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   HYPOTHESES

   RESEARCH METHODOLOGY

   RESULTS & DISCUSSION

   FINDINGS

   RECOMMENDATIONS/SUGGESTIONS

   CONCLUSIONS

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DEVALUATION OF INDIAN RUPEE & ITS IMPACT ON INDIAN ECONOMY

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ABSTRACT

The Indian Rupee has depreciated significantly against the US $ marking a new risk for Indian economy. The year 2012 has begun with catastrophic affect for the rupee. It was Rupees 43.96 against a dollar in the July 2011 and now for $1 it is Rupees 56.22. Rupee hits all time low in May 2012. This kind of decline will have the sweeping impact on the macro economy of the country, as we are heavily dependent on the import of oil, food items and other crucial raw materials. 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. This paper reviews the probable reasons for this depreciation of the rupee and also attempts to study the real implications of the depreciation of the rupee on the Indian economy and shows that in the long run, the Indian economy has more to lose and less to gain with weaker rupee. In this paper effort has been made to highlight on the importance of RBI intervention to control this situation.

KEYWORDS

Depreciation, Dollar, FIIs, Rupee, RBI.

INTRODUCTION

WHAT IS DEVALUATION OF A CURRENCY?

It refers to decline in value of a currency with respect to other currencies, which is most of the times brought by central bank. It should not be confused with term depreciation of currency which is a decline in currency value due to market forces without interference of government.

Devaluation means officially lowering the value of currency in terms of foreign currencies. There could be many motives of the devaluation. It stimulates exports of commodities. It restricts import demand for goods and services. It helps in creating a favourable balance of payments. Almost all the countries of the world have devalued their currencies at one time or the other with a view to achieving certain economic objectives. During the great depression of 1930 devaluation was carried by most countries of the world for the correcting their over-valuation.

OBJECTIVES OF THE STUDY

1) To understand the concept of devaluation.
2) To know about the trend of Indian Rupee and its exchange rate against US $ historically.
3) To understand the causes and the steps taken by government on the major devaluations that took place in India.
4) To study the real impact of the depreciation of the rupee on the Indian economy

WHEN DOES THIS HAPPEN AND HOW?

This happens mostly in developing countries which don't allow currency prices to be determined by market forces. What happens is that they want to avoid financial crisis, for which they adopt policies to maintain a stable exchange rate to minimize exchange rate risk and save their gold (foreign currency) reserves. Restrictions placed are either trade barriers or financial. Financial restrictions are on flow of assets or money across border which is associated with policy of fixed exchange rate or managed exchange rate. The nation will be forced to devalue its currency if its market is too weak to justify the exchange rate. Example a country has depleted foreign reserves and is not credit worthy to borrow from IMF then it has to pay for its imports by devaluation. When currency is overvalued or a country wants to reduce trade deficit then devaluation is used as a policy tool.

HISTORY ABOUT INDIAN RUPEE AND ITS EXCHANGE RATE

In early controlled exchange rate regime, the rupee exchange rate hovered around Rs 4.00 in the 1950s, Rs 5.00 in the 60s, Rs 7.00 in the 70s, and Rs 8.00 in the 80s. In the liberalised era of 90s, the rupee moved to Rs 20 and Rs 40 in the next decade of 2000. During this period, the Government has declared two major devaluations. The rupee was devalued first in 1966 by 57.5% from Rs 4.76 to Rs 7.50 against the US dollar. In the 90s, the rupee was again devalued by 19.5% from Rs 20.5 to Rs 24.5 against the US dollar. Indian rupee and its exchange rate historically is as follows-

YEAR	EXCHANGE RATE
1947	£1.00
1952	$4.79
1960	$4.77
1965	$4.78
1970	$7.56
1975	$8.39
1980	$7.86
1985	$12.36
1990	$17.50
1995	$32.42
2000	$44.94
2005	$44.09
2010	$46.21
2011	$53.65
2012(MAY)	$57.31

DEVALUATION OF INDIAN RUPEE IN 1966

Despite government attempts to obtain a positive trade balance, India suffered a severe balance of payments deficits since the 1950s. Inflation had caused Indian prices to become much higher than world prices at the pre-devaluation exchange rate. When the exchange rate is fixed and a country experiences high inflation relative to other countries, that country's goods become more expensive and foreign goods become cheaper. Therefore, inflation tends to increase imports and decrease exports. Since 1950, India ran continued trade deficits that increased in magnitude in the 1960s. Another additional factors which played a role in the 1966 devaluation was India's war with Pakistan in late 1965. The US and other countries friendly towards Pakistan, withdrew foreign aid to India, which further necessitated devaluation. Because of all these reasons, Government of India devalued Rupee by 57.5% against Dollar.

STEPS TAKEN BY GOVERNMENT

A) IMPOSED QUANTITATIVE RESTRICTIONS

The government used the method of QRs with varying levels of severity until the Import-Export Policy of 1985-1988. Periodically, when import prices reached a premium, the government would impose import tariffs in order to absorb the gains accruing to foreign exporters as a result of India's import.

B) PROVIDED EXPORT SUBSIDIES

Government began to subsidize exports in an effort to further narrow its consistent current account.

DEVALUATION OF INDIAN RUPEE IN 1991

In 1991, India still had a fixed exchange rate system, where the rupee was pegged to the value of a basket of currencies of major trading partners. At the end of 1990, the Government of India found itself in serious economic trouble. The government was close to default and its foreign exchange reserves had dried up to the point that India could barely finance three weeks' worth of imports. In July of 1991 the Indian government devalued the rupee by between 18 and 19 percent. The government also changed its trade policy from its highly restrictive form to a system of freely tradable EXIM scrips which allowed exporters to import 30% of the value of their exports.

STEPS TAKEN BY GOVERNMENT

a) ESTABLISHED A DUAL EXCHANGE REGIME

In march 1992 the government decided to establish a dual exchange rate regime and abolish the EXIM scrip system. Under this regime, the government allowed importers to pay for some exports with foreign exchange valued at free market rates and other imports could be purchased with foreign exchange purchased at a government mandated rate.

b) FOLLOWED A FLOATING EXCHANGE RATE SYSTEM

In March 1993 the government then unified the exchange rate and allowed, for the first time, the rupee to float. From 1993 onward, India has followed a managed floating exchange rate system. Under the current managed floating system, the exchange rate is determined ostensibly by market forces, but RBI plays a significant role in determining the exchange rate by selecting a target rate and buying and selling foreign currency in order to meet the target.

IMPACT OF DEVALUATION ON CURRENCY

Inflation rates in India have risen about 8.50% amid concerns surrounding the devaluation of the rupee and the erosion of the purchasing power of savings. Inspite of Governmental interventions, the rupee is in a free-fall, having slipped by over 20%, making it one of the most awful performing currency globally. RBI made thirteen rate increases attempts to docile the inflation in last one year but hardly achieved any significant result. Inflation rate maintained upwards trend. This is now reflected through the currency depreciation. Inflation directly enhances prices and thereby affects the purchasing power of currency. Currency value and inflation have a direct correlation and impact each other. The currency re-valuation is also essential with the change in domestic prices affected by inflationary forces. Currency is considered to be over valued if the suitable adjustment is not made with the price index fluctuations.

IMPACT OF DEVALUATION ON GOLD

India currency devaluation has also resulted in surge of import by over 200% of gold and silver. Statistics show that imports of gold and silver to India were $8.96 billion a growth of 222%. The Reserve Bank of India purchased 200 tonnes of gold from the International Monetary Fund in 2009. From the start of 2011, some 30 banks in India have been granted permission to import gold and silver. Further gold purchases are expected in coming months, as the Reserve Bank has issued licenses to seven more banks to import gold and silver. Indian banks are therefore contributing to the massive increase in demand for gold and silver. Chinese banks are also catering to the increased demand of Chinese people for gold bullion for investment and savings purposes. In fact, most of the world's central banks are now diversifying from major currencies such as the dollar and euro into gold. In addition to India and China, these countries include Russia, Sri Lanka, Bangladesh, Mauritius, Mexico, Iran and Saudi Arabia. Financial experts believe, the increased demand for gold and silver from India and wider Asia is sustainable and that it will keep the precious metal market thriving.

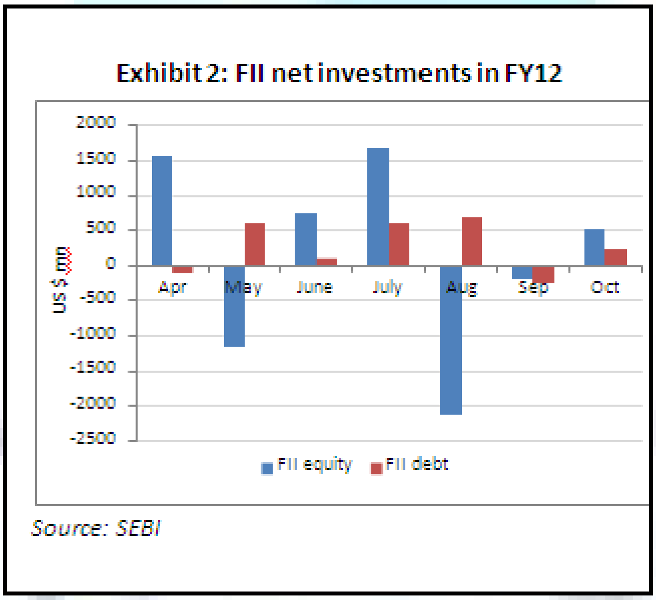
IMPACT OF DEVALUATION ON STOCK MARKET

As a result of devaluation, Indian stock markets will face new threats. The operators and participants were earlier concerned about domestic inflation rate and the Reserve Bank of India's economic policies. But the fall in the value of Indian currency has taken aback all concerned. The investors are bound to suffer as there is always a positive correlation between stock index and corporate results.

CAUSES OF DEVALUATION OF THE INDIAN RUPEE

1. WITHDRAWAL BY FII'S

The main driver of rupee depreciation in the last three months has been the withdrawal of funds by foreign institutional investors (FIIs) from domestic economy. The rather pessimistic view of FIIs is being governed by global developments. FIIs have registered a net sales position of US $ 1,581 million, between August and November so far.



The ongoing Euro-zone debt crisis seems to be intensifying and rescue packages have been of limited assistance in truly resolving the crisis. While the risk of sovereign default by individual Euro states is a concern, the risk of an impending contagion is also significant. It is estimated that the IMF has about $400 billion available to provide funding to the Euro-zone, but Italy alone has to refinance $350 billion worth of debt in the next six months. The support by the IMF thus is a just fraction of the cumulative financing requirement to resolve this debt crisis. Changes in political leaders and finance ministers of these states, debates on the role and mandate of the European Central Bank (ECB) and European Financial Stability Facility (EFSF) and quantum of financial support to be provided by member states remain some points of indecision.

The scenario in the US does not provide an upbeat picture either. Delays in policy formulation on the setting of debt ceiling for the state have reflected some lacunae in management of government finances. While housing starts, industrial production and consumer spending are gradually showing signs of improvement, the rate of unemployment remains uncomfortably high. Growth estimates for the US have been revised downwards to 2.0% in Q3 from the earlier estimate of 2.5%.

The real estate problem, weakening local government finances, lack of transparency in operations and systems of the government and deterioration the assets of the banking system observed in the Chinese economy are further drags to the global macro-economic outlook for the coming months.

Domestic macro-economic prospects as well are weighed by high inflation and sagging industrial production, which have led to downward revision of growth estimates to just 7.6% for FY12.

Consequently, FIIs have withdrawn funds from emerging markets and invested back in the dollar which has been strengthening. In November (so far) itself, FIIs have registered a net sales position to the tune of US $ 87 million.

2. STRENGTHENING OF DOLLAR

As these downbeat forces have played strong over the last few months, investor risk-appetite has contracted, thereby increasing the demand for safe haven such as US treasury, gold and the greenback. The Euro has depreciated 6.55% against the dollar in the last three months which has in turn made the dollar stronger vis-à-vis other currencies, including the rupee. With winter, the demand for oil and consequently dollar is only expected to move further upwards. Domestic oil importers have also contributed to this strengthening to meet higher oil import bills.

3. WIDENING CURRENT ACCOUNT DEFICIT

The current account balance is composed of trade balance and net earnings from invisibles. While earnings from invisibles have been quite robust this year (growth of 17% y-o-y), the trade account has deteriorated on unfavourable terms of trade. Current account deficit (CAD), in Q1 FY12 had widened by Rs 40,000 crore, over Q4 FY11. Furthermore on a quarterly basis, even invisibles earnings have registered some decline. With contribution of exporters remaining on the sidelines and earnings from invisibles continuing to decline, a further widening of the CAD would result in outflow of dollars from the Indian economy accentuating the depreciation in rupee. In particular software receipts would be under pressure given the global slowdown.

4. DECLINE IN OTHER CAPITAL FLOWS

Foreign Direct Investments (FDI), External Commercial Borrowings (ECBs) and Foreign Currency Convertible Bonds (FCCBs) have maintained robust trends this year, when compared with net inflows in FY11. However, on a month-on- month basis, ECBs and FCCBs have registered slowdown. A prospective decline in these other inflows on the capital account of the balance of payments could cause further depreciation in rupee. While FDI has been increasing it has not been able to make up for lower other capital inflows.

IMPACT OF RUPEE DEPRICIATION

1. HIGHER IMPORT BILLS

A depreciation of the local currency naturally manifests in higher import costs for the domestic economy. Assuming that both imports and exports maintain their current growth rates through the year, higher import costs would widen the trade and current account deficit of the country. We expect current account deficit to settle at 3.0-3.1% of GDP by March 2012- end. Additionally, the domestic economy could be faced with a problem of higher inflation through imports. Commodities prices that are internationally denominated in US dollars would naturally be priced higher on the back of a stronger Dollar. Also, while global base metals prices such as nickel, lead, aluminium, iron and steel would have eased, the depreciating rupee would keep the price of imported commodities elevated.

2. FISCAL SLIPPAGE

The fiscal deficit for FY12 was budgeted at 4.6% of GDP in February, with the price of oil pegged at US $ 100 per barrel. Throughout FY12 so far, however, the price of oil has been well above this reference rate, hovering at an average of US $ 110 over the last three months. Oil subsidy for the year is about Rs 24,000 crore for FY12. This will rise on account of the higher cost of oil being borne by the government. While there have been moves to link some prices of oil-products to the market, there would still tend to be an increase in subsidy on LPG, diesel, kerosene. The government has already enhanced its borrowing programme in H2 FY12 by Rs 52,000 crore, to bridge the fiscal gap.

3. INCREASED BURDEN ON BORROWERS

Higher rates will come in the way of potential borrowers in the ECB market. Today given the interest rate differentials in domestic and global markets, there is an advantage in using the ECB route. With the depreciating rupee, this will make it less attractive. Further, those who have to service their loans will have to bear the higher cost of debt service.

4. IMPACT ON EXPORTS

Usually exports get a boost in case the domestic currency depreciates because exports become cheaper in international markets. However, given sluggish global conditions, only some sectors would tend to gain where our competitiveness will increase such as textiles, leather goods, processed food products and gems and jewellery. In case, imported raw material is used in these industries they would be adversely affected. Therefore, exports may not be able to leverage fully.

CONCLUSION

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.

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