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   REVIEW OF LITERATURE

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   STATEMENT OF THE PROBLEM

   OBJECTIVES

   HYPOTHESES

   RESEARCH METHODOLOGY

   RESULTS & DISCUSSION

   FINDINGS

   RECOMMENDATIONS/SUGGESTIONS

   CONCLUSIONS

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   APPENDIX/ANNEXURE

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RUPEE DOWNFALL: A THEORETICAL OUTLOOK

GEORGE PAILY
RESEARCH SCHOLAR
CENTRE FOR DEVELOPMENT STUDIES
THIRUVANANTHAPURAM

ARUN B CHANDRAN
ASST. PROFESSOR IN ECONOMICS
LOVELY PROFESSIONAL UNIVERSITY
JALANDHAR

ABSTRACT

Indian Rupee has plunged to its historical lowest during August – September 2013 as Asia's worst performing currency. It was consistently falling over the last two years and lost one- third of its value from June 2011 (Rs 44/$) to September 2013 (Rs 69/$). The Indian policy makers are finding difficulty in taking appropriate decisions because of the unfavourable economic conditions at both national and international level. As per the rudimentary laws of basic economics, if the demand for US Dollar in India exceeds its supply, then its worth will go up and that of Indian Rupee (INR) will go down accordingly. In economic sense it is called as currency depreciation or rupee depreciation. Imports of goods and services, outflow of capital and additional demand for foreign exchange reserves by RBI constitute demand for dollars. On the other hand exports and inflow of capital from abroad represents supply of dollars. This paper attempts to study the reasons and implications of the rupee depreciation from a theoretical stance. It also attempt to suggest solutions to tackle the volatility of INR.

JEL CLASSIFICATION

E52, E58, F31, F32.

KEYWORDS

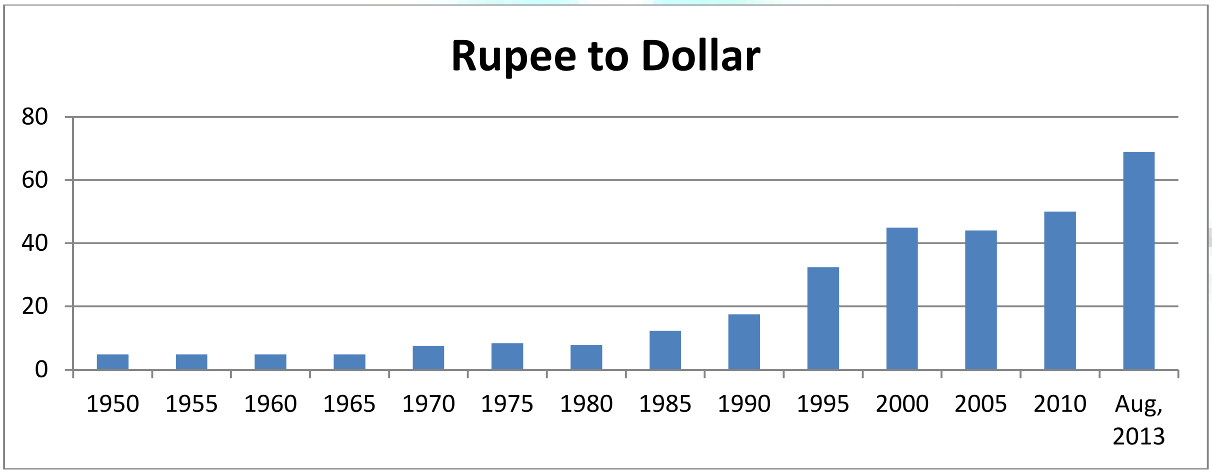
Current Account, Depreciation, Dollar, India and Rupee.

INTRODUCTION

After the independence, India adopted a strategy of development in which government and public sector were assigned to play a pivotal role in shaping our economic system. The trade regime continued till the end of 1980s was mainly guided by high tariffs and non tariff restrictions coupled with a strict import licensing policy. But by the end of 1980s, India was forced to make a shift from its existing trade policies towards reducing state controls on the external and domestic arena of industrialisation and finance because of the economic and political difficulties. A huge Balance of Payment crisis was the main among them. In 1991, when India adopted its new economic policy our foreign exchange reserves were not adequate even for financing the imports of just three weeks (Devika Johri and Mark Miller, 2003). The new trade policy was aiming at export led growth by replacing the ongoing import substitution measures.

As a part of the new economic policy, the Exchange Rate System has also undergone for its fundamental change after 1990. The rupee was officially devalued at 31.37 percent in July 1991 (RBI Bulletin, November 1991). A Dual exchange rate regime was established in India in March 1992. All the foreign exchange earned through current account transactions were required to be submitted to authorised dealers of foreign exchange and they in turn have to surrender it under Reserve Bank of India in which 40 percent is at the exchange rate declared by the RBI and the rest of 60 percent could be retained for sale in the free market. In 1993 India has moved from the dual exchange rate system to a market determined system (Patanaik and Pauly, 2001). But RBI holds certain controls over the flexibility of exchange rate. It is called managed floating exchange rate system. It means RBI intervenes in the foreign exchange market if the rate goes out of the exchange rate band it wants to maintain. Here 'market oriented' means, within this band exchange rate is determined by the demand and supply of foreign exchange.

FIGURE 1



Source: Author's calculation based on data from http://www.exchange-rates.org

OBJECTIVES OF THE STUDY

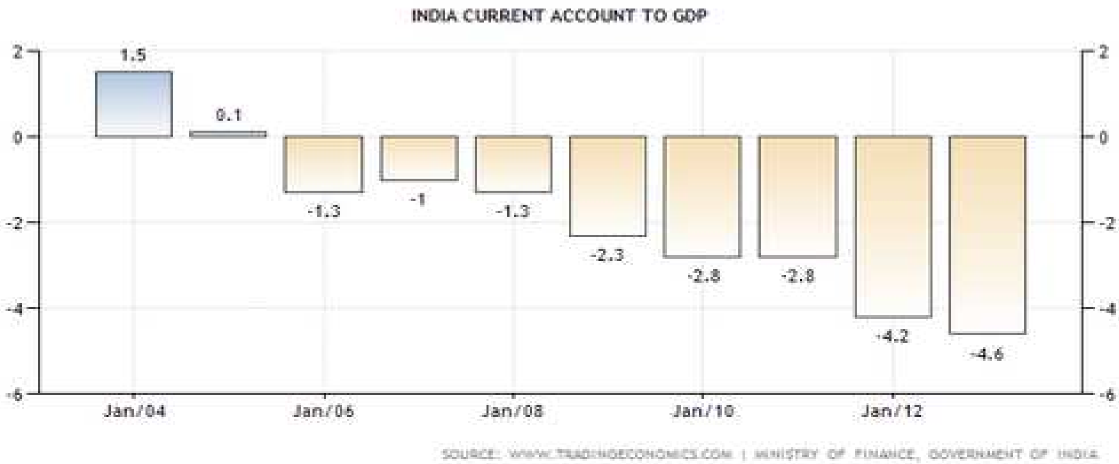
1) To understand the effectiveness of macroeconomic theories on depreciation in the Indian context.
2) To study the implications of rupee depreciation.
3) To suggest possible solutions to check volatility of rupee.

RUPEE DEPRECIATION: THEORITICAL ISSUES

One of the leading reasons behind the rupee downfall which has become the core of ongoing discussions is the widening Current Account Deficit (CAD). India's Current Account Deficit has reached its historical high at 5.5 percent of GDP in 2012-13 from 4.6 percent in 2011-12 (Jayati Ghosh 2013), (see Figure 2). The

Current Account Deficit (CAD) can be economically analysed on the basis of both domestic as well as international trade perspectives. In the international point of view, CAD is the trade balance (difference between exports and imports) and balance on invisibles. Secondly at the national point of view CAD is identical to the gap between domestic savings and investment. If the value of net exports or the gap mentioned above is positive, there is Current Account Surplus. The identity between domestic as well as international point of view (see Figure 3) can be shown below.

FIGURE 2



According to the basic national income identity,

Y = C + I + G + NX

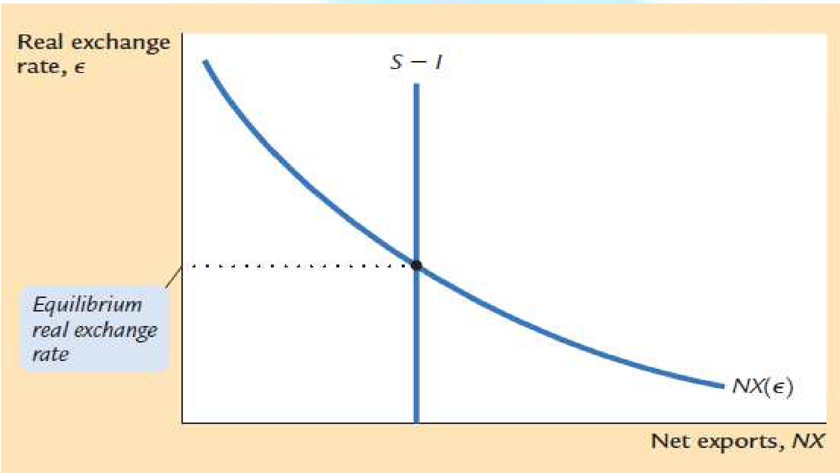
Y – C – G = I + NX

Where ***Y – C- G*** is the total national savings (private savings + public savings)

S = I + NX

S – I = NX

FIGURE 3



Source: Macroeconomics by Gregory Mankiew

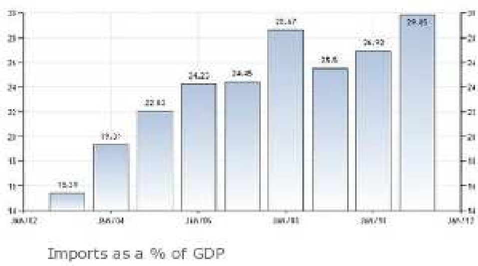
The equilibrium real exchange rate (€) is determined by the equality between net exports (NX) and S-I gap. Suppose for any reason, the net exports declines. In order to establish the identity given above the real exchange rate must decrease. It means domestic currency depreciate with respect to the foreign currency. Remember that in the day to day life by the term 'exchange rate' we mean nominal exchange rate. Nominal Exchange Rate between two countries is the price at which residents of those countries trade. In other words, more simply it is the relative price of the currency of two countries. On the other hand, Real Exchange Rate is the relative price of the goods of two countries. It tells us the rate at which we can trade the goods of one country for the goods of another. The Real Exchange rate is sometimes called *terms of trade.* This conceptual difference does not make any problem for our analysis, because both go in the same direction.

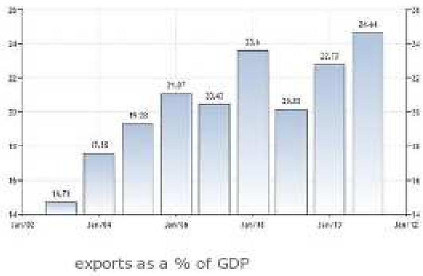
DEPRECIATION OF RUPEE: COUNTRY SPECIFIC ISSUES

After the economic reforms, India's exports have increased dramatically from 18 billion in 1990-91 to 309 billion in 2011-12. The growth rate was substantial till the global crisis of 2008. Though there was a revival of exports in the next financial year, it has again slowed down. One of the main reasons for the rapid slow down of India's exports was the change in the pattern of exports after the reforms. Instead of labour intensive goods in 1990s, India's exports now mainly concentrate on highly capital intensive goods such as engineering products and germs and jewelleries and services. Capital goods industry and service sector of the global economy was the most affected by the financial meltdown. That is why the Chinese economy could maintain a positive trade balance even in the midst of global crisis as they specialise in the production of labour intensive manufactured goods.

Although exports have grown during the last two decades, it could not keep up with growth in imports. Exports-GDP ratio has increased by 11 percentage points between 1991 and 2011 where as import-GDP has grown by 18 percentage points (C Rangarajan, 2013). As per the data on January 2011, India's total export is 24.64 percent of GDP where as imports has arisen to 29.85 percent of GDP (see Figure 4 and 5).

FIGURE 4 **FIGURE 5**





Source: tradingeconomics.com

From the Figures given above, it can be see that the gap between exports and imports is widening year after year. One of the important issue to be addressed here is why can't India reduce its imports to bring CAD at a reasonable level. In April 2013, the exports have increased by 2 percent compared to April 2012. But during the same period imports has increased by 11 percent and it ultimately resulted in 26 percent increase in the trade deficit (Jayati Ghosh, 2013). The recent growth of imports is mainly attributed to petroleum products and valuables such as gold which are generally having less price elasticity of demand in nature (mostly shows positive income elasticity). Oil and gold import accounts 35 and 11 percent respectively in India's trade bill. Oil imports as a proportion of GDP doubled between 2004-05 and 2011-12. Non oil imports have also recorded an increase from 14.4 to 18.5 percent of GDP during the same period (Rangarajan 2013). Among the non oil imports, gold has become a prominent contributor increasing from 1.5 to 2.5 percent of the GDP from 2004-05 to 2010-11. Because of higher perceived returns on gold holdings and traditional nature of Indians to absorb more and more gold, the demand for gold as an investment tool has been increasing over time. The quote made by John Maynard Keynes about India a century ago as "that sink for precious metals" has been perfectly realised here. Gold has been a good investment tool and status symbol in India historically. With the limited access to financial instruments especially in the rural areas, gold and silver are the popular saving instruments. Almost all of India's demand for raw gold is met through imports. Trends shows that the demand for gold as a non jewellery item is steadily increasing over time (see Figure 6)

FIGURE 6

Source: Economic Survey 2012-13, Govt of India

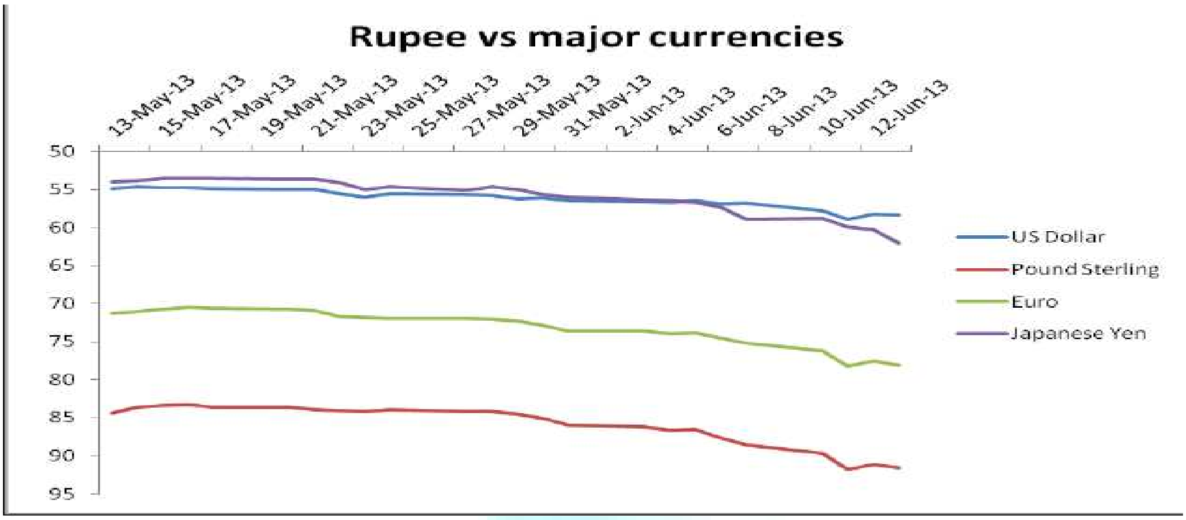
In the year 2011-12, both oil and gold imports recorded a sharp increase compared to previous year with a growth rate of 45 and 40 percent respectively relative to 22 and 18 percent. As a result, the merchandise trade balance has declined significantly especially since 2004-05.

The ongoing current account deficit can be financed only by increased capital inflow which creates a surplus in the capital account. Over the past two decades, the composition of India's capital account has been undergone for substantial change. In 1990-91, Foreign Direct Investment (FDI) and Portfolio Investment constituted a small portion where as in the year 2011-12 it is about 60 percentage of the capital account. Capital flows rise during the favourable cycles and fall in the bad times of business cycles. If the Current Account Deficit is not financed by an equivalent amount of capital inflow from abroad, then people will buy foreign exchange from the Reserve Bank of India, to make the excess payments of imports. It will reduce the forex reserves held by the Reserve Bank. If the RBI gets worried about its foreign exchange reserves and want to conserve them, it will devalue rupee. This is the connection between trade deficit, inflation and depreciation.

On 20th May 2013, Rupee – Dollar Exchange Rates were Rs 54.98/dollar. Soon after, on 22nd May, Ben Bernanke, chairman of Federal Reserve has announced its new policy of quantitative easing. i.e. the policy of keeping down the interest rates by injecting liquidity into the system. Bernanke's announcement have prompted the speculators to shift their funds from India to US capital markets where the interested rates are expected to rise and this has caused the further depreciation of Indian rupee along with all other currencies. And on 28th august 2013, rupee has reached at its lowest point of around 69 per dollar. Take an example how does a policy change in a foreign country lead to capital flight from India. Suppose a foreign investor (say, from USA) invest $200 in India through portfolio investment. Let the prevailing interest rate in India be 10 percent and the exchange rate Rs 50 per dollar. Therefore in rupee terms she has invested Rs 10000 and this money grows to 10000 (1+ 10/100) = 11000 which is equal to $220. If she expects a depreciation of rupee to Rs 60 per dollar, then the principal after the same time period will be only $183.3 (i.e. 11000/60 = 183.33). In this case her loss is 9 percent of money she has invested. So what she can do at this time is shift her capital from India either to USA or any other country where the interest rate is expected to rise.

Though the monetary and fiscal policies of a foreign nation affects the exchange rates of its trading partners, the sole reason behind the recent rapid fall of rupee can't be fully attributed to Fed's policy (Prabhat Patnaik 2013). Bernanke's announcement might have had an additional effect on the plunge of rupee, but the rupee has been falling down quite a long time before. More over rupee is losing its value not with US Dollar only, but it has been against all other major currencies (see Fig 7). Therefore beyond the influence of international economic conditions, there exist some intrinsic characteristic features of Indian economy which is also responsible for the fall of its currency value.

FIGURE 7



Source: Author's calculation based on data from tradingeconomics.com

If the prospective yield of investment is the same in India and USA, capital might be flowing to USA because the wealth holders feel more safety in the home base of capitalism as compared to India or any other developing country. Even if India can offer a rate of return which is adequate to prevent the capital flows from India to US, there might be occasions in which investors get panic and shift their funds to US (the core) from India (the periphery) because of the basic asymmetry in the world economy (Patnaik). As long as the centre is the centre and periphery in 'only' peripheries, there will always be a tendency to flight capital from the periphery to core where unlimited free capital flow is allowed and therefore there exist a downward pressure on the periphery's exchange rate (see Figure 8)

FIGURE 8

Source: Author's calculation based on data from tradingeconomics.com

Because of this condition even if India reduces its volume of imports to some extent, its value does not decreases because of the weak currency we have. If capital inflows to India have remained in a balance from its peak of 2007, our GDP would have been six times higher (Rajwade, 2012). Theoretically speaking, when the real exchange rate decreases, the demand for our goods in the international markets becomes cheaper. But in India's case it is not happening. It is because of three reasons: - the nature of goods we are exporting, greater domestic inflation which offsets the effect of depreciation and unfavourable conditions for increased exports in the global markets especially in the Euro zone and United States.

CONCLUSION

As per the macroeconomic identity we have discussed earlier, increased Current Account Deficit reflects the increased need for investment which cannot be made by the domestic savings. In an article published in *Economic and Political Weekly* by Montek Singh Ahluwalia, argues that we need around 3 percent Current Account Deficit for at least five years in order to finance the investment projects on infrastructure. The only way to fill this gap is the foreign investment. But the capital flows from abroad is highly volatile in nature. So we can't solely depend on foreign capital. More over the difference between domestic savings and investment itself is highly influenced by exchange rate fluctuation. Not depending on the capital flow from abroad, the cheapest way to finance the additional need of investment is the increased domestic savings. Latest figures from IMF show that China's personal savings rate has become the highest in the world. India's savings rate is not bad; it is about 32 percent of the GDP (IMF World Economic Outlook Report, 2013). But the disappointment is not embedded in figures, but we have never reached to our potential level of savings and investment. Appropriate government policies can reduce the influence of highly volatile foreign capital.

Reserve bank of India is the 10th largest in terms of foreign exchange holding. As on 11th October 2013, our forex reserve is $273 billion (RBI 2013). The size of our reserves provides fairly high assurance that we can mange temporary disruptions. But the size may not be sufficient to defend the Balance of Payment shock that we are going through. RBI tried to regain rupee strength by depleting its reserves by 27 billion, but it gave a realisation that trying to defend currency fall by selling our reserves is not as worth as we think in the present economic conditions. It reflects the need for increased reserves capable of managing long term disruptions.

Though it was a late step to increase the import duty on gold, it has helped to give a little relief against unregulated gold imports. But increased import duty on gold cannot be considered as an efficient tool for import reduction as it will increase the chances for smuggling. It is possible only through giving alternative investment tools for the people. The newly introduced inflation indexed bonds is a welcome step. Imperfections in the capital markets are the main reason for the accumulation of gold stocks especially in the rural areas. A well developed capital market will help to attract more people towards shares and equities. Finding ways for efficient energy utilisation and alternative energy sources will help to reduce oil imports at least to a certain extent. By increased present consumption of imported products, we give the burden of deficit to our future generations and it will limit their ability to act as productive asset in our development path. Though India has made a shift from import substitution to export promotion trade policy, we could not expand exports to our reach. India's rural areas are characterised by massive potential for small scale and medium scale manufacturing and agro related industries. Furthermore, expansion of services such as education can pave new arenas for India to earn foreign exchange in large scale. India's education system is the best among the developing countries and some institutions like IITs and IIMs can compete even with world class educational institutes. Our doctors and nurses trained in India are of great demand in the western labour markets. Compared to western countries, education in India is relatively cheap. More over PTAs and FTAs with unexplored markets such as Africa and Latin America may open new ways for boosting our exports in the long run.

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