign currency i.e. most of the money has been borrowed in foreign currency since developing countries like India find it extremely difficult to borrow in domestic currency. As a result, depreciation of rupee has put tremendous stress on government balances. If the depreciation continues, government may actually find it difficult to meet its debt obligations.

2. Cost of Production

Automobiles, electronic good, airlines, fertilizers, oil marketing companies are few sectors that will be adversely impacted by the increase in input costs resulting from the weakening of rupee. Fuel is one of the major inputs in most of these industries. For example, in case of airlines fuel alone account for 35 percent of their operating costs and their ability to pass on the costs is also very limited. Prices of crude petroleum has not only been increasing but increasing at a greater rate and much of this increase can be attributed to weakening rupee. This is severely going to impact the profitability of these industries. A weak rupee will also increase under recoveries of oil marketing companies. Under recoveries could be up to Rs 1050 billion in 2013-14.

3. Companies with foreign debt

A falling rupee is likely to have an adverse impact on the balance sheet of companies that have high foreign debt. According to a CRISIL Research report “For companies in the CNX Nifty (excluding banking and financial services), around 40% of debt is denominated in foreign currency. In total, corporate India had forex debt outstanding of over $200 billion as of March 2013, of which close to 45% is short-term debt”. All these companies are likely to face a tough time in meeting their debt obligation.

4. Inflation

A major impact of depreciating currency will be on inflation. Imported goods will become costlier. Companies may pass on the increase in their input costs on the consumers. Price of petrol, diesel and fertilizers may increase if government tries to cut down its subsidy bill, which has been constantly rising because of weakening rupee. Apart from this, cost of foreign travel and foreign education will increase manifold. Inflation as measured by the consumer price index has already witnessed an increase of 0.56% from May to June, 2013.

Figure 5

In month of July, Reserve Bank of India (RBI) has taken a no. of steps to arrest the fall of rupee. It recently tightened liquidity to contain speculation and volatility in the foreign exchange market. It reduced the Liquid Adjustment Facility to 0.5 percent of the total deposits from the previous level of 1 percent. RBI has also made it mandatory to export 20 percent of the all gold imported into the country. Besides these steps, RBI has been actively intervening in forex market as well.

All these steps by RBI may prove to be fruitful in containing the free fall of the rupee but they do have certain adverse effects. Frequent interventions in the foreign exchange market have had a toll on the forex reserves of the country. In the first three months of fiscal 2013-2014, Forex reserves have fallen by 4.6%. They stand at $280.2 billion (Figure 6) as of July 12, 2013. Also, borrowing costs of banks and corporate have gone up due to the monetary tightening and this has in turn impacted the economic growth.

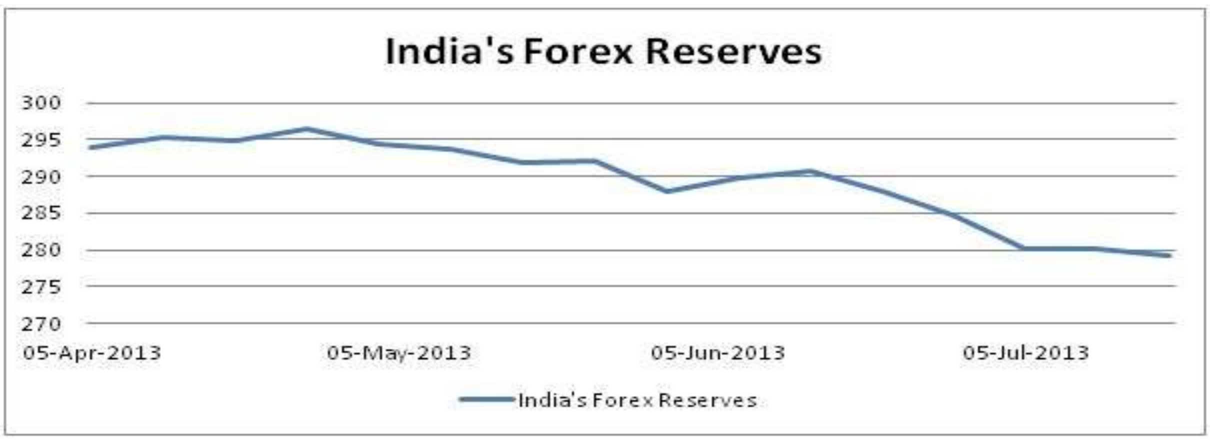


Figure 6

On 31 July, 2013 rupee again breached 61 level. Investors were upset with no action in RBI policy review on 30th. Government is planning to come up with sovereign bond issue to overseas investors in order to attract dollar inflows. This may temporarily improve India's current account and may prop up Indian rupee but it can best act as a quick fix. In the long term, issue of these bonds may compromise with the financial stability of the country. Also, steps like increasing duty on gold imports are less likely to be fruitful because India has somewhat inelastic demand of gold which is unlikely to be affected by the increase in prices.

Policy options with RBI to control devaluation of rupee

a) **Raising Policy rates:** The rationale was to prevent sudden capital outflows and prevent meltdown of the currencies. In India's case, this cannot be done as RBI has already tightened policy rates significantly since Mar-10 to tame inflationary expectations. Higher interest rates along with domestic and global factors have pushed growth levels much lower than expectations. In its Dec-11 monetary policy review, RBI mentioned that future monetary policy actions are likely to reverse the cycle responding to the risks to growth. India's interest rates are already higher than most countries anyways but this has not led to higher capital inflows. On the other hand, lower policy rates in future could lead to further capital outflows.

b) **Using FOREX Reserves:** RBI can sell forex reserves and buy Indian Rupees leading to demand for rupee. Based on weekly forex reserves data, RBI seems to be selling forex reserves selectively to support Rupee. Its intervention has been limited as liquidity in money markets has remained tight in recent months and further intervention only tightens liquidity further.

c) **Easing Capital Controls:** Dr Gokarn Deputy Governor of RBI said in his speech capital controls could be eased to allow more capital inflows. He added that "resisting currency depreciation is best done by increasing the supply of foreign currency by expanding market participation".

Steps taken by Government

a) Increased the FII limit on investment in government and corporate debt instruments.
b) First, it raised the ceilings on interest rates payable on non-resident deposits. This was later deregulated allowing banks to determine their own deposit rates.
c) The all-in-cost ceiling for External Commercial Borrowings was enhanced to allow more

ECB borrowings

Administrative measures: Apart from easing capital controls, administrative measures have been taken to curb market speculation.

a) Earlier, entities that borrow abroad were liberally allowed to retain those funds overseas. They are now required to bring the proportion of those funds to be used for domestic expenditure into the country immediately.

b) Earlier people could rebook forward contracts after cancellation. This facility has been withdrawn which will ensure only hedgers book forward contracts and volatility is curbed.

c) Net Overnight Open Position Limit (NOOPL) of forex dealers has been reduced across the board and revised limits in respect of individual banks are being advised to the forex dealers separately.

Summary

Thus we can see that since 1950 besides few appreciation rupee is depreciating against US dollar and the causes of depreciation are invariable different. Even after taking few measures by government if we see the recent depreciation, Rupee depreciation has abated but it still remains under pressure. Both domestic and global conditions are indicating that the downward pressure on Rupee to remain in future. Thus, RBI should likely to continue its policy mix of controlled intervention in forex markets and administrative measures to curb volatility in Rupee. Apart from RBI, government should take some measures to bring FDI and create a healthy environment for economic growth. Some analysts have even suggested that Government should float overseas bonds to raise capital inflows.

As per The United Nation's World Economic Situation and Prospects (WESP), 2013 report, four years after the eruption of the global financial crisis, the global economy is still struggling to recover. During

2012, growth of the world economy has weakened further. The global economy is expected to grow at 2.2 per cent in 2012, at 2.4 per cent in 2013 and 3.2 per cent in 2014.

Weaknesses in the major developed economies are at the root of the global economic slowdown. The report stresses that most of them, but particularly those in Europe, are trapped in a vicious cycle of high unemployment, financial sector fragility, heightened sovereign risks, fiscal austerity and low growth. Several European economies and the euro zone as a whole are already in recession, and euro zone unemployment increased further to a record high of almost 12 per cent this year. The US economy slowed significantly during 2012 and growth is expected to remain meager at 1.7 per cent in 2013. Deflationary conditions continue to prevail in Japan. The economic woes in Europe, Japan and the United States are spilling over to developing countries through weaker demand for their exports and heightened volatility in capital flows and commodity prices.

Economies in developing Asia have weakened considerably during 2012, as the region's growth engines, China and India, have shifted into lower gear. While a significant deceleration in exports has been a key factor behind the slowdown, both economies also face a number of structural challenges that hamper growth. Given persistent inflationary pressures and large fiscal deficits, the scope for policy stimulus in India and other South Asian countries is limited. China and many East Asian economies, in contrast, possess much greater space for countercyclical policy.

According to the report, present policy stances fall short of what is needed to spur economic recovery and address the jobs crisis. While policy efforts have been significant, especially in the euro zone, in trying to redress sovereign debt distress, the combination of fiscal austerity and expansionary monetary policies has had mixed success so far in calming financial markets and even less so in strengthening economic growth and job creation.

It is essential to change course in fiscal policy, the UN report says, and shift the focus from short-term consolidation to robust economic growth with medium to long-term fiscal sustainability. Premature fiscal austerity should be avoided and, while necessary, fiscal consolidation should focus on medium-term, rather than short-term adjustment.

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