Depreciaiton Of Indian Currency And Growth Rate In Indian Economy

Dr.G.K. NAGARAJU
Assistant Professor of Economics
Government First Grade College, Tumkur

ABSTRACT

Depreciation refers to a fall in the value of the domestic currency which is caused by the demand for foreign currency exceeding its supply in the market. In such a situation one has to pay more than before to get units of foreign currency. This fall takes place in the market and on its own. Market determined exchange rate serves the purpose of aligning the domestic economy with the world economy was the price route. As consequences the domestic price gets linked up with those of the world price. With the liberalizations and globalization of the economy in recent years, imports are bound to increase. The lessening of restrictions on imports and lowering of tariff on imports which the economic reform implies, an increase in imports has in fact taken place. Again with trade is having become an important element of the new strategy of growth. India being a developing economy with high inflation, depreciation of the currency is quite natural. Depreciation of rupee is good, so long as it is not volatile. A random depreciation that we have seen in the last few months is bad and it has hurt the economy. Right from the beginning of year 2013, the value of rupee has been depreciating.

INTRODUCTION

Since its Independence in 1947, India has faced two major financial crises and two consequent devaluations of the rupee. These crises were in 1966 and 1991with similar causes. As a developing economy, it is to be expected that India would import more than it exports. Despite
government attempts to obtain a positive trade balance, India has had consistent balance of payments deficits since the 1950s. The 1966 devaluation was the result of the first major financial crisis the government faced. As in 1991, there was significant downward pressure on the value of the rupee from the international market and India was faced with depleting foreign reserves that necessitated devaluation. There is a general agreement among economists that by 1966, 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.

1991 is often cited as the year of economic reform in India. Surely, the government's economic policies changed drastically in that year, but the 1991 liberalization was an extension of earlier, albeit slower, reform efforts that had begun in the 1970s when India relaxed restrictions on imported capital goods as part of its industrialization plan. Then the Import-Export Policy of 1985-1988 replaced import quotas with tariffs. This represented a major overhaul of Indian trade policy as previously, India's trade barriers mostly took the form of quantitative restrictions. After 1991, the Government of India further reduced trade barriers by lowering tariffs on imports.

Clearly, there are many similarities between the devaluation of 1966 and 1991. Both were preceded by large fiscal and current account deficits and by dwindling international confidence in India's economy. Inflation caused by expansionary monetary and fiscal policy depressed exports and led to consistent trade deficits. In each case, there was a large adverse shock to the economy that precipitated, but did not directly cause, the financial crisis. Additionally, from Independence until 1991, the policy of the Indian government was to follow the Soviet model of foreign trade by viewing exports as a necessary evil whose sole purpose was to earn foreign currency with which to purchase goods from abroad that could not be produced at home. As a result, there were inadequate incentives to export and the Indian economy missed out on the gains from comparative advantage. 1991 represented a fundamental paradigm shift in Indian economic policy and the government moved toward a freer trade stance.

CAUSES

1. Demand Supply Rule: The value of rupee follows the simple demand and supply rule of economics. If the demand for the dollar in India is more than its supply, dollar appreciates and rupee depreciates. Similarly, when the supply of dollars in India increases its demand, the value of dollar decreases in terms of rupees.

2. Dollar gaining strength against the other currencies: The central banks of Eurozone and Japan are printing excessive money due to which their currency is devalued. Hence, making the US dollar stronger against the other currencies including the Indian rupee, at least in the short term.

3. Oil prices: Oil price is one of the most important factors that put stress on the Indian Rupee. India has to import a bulk of its oil requirements to satisfy local demand, which is rising year-on-year. In International markets, prices of oil are quoted in dollars. Therefore, as the domestic demand for oil increases or the price of oil increases in the international market, the demand for dollars also increases to pay our suppliers from whom we import oil. This, increase in demand for dollar weakens the rupee further.

4. As per the data reported, FIIs (Foreign Institutional investors) are showing some disinterest in Indian markets lately. Sluggish economy and recovery in stock markets of developed economies like US and Japan are believed to be the key reasons. Since FIIs inflows have played important role in keeping rupee at current levels, an intense selling activity by them does not augur well for the near term direction of the rupee.

5. Consistently high inflation has resulted into Indian goods becoming expensive in the global markets, thus making it less competitive, especially when compared to goods from China. Thus, rupee may have hardly any support by way of higher exports. Lastly, gold imports, another key reason why the deficit is high and rupee under pressure, may not slow down in a hurry.

EFFECTS OF DEPRECIATION

One of the more obvious reasons why the current depreciation is not to be welcomed is the effect on domestic living standards. There are several ways in which the falling rupee immediately has an inflationary impact, one of the most important of which is the price of energy. Since the misguided decontrol of oil prices, it is not only the globally traded price of fuel but also the exchange rate that determines domestic oil prices. Both durable consumer goods such as automobiles, white goods and electronic items and non-durable goods such as soaps and toiletries are all likely to become more expensive. And, of course, food inflation-the most worrying aspect of recent price movements-is likely to go up as a well.

1. Advantage to Exporters: Weakening of rupee gives up a huge advantage to the exporters. While exporting products, if the rupee devaluates, the exporter gets more money.

2. Boom to tourism industry: Travel and tourism is a sector which will benefit from the depreciation of the rupee. If a tourist comes to India and the rupee devaluates then it would become cheaper for him.

3. Imports become extremely expensive: A depreciating rupee would mean that the importers would have to pay more for their imports. So, this means that price of the goods or commodity which is being imported to India increases substantially.

4. Reduction in Purchasing Power Parity: One of the outcomes of a depreciating rupee will be the rise in inflation in the economy. When the inflation rises, prices of goods and commodities shoots up. Therefore, the purchasing power of the rupee falls down.

At the end of the nineteenth century, Oscar Wilde in his famous play The Importance of being Earnest had talked of the precipitous fall in the value of the Indian rupee. Well over a century later alas, the Indian rupee is still falling, its latest fall as precipitous as any in Oscar Wilde's time. On July 12, 2011, the exchange rate was 44 rupees to a US dollar; by end-June 2013, it has plummeted to 60 rupees per US dollar, a 27 percent decline in two years.

The Government has attributed this decline to the fact that Ben Bernanke, the Chairman of the U.S. Federal Reserve Board, announced on May 22nd that an end was in sight to the Fed's policy of quantitative easing-i.e. the policy of keeping down US interest rates by injecting liquidity into the system. Bernanke's announcement made speculators shift funds to the U.S. where the interest rates are expected to rise, and this has reduced the value of all other currencies, including the Indian rupee (and even of gold), vis-a-vis the US dollar. The Government therefore claims that what is happening to the rupee is happening to other currencies as well, so that there is nothing specifically to worry about. Sooner or later the "markets" will settle down.

The Finance Ministry has argued that this sharp decline in the rupee is "no reason to panic". Its representatives have suggested that this is happening because most currencies have depreciated relative to the U.S. dollar ever since Ben Bernanke, the head of the United States Federal Reserve, indicated a possible decline in the monetary policy of "quantitative easing" that had encouraged capital to move away from the U.S. in search of higher returns in other currency assets. But this is simply not true. First of all, the rupee had declined even when the U.S. monetary policy was at its most lax and when countries such as Brazil had complained about the currency wars generated by the U.S. quantitative easing.

Further, recent trends indicate a significant worsening of both trade and current accounts. Both exports and imports actually declined in 2012-13 compared with the previous year, but even so the trade deficit still increased by nearly 4 per cent, or more than $7 billion. In April 2013, exports were 2 per cent higher than in April 2012—but imports were 11 per cent higher and non-oil imports were 15 per cent more. So the trade deficit increased by more than 26 per cent in April 2013 compared with the previous year (Finance Ministry, Monthly Economic Report April 2013).

There are several ways in which the falling rupee immediately has an inflationary impact, one of the most important of which is the price of energy. Since the misguided decontrol of oil prices, it is not only the globally traded price of fuel but also the exchange rate that determines domestic oil prices. What is more, the increasing costs of imports can also affect exports, thereby wiping out any global cost advantage accruing from the devaluation. For example, important export sectors such as gems and jewellery, automobiles, machinery and chemicals are all very import-dependent, and their rising costs could nullify the impact of the devaluation on their ability to sell more cheaply in export markets. This is made worse by the fact that in the current depressed global trade context, buyers are able to renegotiate contracts once the exchange rate has changed.

Indeed, many global buyers even in sectors such as garments and leather goods now insist on contracts and invoicing in rupee terms. This allows them to benefit completely from rupee depreciation, while the local producers are forced to bear the rising domestic costs. This means that the falling rupee need not generate any significant increase in exports as may be hoped.

The rupee cannot be allowed to depreciate continuously as it is doing now. Every such depreciation increases the costs of imports, especially of oil, which, under the current regime of automatic-pass-through to the ultimate consumers, entails an inflationary burden on the people. In fact this burden is implicitly assumed by the government when it expresses the belief that the markets will ultimately “stabilize”. In economists’ jargon this burden is one of the “stabilizing” or “equilibrating” factors.

To see this imagine a simple world which produces one single commodity using an imported current input (oil), and labour, applied to capital stock. The price of the product, as is usual in oligopolistic markets, is a mark-up over the sum of the current input cost and the labour cost per unit of output. Now suppose the current input cost rises by 10 percent because of currency depreciation, then, with a given mark-up, if real wages remain unchanged, then the price level will also rise by 10 percent. The nominal depreciation of currency by 10 percent, accompanied by a price rise of 10 percent, will mean that the real effective exchange rate remains unchanged, i.e. the economy gets back to square one, where the same factors that had caused the initial depreciation would cause a further depreciation; and so on ad infinitum. It is only because real wages are not expected to remain unchanged that anyone would at all believe that some new “equilibrium” will be reached where the economy will settle down.

HOW TO CONTROL THIS SITUATION

1. Government should increase the limit of FDI in the existing sectors
2. Government should create a stable political and economic environment in order to make India an attractive destination for foreign investments.
3. Government should develop import- substituting industries in order to make India less dependent on imports.
4. RBI should sell Forex reserves and buy rupees in an immediate action in order to arrest the further decline in the value of rupees.

CONCULUSION

The rupee's decline affects everyone in the economy because it feeds directly and indirectly into general inflation, which is a continuing problem even as output growth decelerates, and therefore hits common people hard. There are several ways in which the falling rupee immediately has an inflationary impact, one of the most important of which is the price of energy. Since the misguided decontrol of oil prices, it is not only the globally traded price of fuel but also the exchange rate that determines domestic oil prices. Going by the way the economies in the euro zone and the US have been behaving, it would be naïve to expect that the export earnings would be contributing significantly to foreign exchange inflows in the near future. The govt should concentrate on correcting the economic fundamentals rather than indulge in soap operas in a run up to the election. A better co-ordination with RBI is required rather than blame game. Apart from all the political parties should come together in fixing the problem and getting back the investors' confidence.

REFERENCE

- Finance Ministry, Monthly Economic Report
- Government of India, Economic Survey, Various Issues
- Government of India , Foreign Trade Statistics of India, Various Issues
- Roy, Surbroto and William E James (ed), 1992, Foundations of India's Political Economy, Sage Publications, New Delhi
- Uma Kapila (ed) 2001, Indian Economy Since Independence, Academic Foundation, Delhi