Depreciation of the Rupee

Sankhanath Bandyopadhyay*

Introduction

The rise and fall of the value of a currency vis-à-vis other currencies is a normal development in an interconnected global economy. However, it can become a matter of concern beyond a point, because a section of people in the country gets affected when the value of its currency either rises or appreciates too much (e.g. exporters are worse off as their products become more expensive in the global market leading to a fall in demand for the same, but importers are better off as importable become cheaper in foreign currency terms) or it declines or depreciates too much (e.g. exporters face internationally lower prices for their exportable as their currency gets cheaper and importers face higher prices of importable as foreign currencies get dearer).

The depreciation of the Indian National Rupee has been witnessed since quite some time now. A conventional argument is that this automatically corrects the situation by depressing imports (fall in import demand due to rise in cost of imports) and augmenting exports (rise in export demand in rest of the world due to falling export prices), through which the domestic currency reaches its ‘equilibrium’ value. However, this may not happen due to a number of complex factors, and, even if such correction happens over some time, the country may face a number of problems in the meanwhile.

Why has the Rupee declined so much?

Reserve Bank of India (RBI) data reveal that, during 2007-2008, the rupee was hovering around Rs. 39 - 40 per US dollar (USD). Since April 2008, the rupee started declining against dollar, but fluctuated between Rs. 44 - 53 vis-à-vis the USD. Since early May 2013, there has been a considerable fall in its value leading to a historic low of Rs. 60 per USD by the end of June 2013.

For a long time, and especially after the 2008 global financial crisis, the United States (US) had maintained ample liquidity (in terms of USD) in the global market by following an easy money policy and keeping the interest rate low. This had motivated financial investors to borrow cheap in the dollar markets and invest in emerging markets (where returns are higher), making substantial profits arising out of the difference between the higher return on investment and lower repayment cost of their borrowed funds.

During this phase of easy money policy by the US, the situation was opposite to today’s scenario – foreign portfolio investments brought a surge of capital inflow in India, and, the RBI was struggling to stabilize the rupee from appreciating too much by buying US dollars. The popular consensus is that the US Federal Reserve Chairman Ben Bernanke’s announcement of a
gradual phasing-out of its easy money policy (or the end of the “quantitative easing” or QE policy) triggered financial investors to pull-out their assets (or financial investments) from emerging countries (including India), which led to a drastic decline of the rupee vis-à-vis the US dollar. A tightening of money supply by the US would raise the US interest rates, making dollar-denominated assets more attractive compared to the rupee-denominated assets. According to Felix Huefner, Deputy Director of the Institute of International Finance (the Global Association of Financial Institutions, with its headquarters in Washington DC), “In its early phase, quantitative easing (QE) has meant a weaker dollar and additional capital flows to emerging market (EM) economies. Now that markets focus on the end of QE, the pendulum has swung to the opposite direction.”

However, although the US Federal Reserve System’s phasing-out of easy money policy may have been an important factor aggravating the rupee’s decline, the gradual fall of the rupee had started much earlier due to some India-specific factors, e.g. India’s growing current account deficit (CAD), inflationary pressures, slower pace of economic growth and downgrading by some of the international credit rating agencies. In other words, though the returns on Indian assets have apparently been good, some of the potential risk-factors had started prompting investors (especially the risk-averse ones) to switch away from the rupee to other currencies. Moreover, for the last couple of years, the rupee has declined not only against the US dollar, but also against other currencies like pound, euro and yen. Such erosion in the value of rupee vis-à-vis other currencies has led investors to hold their assets in other currencies instead of rupee, aggravating further the fall in rupee value against other currencies.

What is the impact on Indian economy?

As the rupee declines continuously, the costs of imports go up. The rising costs of imports can have a dampening effect upon luxurious consumer importable, like, gold, jewellery and precious metals, which is good for the economy (in terms of reducing the country’s current account deficit). However, since many of the industries in India, like, automobiles, machinery, chemicals, and major food processing industries, are heavily import-dependent, the rising costs of imports for them may undermine their export-competitiveness. Moreover, as the cost of fuel passes in all other prices directly in production costs as an intermediate input, a rise in the cost of fuel imports is inflationary. On the other hand, some sectors, like, Information Technology (IT) & IT Enabled Services, textiles, and pharmaceuticals are expected to benefit due to their large export exposure in the international market.

What steps has the RBI taken to check the depreciation of rupee?

The rupee has declined because the demand for US dollar and other foreign currencies have gone up substantially relative to rupee. In a demand-supply framework, this means there is an
excess supply of the rupee as compared to the demand for it. Hence, to restore the value of the rupee, it should be made scare in supply. Foreign Institutional Investors (FIIs) and speculators invest abroad in dollar-denominated securities via borrowing rupee to take advantage of the arbitrage opportunities. Hence, the RBI increased borrowing costs of banks so as to limit their capacity to lend to such FIIs and speculative investors. The RBI did this by increasing Marginal Standing Facility Rate or MSF (an ultra short-term borrowing scheme for scheduled commercial banks, introduced by RBI in May 2011), limiting the borrowing amount under the liquidity adjustment facility (LAF) by banks, and raising the Cash Reserve Ratio (CRR) etc.

The way forward

The fundamental India-specific reason for the depreciation of the rupee over the last few years has been the country’s growing current account deficit (CAD). As imports have increased substantially compared to exports, the demand for foreign currencies (especially the US dollar) has increased substantially relative to the rupee leading to a fall in the value of rupee. The Indian economy has continued to face the problem of a growing current account deficit, which has been financed for long mainly through Foreign Institutional Investments (FIIs). These Foreign Institutional Investments (FIIs) are a highly volatile and unpredictable source of funding, which depend upon the risk-return perceptions of such FIIs for a country. It is not surprising that a reversing trend of such inflows is now exposing the vulnerabilities of capital inflows for India. Taking lessons from this experience, India should try to diversify its export market by engaging more with emerging market economies (EMEs), take proactive policies to augment greenfield Foreign Direct Investment (FDI) inflows, and curtail its unproductive luxurious imports (e.g. gold).

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* The author is with Centre for Budget and Governance Accountability (CBGA), a New Delhi based policy research organization. He can be contacted at sankhanath@cbgaindia.org. To know more about CBGA’s work, please visit www.cbgaindia.org