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## Indian Rupee vs. Dollar: A Deep Insight

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### **Abstract:**

*Persistent weakness in the rupee and increasing volatility has reduced the benefits of borrowing overseas. Over the past one year, the rupee has consistently depreciated against the dollar. Since January 2013, the rupee has lost more than 20 % of its value, making it the worst performing currencies in Asia. The depreciating rupee will add further pressure on the overall domestic inflation and since India is structurally an import intensive country, as reflected in the high and persistent current account deficits month after month, the domestic costs will rise on account of rupee depreciation. This paper reviews the likely reasons for this depreciation of the rupee. It also reflects on the policy options to help prevent the depreciation of the Rupee.*

**Key words:** Financial Crisis, Rupee Depreciation, Rupee Devaluation, Indian Economy, Exchange Rate, Current Account Deficit

### **1. Introduction**

Presently Rupee is under volatile trend, caused by sudden changes in demand and supply forces in forex markets. In a very short span rupee has depreciated more than 20%. US Dollar (USD) to Indian Rupee (INR) exchange rate reached highest in its lifetime 68.85 INR on 28 Aug 2013. A major international event which triggered the steep fall of ₹ against US\$ was the statement of Chairman of US Federal Reserve, Mr. Ben Bernanke expressing tightening of Quantitative easing and restricting supply of US \$ 85 billion per month to boost US economy. International trade and investment decisions have become very difficult due to volatile exchange rate because volatility increases exchange rate risk. If the participants in international trade are aware about exchange rate risks, they may prefer to switch to domestic activities where profits are relatively less uncertain rather than continuing trading in foreign markets.

India is not the only emerging nation experiencing a steep decline in its currency's value. Several emerging market nations are also experiencing sharp depreciation over the prospect of imminent tapering of the US Federal Reserve's policy of quantitative easing (QE) program. The South African Rand and the Brazilian Real touched four-year lows against the US \$ in June 2013. Except the Chinese Yuan and Bangladeshi Taka, most Asian currencies have witnessed sharp depreciation since the beginning of 2013. Nevertheless, the Indian rupee has fared more poor than other emerging nation currencies because of its twin deficits – current account and fiscal deficits.

### **2. Literature Review**

Simon W.L.S. in his study found that both exchange rate and current account balance have direct and positive relationship with inflation. Due, P., Sen, P examined the interactions between the real exchange rate, level of capital flows, volatility of flows, fiscal and monetary policy indicators and the current account surplus for the Indian economy for the period 1993Q2 to 2004Q1. The estimations indicate that the variables are co-integrated.

### **3. Objectives**

- To analyse the current trends and patterns of the movement Indian Rupee versus the dollar in the forex market.
- To analyse what are the long term as well as short term reasons behind recent fall in Rupee-dollar exchange rate.
- To study the implications of rupee downfall on Indian Economy.
- To suggest the measures to combat the current account deficit.

### **4. Methodology of the Study**

The kind of research conducted here is exploratory research. Information was collected from various secondary sources to study the trend of exchange rate and further study the impact of Rupee depreciation on Indian Economy. Statistics published by the Reserve Bank of India, IMF, etc. have also been accessed to justify the above mentioned objectives. Information has been collected with the help of Books, Magazines, Newspapers, Research Articles, RBI Report and CRISIL Report.

### 5. Volatile Life Line of Rupee

- In 1947, post independence one US \$ was equal to one Indian rupee, and there were no foreign borrowings.
- In 1951 Five year plan was introduced and Indian Government started foreign borrowings to finance welfare and development activities. 1 US\$ = • 4.8.
- In 1966, the government announced rupee devaluation to encourage exports and 1 US \$ became equal to • 6.35.
- In 1973 oil crisis broke out, Oil prices quadrupled and Government enacted FERA to curb illegal forex transactions. 1 US \$ = • 7.67.
- In 1975 Exchange value of rupee linked to a basket of selected currencies. Foreign currency (non resident) account scheme introduced to encourage private remittances from abroad. 1 US \$ = • 8.7
- In 1982, export import bank of India got established. 1 US \$ = • 9.1.
- In 1985 domestic production got lowered. Balance of payments situations got worsened Government launched first stirrings of liberalisation through long term fiscal policy. 1 US \$ = • 12.36
- In 1991 rupee was devalued in two stages. India was in the grip of high inflation, low growth and insufficient foreign reserves. There was great Political and economic instability. Foreign exchange reserves were depleting. The government opened up the economy. This was followed by several other reforms liberalizing the economy and exchange rate regime shifted from fixed to flexible exchange rate regime. India mortgaged gold to IMF to come out of a dismal Balance of Payment crisis. 1 US \$= • 22.69.
- Flexible Exchange Rate System was favoured for two reasons. The first argument was related to the competitive position of a country in the global market. For example, if the price level of a country rises, it will make its goods & services uncompetitive in global market and the balance of payments will suffer from a deficit. In order to bring equilibrium in the BOP, the country may use various macroeconomic measures to reduce the price level; this may lead to painful adjustment and may result in welfare losses. Thus it is better, to leave the exchange rate to depreciate to compensate for the rise in price level and to maintain the competitive position of the country without any painful adjustment. The second argument was based on the assumption that the stabilizing behaviour of speculators will make exchange rates relatively stable compared to fixed rate regime. For example, if a currency depreciates from its long run value, speculators would know that the move is only momentary, hence, would buy the currency since it is expected to appreciate in the future. Therefore, they stabilize the exchange rates' actual movements. The flexible exchange rate regime also protects a country from adverse external shocks. Under the Bretton Woods system a decrease in the demand for the exports of a nation would result in domestic contraction in this nation. However, under flexible exchange rate regime the exchange rate would adjust to compensate for the shock, maintaining equilibrium in the current account and competitiveness and consequently the level of demand.
- In 1992 Government sets up SEBI in wake of Harshad Mehta Securities Scam. Rupee was further devalued to boost exports and earn precious dollars. Dual exchange rate system (LERMS) got introduced 1 US \$= • 25.92.
- In 1993 India moves to a market determined exchange rate system after merging the dual rates of transitional liberalised exchange rate system(LERMS) introduced by RBI earlier. Unified exchange rate system came into practice. Rupee was let free to flow with market sentiments, with provision of intervention by central bank under situation of extreme volatility. 1 US \$= • 31.44
- In 1996 import licensing was abolished and tariffs were brought down substantially. 1 US \$= • 35.43.
- In 1997 a series of measures were introduced in response to Asian currency crisis Finance Minister P Chidambaram presented budget bringing down tax rates. 1US \$= • 36.32.
- In 1998 Asian currency crisis hits the world, the rupee sank further. 1 US \$= • 41.27
- In 2000 Foreign Exchange Management Act, 1999 replaces FERA. 1 US \$ = • 44.7
- In 2004 Manmohan Singh became prime minister. 1 US \$= • 45.32.
- In 2006 India's Growth rate hits a record of 9.8% owing to high domestic and global demand. 1 US \$= • 45.31.
- In 2008, Lehman Brothers collapsed. It filed for Bankruptcy protection, recession followed. Rupee gradually depreciated since owing to worst global economic crisis. 1US \$= • 46.1.
- In 2009, UPA Government returns to power 1US \$= • 48.40.
- In 2012, Government announces retrospective taxation of corporate deals spooking investors. Finance Minister P Chidambaram moves plans to push India on the path of fiscal consolidation. 1US \$= • 53.32.
- In 2013, Rupee plunges to a all time low. 1 US \$= • 68.85 on 28<sup>th</sup> Aug 2013. Rupee depreciated due to outflow of foreign exchange, stuck up economic policies, poor infrastructure, high current account deficit, low growth.

Despite a modest recovery in the rupee's value between 4<sup>th</sup> September 2013 and 12 September 2013, the investors remain wary of India's excessive dependence on volatile "hot money" flows to finance its current account deficit.

India's Balance of Payments mostly balanced in 1970s. In fact in second half of 1970s there is a current account surplus. This was a period of import substitution strategy and India followed a closed economy model. In 1980s, current account deficits start to rise culminating into a BoP crisis in 1991. It was in 1991 Indian rupee was devalued twice.

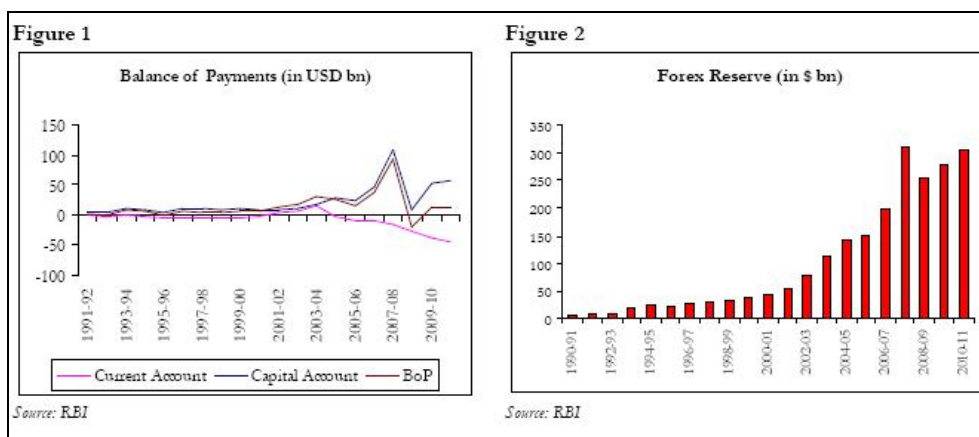


Figure 1

India has always had current account deficit since initial years in 2000s as shown in Figure 1 above. The deficit has been financed by capital flows and capital flows have been higher than current account deficit most of the times resulting in balance of payments surplus. The surplus has in turn led to rise in Forex Reserves from US \$ 5.8 bn in 1990-91 to USD 304.8 bn by 2010-11 as shown in Figure 2. In 1990-91, gold contributed around 60% of forex reserves and forex currency assets were around 38%. This percentage has changed to 1.5% and 90% respectively by 2010-11.

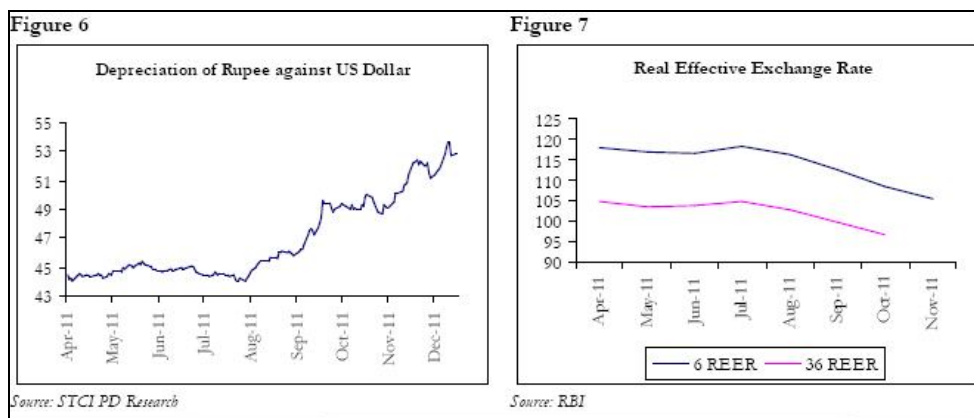


Figure 2

The rupee has depreciated by nearly 20% against USD from Apr-11 to 20-Dec-11. Real effective exchange rate (REER) is based on basket of currencies against which a country trades and and is adjusted for inflation. A rise in index means appreciation of the currency against the basket and a decline indicates depreciation. RBI releases REER for 6 currency and 36 currency trade baskets since 1993-94. In terms of 6 REER (Apr-Nov) and 36 REER (Apr-Oct) Rupee has depreciated by 10.44% and 7.7% respectively.

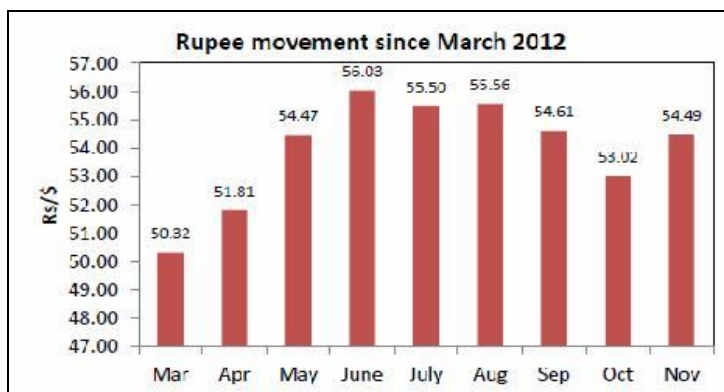


Figure 3

The above figure also shows consistent of rupee since March 2012.

The movement of rupee from January 2013 to January 2014 is shown in following figure:

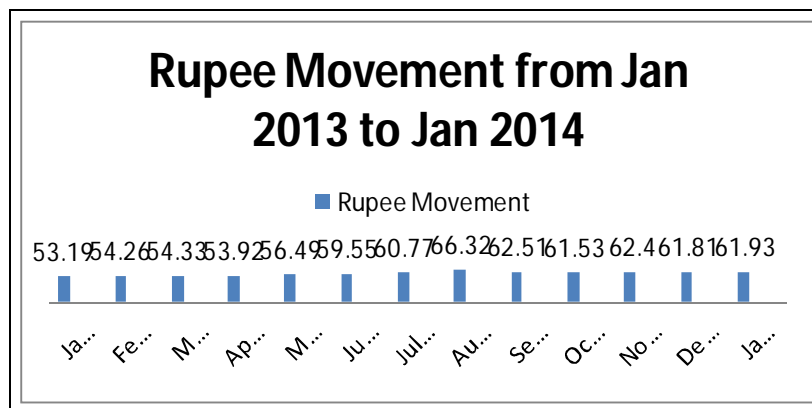


Figure 4

## 6. Causes of Rupee Depreciation

Indian rupee has become has excessive volatile leading to sudden and sharp depreciation of Indian Rupee against US Dollar due to combination of a number of economic factors given below:

- Increase in current account deficit touching to 4.8% GDP.
- Slow down of Exports due to economic recession in Europe and USA. Thus volume of exports has been lowered considerably due to weak demand from traditional markets.
- Increase in imports of oil is further putting pressure on Indian currency since India imports over 80 percent of its oil
- Increase in imports of non productive items like gold have pushed India's trade and current account deficit wider.
- With the beginning of Federal Reserve's aggressive policy of QE, the investors borrowed cheap money in the US and invested in higher yielding assets in India. Indonesia, South Africa and other emerging nations. This resulted in more money flowing into debt, equity and commodity markets in these countries. In India, many corporates resorted to heavy borrowings overseas. The massive capital inflows also enabled India to comfortably finance its deficits. However, this money will quickly leave India and other emerging markets when the tapering of QE program begins. Already, India is witnessing a huge outflow of dollars as investors have started pulling money out of bond and equity markets. The foreign investors pulled out a record Rs.620 bn (\$10 bn) from the Indian debt and equity markets during June-July 2013. If the Federal Reserve decides to taper the QE program, the liquidity withdrawal would continue to put pressure on the rupee over the next one to one and a half year.
- Sudden disinvestment by Foreign Institutional Investors (FII) from Indian equity and debt markets.
- Slow movement in liberalization process
- Weak political sentiments causing negative impact on overall picture of India.
- Other economic problems like high inflation, adverse fiscal deficit due to various subsidy schemes, weak sentiments in capital market, high Consumer Price Index, decline in economic growth, slow industrial growth is accelerating the speed of depreciation of rupee against dollar.
- US dollar is getting strength from revision of credit rating, improvement in long term interest rates, higher crude oil prices. Dollar index has touched a three years high level of 84.30, making it a stronger currency in international forex markets.
- Economic growth in India in the April-June 2013 slipped to 4.4% due to a contraction in manufacturing and mining.
- A sharp rise in domestic food prices has also put a grinding pressure on the rupee.
- Apart from economic factors the rupee remains vulnerable to geo-political tensions in the Middle East and North Africa. As the threat of US-led war against Syria rises, oil prices are expected to rise which will further make it difficult for the Indian government to reduce CAD.

## 7. Impact on Indian Economy

- Volatility of Rupee has adverse effect on profitability, revenues, expenses, costs, imports, increasing burden of foreign currency loans and making our companies uncompetitive in international business.
- The rapid decline in rupee value will increase inflation due to increase in price of oil which will which in turn will adversely affect all related sectors of economy.
- Weakening rupee will also make capital items import expensive, hampering the development of India's industrial sector and will adversely affect manufacturing competitiveness and capacity.
- Depreciation of Rupee is escalating the overall cost for the students planning for higher studies abroad.

- Depreciation of Rupee is against the interest of tourists planning trips to foreign destinations, or for the patients bound to medical treatment abroad.
- Foreign acquisitions plans by Indian companies have become more expensive.
- Importers pass on high cost to local consumers, pushing up inflation in Indian economy further
- Rupee depreciation will change business models. Indian businessman will be encouraged to target exports to strong currency nations and imports from weak currency nations.
- Rupee depreciation is good for exporters that do not use imported inputs. It provides a good platform to Indian exporters to compete with other suppliers in global markets by reducing prices without affecting profitability. Exporters must take the advantage of this opportunity to penetrate deep into global markets. They must focus on understanding business models of foreign buyers. They must make their supply chain management effective, improve technology, develop competitive manufacturing capacity and improve the quality of their goods. This is probably the best time for our exporters to compete with China and replacing them from foreign markets.
- On the other hand, Exporters using high contents of imported raw materials like diamond, jewellery, capital goods etc. will be adversely affected by steep appreciation of US \$.
- Global rating agencies will revise our rating downwards to “Junk” status, making International borrowing difficult and even more expensive for India.
- India Inc is expected to be greatly affected by the rupee's depreciation against the dollar because Indian corporate have increasingly been resorting to borrowing from abroad in order to take advantage of the lower interest rates. Thus they have large foreign debt on their books and no natural hedge in the form of forex earnings. Indian Corporates shall be badly hurt by the downfall of the rupee. This is because the outgo towards interest on this debt, marked-to-market losses, and rollover of hedged positions will increase. For example, CNX Nifty (excluding financial & banking services), around 40% of debt is denominated in foreign currency. In total, corporate India had forex debt outstanding of over US\$ 200 billion on March 2013 and only half of this forex debt is hedged.

As per RBI survey, most of Indian companies have not hedged their repayment of foreign currency loans raised in US \$. This casual approach towards hedging of currency exposure has made cheap foreign currency loans more expensive than Rupee loans due to fast appreciation of US\$.

- Moreover, the Rupee's depreciation will increase input costs across many sectors. Sectors that will be negatively impacted by the rupee's depreciation include automobiles sector, auto components, airlines, consumer durables, oil companies & fertilisers. Airlines with a greater proportion of revenues accruing from domestic operations will also be hurt as 70 per cent of their operating costs are incurred in dollars,
- There will be a positive Impact on profitability of crude oil producers and refineries  
Crude oil producers and oil refiners stand to gain, as their product prices and profitability, (denominated in dollars), are determined by global demand-supply dynamics. Therefore, a weaker rupee will boost their earnings in rupee terms.

### 8. Widening Current Account Deficit

India recorded a Current Account deficit of 5.20 USD Billion in the third quarter of 2013. Current Account in India is reported by the Reserve Bank of India. Current Account in India averaged -1.70 USD Billion from 1949 until 2013, reaching an all time high of 7.36 USD Billion in the first quarter of 2004 and a record low of -37.90 USD Billion in the second quarter of 2012. Current Account is the sum of the balance of trade (exports minus imports of goods and services), net factor income (such as interest and dividends) and net transfer payments (such as foreign aid).



Figure 5

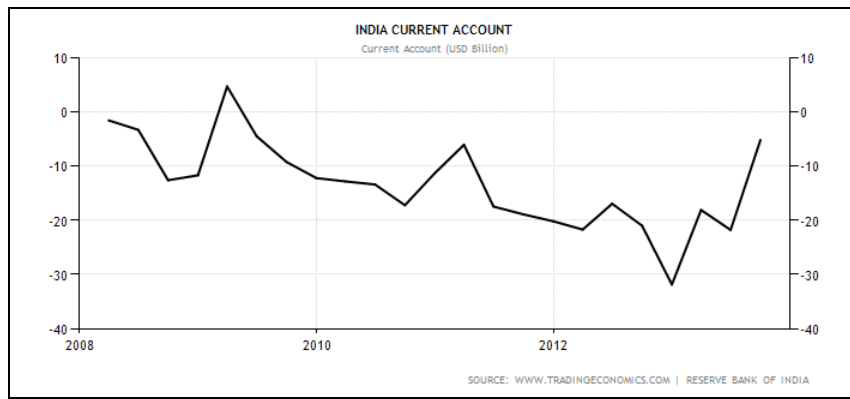


Figure 6



Figure 7

The Current Account Deficit reached to 4.8% of GDP which has breached the comfort level of 2.5% of GDP as mentioned by RBI in 2012-13. The Primary reason for ballooning CAD is huge imports in relation to Exports. India imports crude oil as India can only produce 20% of the demand , rest 80% is being imported from different oil Producing countries first being Saudi Arabia followed by Iraq. The steadily worsening balance of payments

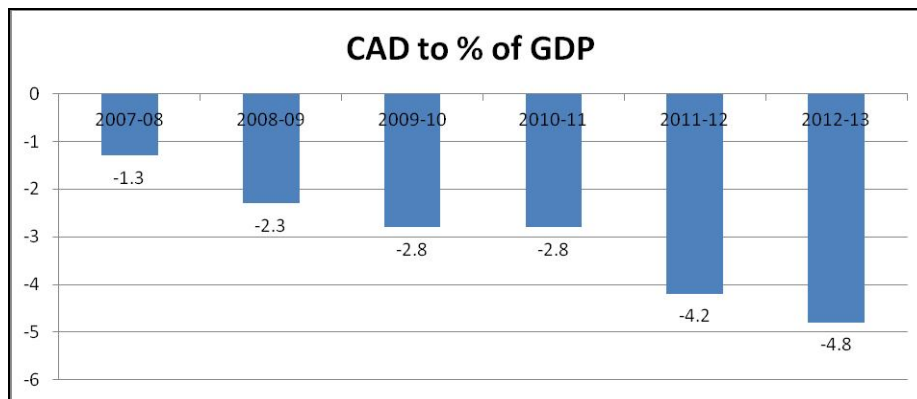


Figure 8

**9. Policy Response of Government amid of Weakening Rupee**

During July-August 2013, following measures were introduced by the Indian authorities to stop the depreciation of rupee and reduce the current account deficit:

- The duties on the import of gold, silver and platinum were increased to 10 %.
- The limits on foreign ownership of sensitive sectors such as telecommunications and insurance were further liberalized.
- New restrictions were imposed on Indian residents seeking to send money abroad to purchase property.
- In mid-August, the existing limits on overseas direct investments by Indian companies were substantially reduced. However, this policy was withdrawn by the new governor of RBI on September 3.
- The interest rates limits for deposits meant for non-resident Indians were liberalized.

- Regulators toughened rules for derivatives trading in the currency market. RBI has barred from trading in domestic currency futures and the exchange-traded options market on their own. Banks can only trade on behalf of their clients.
- The margin requirement on the domestic dollar-rupee forward trade was increased to 100% of the traded amount, which means investors will have to give the entire amount of the transaction upfront.
- The state-owned oil marketing companies (OMCs) – which buy dollars to finance their imports – were asked to trade only with a single state-owned bank. RBI issued orders to Indian Oil (IOC), Hindustan Petroleum, Bharat Petroleum and Mangalore Refinery to stop seeking quotes from several banks for their monthly USD requirement. Oil firms seeking multiple quotes for their dollar requirement was felt to be one of the prime reasons adding to speculation on demand for the USD and volatility. IOC, the nation's largest refiner, will buy their monthly requirement of USD 3.8 to 4 billion dollars from its official banker State Bank of India.
- RBI eased norms for Non-bank asset finance companies (NBFC) to raise debt from beyond the borders by allowing the lenders to raise such funds through the automatic route as against the approval route earlier, aiming at improving dollar supply.
- The government further changed FDI limits in as many as twelve sectors including telecom and defence. Paving way for fresh investments in telecom companies, the government cleared 100% FDI in telecom sector. To boost the sagging economy, the government also raised FDI in defence sector from 26 per cent to 100 per cent. FDI in other sectors like gas refineries, commodity exchanges, power trading and stock exchanges have been allowed via the automatic route. The government cleared 100% FDI in telecom sector, 100% FDI in Single brand retail sector, 100% FDI in Asset Reconstruction sector, 100% FDI in courier services sector, 49% FDI in Power Exchanges sector, 49 % FDI in Petroleum sector, 74% FDI in Credit Information sector, 49 % FDI in insurance sector, 49 % FDI in tea plantation sector, and 49 % FDI in Stock Exchanges, depositories sector.

However, the above-mentioned policy measures failed to arrest the sliding value of the rupee in the currency markets.

#### **10. Forex Swap Window for OMCs: A Sensible Policy Move**

On August 28, the RBI announced a forex swap window for oil marketing companies (OMCs) to meet their daily dollar requirement of over \$400 million through a designated bank. The OMCs will have to return the dollars to the RBI at a later date. By offering this facility to OMCs, the RBI took away a monthly demand of \$9 billion from the currency markets. This sensible move by outgoing RBI governor D Subbarao had an immediate impact as it successfully tamed speculative pressures on the rupee.

The RBI had announced a similar forex facility for OMCs at the onset of global financial crisis in 2008.

#### **11. Hedging Currency Risk**

Indian Corporates have to develop innovative hedging strategies by using financial derivatives like forwards, exchange traded futures and options, to protect against adverse movement in exchange rates. Corporates must use currency option which will provide flexible hedging, portfolio of derivatives and partial hedging strategies to protect against volatility of US \$/ Indian exchange rates. Foreign Currency loan must be hedged by using currency swap, option and rollover forwards with the help of commercial banks. Hedging strategy has to be dynamic to meet future challenges of depreciation or appreciation trend cycles of Rupee against major foreign currencies.

#### **12. Conclusion**

There are no quick fixes to country's imbalanced external sector and the Indian economy remains vulnerable to external shocks and global liquidity conditions. It is desirable to impose more curbs on imports of non-essential items. In addition to higher custom duties, strict quantitative restrictions on the import of gold, silver and non-essential items should be imposed. The government should also consider imposing higher custom duties on consumer electronics goods.

Since oil is the biggest item in its import bill, India should immediately accept Iran's offer to sell crude oil entirely in rupees and at concessional terms. By accepting this offer, India could potentially save \$8.5 billion in foreign exchange spending.

India should immediately work out modalities for trading of goods in local currencies. India could begin trading in local currencies with BRIC partners and Asian countries. Russia, Malaysia and some other countries have expressed interest in trading in local currencies with India.

Issuing dollar-denominated sovereign bonds in the midst of a crisis-like situation is a risky proposition. Further, India will have to offer a higher rate of interest to attract investors which in turn would further increase country's external indebtedness.

Instead of approaching the IMF for a soft loan which comes with inflexible conditions, India could enter into currency swap agreements with key trading partners.

Steady decline in GDP growth, constant and continuing contractions in industrial output, spiralling inflation, growing instance of financial corruption, policy confusions etc. do not portray India as a favoured investment destination. It is here that the government has a very crucial role to play. The government should focus on Boosting exports and looking for more stable longer term foreign inflows to reduce current account deficit. The exports have risen but so have prices of crude oil leading to further widening of current account deficit. Though FDI has been allowed in many sectors, Efforts have been made to invite FDI. Attracting FDI into India has become a vital ingredient of the economic development strategies for India. FDI has been a budding factor that has strengthened the

economic life of India. "Investor friendly" environment will help India establish itself as a favored destination of foreign investors. India has enormous potential for absorbing greater flow of FDI in years to come.

Volatility of rupee has to be controlled soon to stop further damages and uncertainty in business. We need to restrict non essential imports to correct current account deficit and thus the pressure on rupee.

Long term export promotion strategies have to be developed. Big exporters may establish warehouses abroad or build manufacturing capacities in their targeted global markets. Sincere efforts are required to encourage foreign inward remittances like issuing Dollar based long term bonds and encouraging investments in India.

We need to preserve foreign exchange reserves to protect value of Rupee in unexpected market situations. Government should encourage bi or multilateral agreements, to encourage local currency payment.

Market sentiments have to be improved, to stop devaluation of Rupee against major foreign currencies. Foreign trade and borrowings transactions need innovative hedging to protect against currency risk, duly approved by management, thus protecting profit margin and remaining competitive in international business.

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