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Rolling Rupee : An Economic Saga

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Introduction

Before 2011, the rupee was hovering around the 44-46 band, but over the past one year there has been a continuous depreciation in its value. An approximate 18 % depreciation occurred in three months of time span. From 44-46 per Dollar ($) for almost 20 months, Indian rupee depreciated sharply to 51.8 by December 2011. The experts believe that there will be further depreciation in its value. This rupee depreciation combined with negative industrial productivity, rising inflation (in real terms) have created enough headache for the policy makers. Persistent inflation, high interest rates, low domestic business confidence, rising government and trade deficit and gloomy international economic outlook are turning out to be the biggest challenges for present government.

The present situation is the outcome of global turbulence which has created a condition of uncertainty in domestic market. Current global development has not been favorable for India. The debt crisis in Euro zone has led to flight of US $ from Indian market which has affected stock market adversely. In fact, all Asian markets are into trouble but the worst effected seems to be the Indian stock market. According to Morgan Stanley Barren data, Indian market performed worst with -14.18% downfalls as compared to other Asian markets like Brazil (-5.93%), China(-3.96%), Indonesia(10.27%), South Korea(8.07%), Malaysia(4.42%) and Russia(2.58%). These markets have performed better than India. India who was one of the best performers on the global equity front in 2010 is proving to be the worst Asian performer in 2011.This kind of situation has in fact bolstered the negative sentiments against Indian economy which can be bad for the economy in the long time period. Among all other Asian currencies the rupee has emerged as the most vulnerable currency. While other Asian currencies have depreciated in single digit (except Chinese Yuan), the rupee depreciated approximately 18% in 2011.

On the domestic front also several problems are cropping up. GDP growth has dropped to 6.9% in September 2011 which is the slowest GDP reported in past two years. Thisachieved GDP growth in 2011-12 is a sharp downturn from 7.8% of earlier forecast in the beginning of the year.

Depreciation Vis A Vis Devaluation

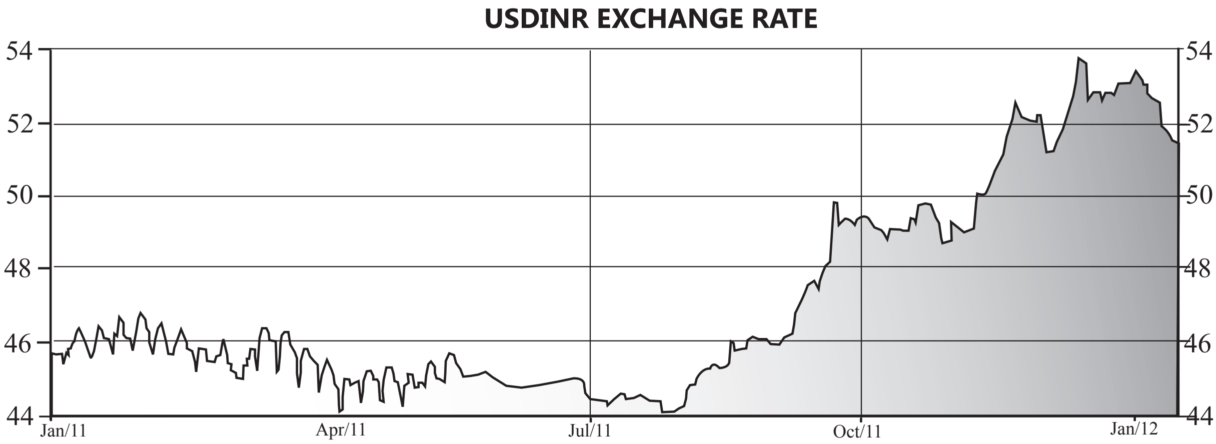
In everyday use, devaluation and depreciation are often used interchangeably while, there is a distinct different between these two. The effects of these two things are similar but the factors behind them are entirely different.

Currency devaluation is a deliberate downward adjustment in the official exchange ratesestablished, or pegged, by a government against a specified standard, such as another currency or gold.Thus it's an active decision of a government to reduce the value of its own currency against other currencies.Governments devalue their own currencies to make either their exports more attractive in foreign market or to discourage import, thus helping to reverse the balance of payments deficit.

While depreciation is purely according to the market forces i.e. supply and demand side factors of currency in which government has no role to play. Depreciation is market driven process in which there is no government intervention. It's decrease in value of currency with respect to other currencies.As more and more of dollar flows out of India, dollar demand exceeds its supply resulting in rupee depreciation and dollar appreciation. At the same time it also leads to rising prices of imported commodities. This market driven system is known as 'Free Floating Exchange Rate' regime where market demand and supply of local and foreign currencies governs the value of currency. Thus according to the availability or shortage of currency in market it either depreciate or appreciate.While depreciation is reduction in value of currency, it can be advantageous as it makes exports in the depreciated currency less expensive and can be used for capturing more market overseas. Since in the present situation the exchange rates moves in accordance to the market we mostly get across with the situation of depreciation only. In day to day use, we mostly refer to depreciation and devaluation as the same, but technically there exists a great deal of differences between them.

Current Rupee Tumble

As discussed earlier, the rupee has depreciated from 44-46 band to 50 plus per dollar across three four months of time span. The graph given below also explains the same situation where between July 2011 to December 2011 rupee band has widened from 44 rupees to as high as 53 rupee per dollar level.Various internal and external factors seems to be responsible for this .Though there is the turbulence in the global financial markets but the strange sight of funds gravitating to the dollar despite the troubles in the U.S. economy is creating a very mysterious picture for the international investors. The current wave seems to be favoring the American economy while the tide is surely against India.



Not only Spot market rates are rising there is a hike in Forward rates also. Even the forward rate for the rupee-dollar exchange rate for December is as high as 50 paise which is forcing the importers to hedge their position fearing free fall of currency which in turn is making the forward hedge even more expensive proposition. The one month forward premium on the dollar has also registered a substantial jump of 454 bps between August and October (Table1).

Table 1: inter-back forward premium on dollar (%)

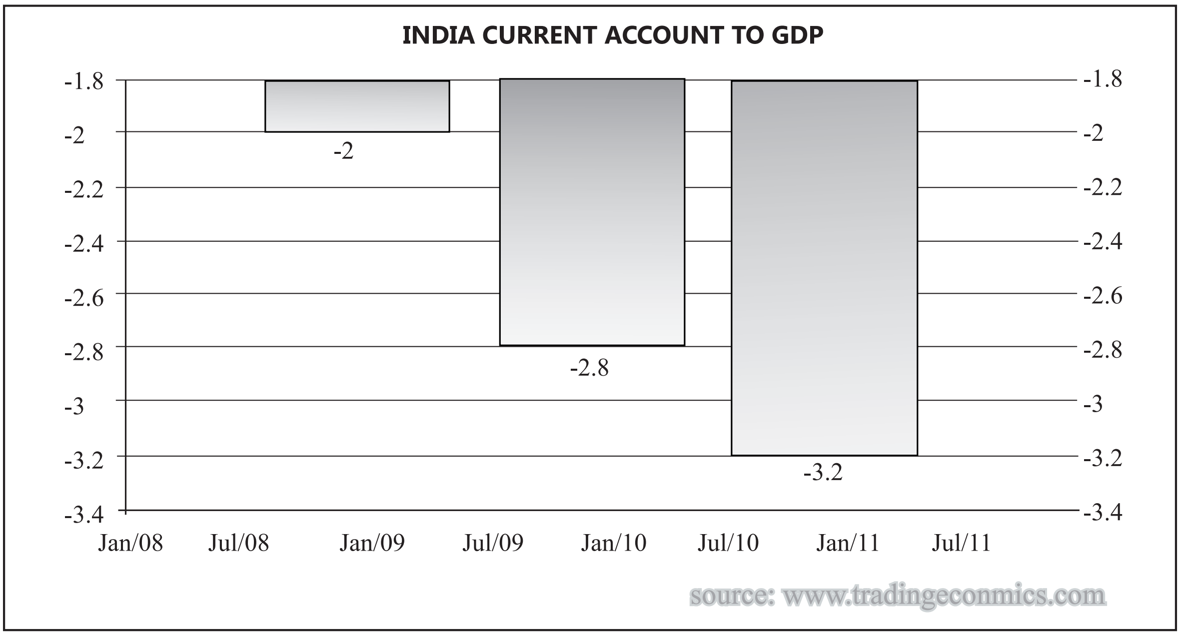
Month	1-month	3-month	6-month
august	2.09	2.91	2.89
september	5.64	5.15	3.70
october	6.63	5.73	4.75

Source:RBI

Impact Of Rupee Fluctuations On Indian Economy

1. Balance Of Trade

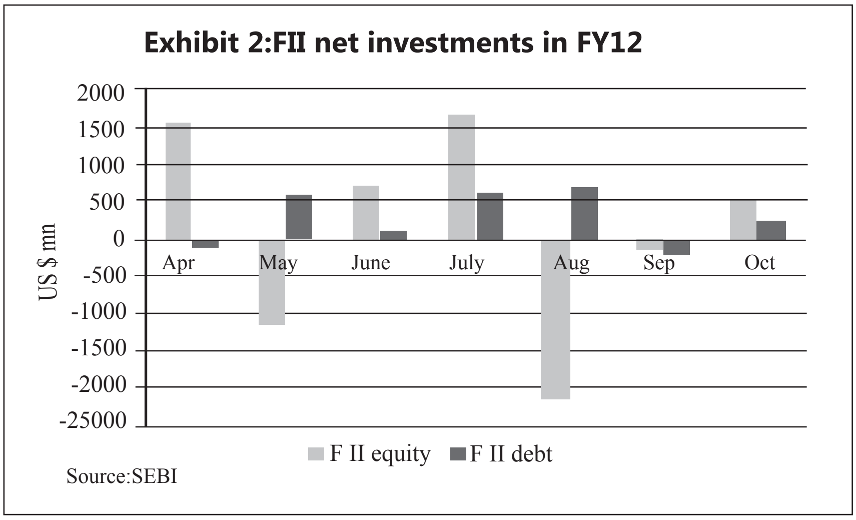
As a consequence of rupee depreciation import payments are continuously growing while export receipts are sliding down not only because of weak rupee but also due to lame global demand particularly from the euro zone. Thus sectors like petroleum and petroleum products, drugs and pharmaceuticals and engineering goods which have import inputs of as much as 77 percent, 19 percent and 21 percent, respectively – are suffering most due to rupee depreciation. They would have to pay more for the imported raw materials which would decrease their profit margins. At the same time Rupee depreciation makes Indian goods and services cheaper for overseas buyers, thus leading to increases in demand and higher revenue generation.So, it is good news for industries such as IT, textiles, hotels and tourism which generate income mainly from exporting their products or services.Rupee depreciation is generally bad for industries which rely mostly on imported inputs while depreciation of the rupee is welcome news for industries which are exporting a majority of their products and services. Thus Indian IT industry which is a major contributor to current account under invisible export relies mostly onforeign clients, especially the United States, for more than 70 percent of its revenue can benefit greatly with current currency fluctuations.While earnings from invisibles have been quite robust this year (growth of 17% y-o-y), the trade account has deteriorated on unfavorable terms of trade (import more than export).The trade deficit has widened to $43.9 billion as compared to $37 billion during corresponding quarter last year, the RBI said[1]. Widening of this current account deficit could put even more pressure on Rupee.



As given in the graph also, there has been an alarming rise in current account deficit in Indian GDP.The Current Account in India was last reported at -3.2 percent of GDP. From 1980 until 2010, India's average Current Account as percent of GDP was -1.24 percent reaching an historical high of 1.50 percent in December of 2003 and a record low of -3.20 percent in January of 2011[2]. But since, traditionally India has been a current account deficit economy it is not a very big concern. Major concern comes from declining capital inflows.

2. Declining Capital Inflows

Foreign Institutional investments between January to June 2011 were 14,329 crore which was nearly half of 30,915 crore of year ago during 2010. Foreign Direct Investments also declined by 28% in 2010-11 to a four year low of 27.0 billion $ as against 37.76 billion $ in 2009-10.This escalates the problem for Indian stock market even more. In 2011, FIIs withdrew around Rs 3,800 crore from share market. In the recent episode of depreciation, a sharp fall in capital inflows led to adrying up of supply, while demand on account of the current account deficit continued unabated, leading tothe outcome we saw[3]. A country like India which mostly has deficit in their current account survives on surplus in their capital account. So in present situation when capital inflows are dwindling, current account drives the exchange rate and put further pressure on currency.



3. Inflation

India being net importer country and crude being the primary item of import will see a rising cost of crude oil due to depreciating rupee. Inflation which has been haunting Indians for past 2 years will rise even if the price of crude falls in international markets. Hence inflation will be the key risk due to deprecation of rupee. As India imports around 70% of its crude oil requirements government now has to bear more burden of rising oil import bill. Since oil is subsidized by the government, higher import bills will lead to rise in fiscal deficit for the government and will push the inflation.

The deputy governor of Reserve Bank of India, SubirGokaran said that the rupee depreciation is moving as per market dynamics and the fall in the value of the rupee will particularly impact India's energy import bill. Mr.Gokaran said that any action taken by the RBI to arrest the fall of the rupee might have consequences in the near future. He said that the immediate impact of the fall in the value of the rupee will be on the inflation rate which has been hovering near the double - digit mark for several months. Indian corporate sector which import raw materials from abroad will also be hit hard as they have to pay more for imports and they may have to reconsider the prices of their goods and services.

The rupee's depreciation is set to hit infrastructure sector projects also which are greatly dependent on international market borrowings and imported equipment in a big way. Experts apprehend that the over 18 per cent slide in the rupee since August would raise the cost of infrastructure projects substantially.Thus depreciating rupee may compound the macroeconomic problems as prices of imported goods will surge which worsen the current account deficit. India won't be able to take advantage even if commodity prices ease due to global slowdown.

Outlook And Policy Measures

With all the analysis so far we have seen that Indian rupee has passed through several stages where external and internal factors in combination use to affect its value. Considering the situation of Indian economy presently we wonder whether this depreciation is obvious and natural in relation to the domestic situation or just is flowing along with the wave. On the superficial level it seems to affect only import, export, foreign capital inflows etc. but the biggest threat is hidden behind these factors in the form of alarming rise in India's external debt. India's overall external debt outstanding as of June-2011 was $317 billion, an increase of 38 per cent in last two years. The short-term external debt increased at a much faster pace of 62 per cent (in absolute terms) during the same period and it now constitutes about 21.6 per cent of total external debt.[2]The biggest problem is that most of this external debt (43%) is maturing within one year of time. The present depreciated rupee can be hazardous for Indian economy.

With the depreciating rupee Indian export of services should get greatly benefitted. But even Indian services export shows sluggish growth. So the dependency on invisible earnings neutralizing trade deficit is also not happening. The present situation needs to be carefully observed and analyzed and swift actions are needed to avoid serious repercussions on the economy. On one hand, RBI is trying hard to control inflation by various monetary tools; depreciation is proving to be another challenge for them. Though official foreign reserve kitty looks sufficient, but in reality, the actual foreign currency reserves with RBI are not sufficient enough so that it can intervene in market and rectify the situation. In future also India should learn to deal with currency fluctuations on its own rather than relying on central bank to intervene and control the situation.

For this purpose government needs to magnify its policies to boost and encourage exports which actually are the real earning of economy. Inviting and attracting more foreign investment is another way to correct the situation but any kind of foreign money involves its own repercussions for the economy in the long run. Now I believe the time has come when we need to accept that turbulences in global economy will persist and as an economy we should develop ourselves in such a way so that there is least effect of these disturbances on India. Since any stable source of capital inflow is missing, the rupee seems to remain highly fluctuating currency in coming time.

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