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Catching the fall: Decoding the fall of Indian currency

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ABSTRACT

The centre of concern in the Indian economy these days is the falling value of the Indian currency. Though much is being said about the reasons and the impact a fall in currency will have, little is being presented with clarity. As Lionel Trilling rightly said "We invented money and we use it, yet we cannot understand its laws or control its actions. It has a life of its own." This life blood of the economy is very enigmatic in nature, and more so for the common man. In the global economy that we live in it is essential for the people of the nation to understand the economic implications of money, its fall and its weakening. *When he Indian rupee touched a lifetime low of 68.85 against the US dollar on August 28, 2013* RBI had announced a number of measures to take control of the situation, with government requesting not to but gold. All these measures and actions did not yield the desired result. This qualitative research paper aims at presenting the complex matter of the falling value of Indian currency, its reasons and its impact in a simple way to be understood by a layman. The research uses secondary data from various sources. To make the perplexing figures understandable the paper uses flow charts and diagrams.

Introduction

"We invented money and we use it, yet we cannot understand its laws or control its actions. It has a life of its own."- Lionel Trilling, American literary critic (The Rupee Impact, 2012). The statement is perfectly true and at the same time the simply stated words are quite perplexing to answer. In the open economy that we live in moves the difficulty of answering a few notches higher. Money is not an organic creature but its value keeps changing with the society and its economic conditions. One rupee in 1947 is not the same as one rupee today, both in terms of appearance and purchasing power (Hans, 2012). Who would know it better than a common Indian man the changing value and the faces of rupee? And adding bewilderment to the baffling situation is the international economic scenario. To the upper class of the society the change in the currency value is just a mere delay in the luxuries enjoyed, to the lower class it's another struggle foe daily needs and for a large section of the middle class its utter confusion that requires a whole lot of reshuffling of needs demands and desires.

The Indian rupee touched a lifetime low of 68.85 against the US dollar on August 28, 2013. The rupee plunged by 3.7 percent on the day in its biggest single-day percentage fall in more than two decades. Since January 2013, the rupee has lost more than 20 percent of its value, the biggest loser among the Asian currencies (Singh, 2013). The situation was somewhat revived by the Reserve Bank of India that decided to open a special window for helping state owned oil companies – Indian Oil Corp Ltd., Bharat Petroleum Corp and Hindustan Petroleum Corp. (Samudranil, 2013). From the start of this financial year, the Indian Rupee has depreciated by 6.86 per cent and it was the worst performer among major Asian currencies losing nearly 12 per cent of its value since touching its 2011 high of 43.85 against the dollar on July 27. The rupee would have fallen further but for the market intervention by the Reserve Bank of India. (Falling rupee adds fuel to India's crisis, 2013). Who would know the fickle nature of money better than Reserve Bank of India (RBI) Governor D Subbarao. As the rupee went on a free fall in the last five months of 2011 - spooking businesses and investors alike and prompting the RBI to take measures to stem the slide - most people were left wondering what this ado was about. (The Rupee Impact, 2012). Strong demand of US currency from importers and banks, continuous capital outflows, widening current account deficit and dollar's strength against other currencies overseas amid expectation that the Federal Reserve will soon taper its bond-buying programme has put pressure on the rupee. (Sharma, 2013)

The investors borrowed cheap short-term money in the US and invested in higher yielding assets in India, Indonesia, South Africa and other emerging markets. This resulted in more money flowing into debt, equity and commodity markets in these countries. In India, many companies resorted to heavy borrowings overseas. The massive capital inflows also enabled India to comfortably finance its trade and current account deficits rather than addressing the structural aspects of CAD.

However, this money will quickly leave India and other emerging markets when the tapering of QE program begins. Already, emerging markets are 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 12 to 18 months. (Singh, 2013)

In simplest words money can be defines as the worth/ value /significance assigned to a commodity, a piece of paper, a coin or electronic data (cards). Money can be classified into six types. Commodity money comprises product/service/goods, representative money includes token coins and notes, receipt money, fractional money, fait money and commercial money embrace cheques, demand drafts and bankers draft, etc.

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Figure 1 Types of Money

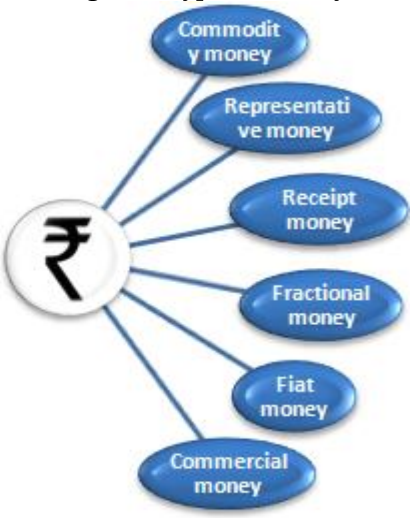


Figure 2 Implication of a Weak Currency

The CAD, the difference between the inflow and outflow of foreign exchange, had touched an all-time high of $88.2 billion, or 4.8 per cent of GDP, in the last fiscal.

The deficit for April-June was at $21.8 billion or 4.9 per cent of GDP. (India, 2013) .This difference was mainly due to the high gold imports which were curbed by RBI and the centre. "In a more equitable world order, it is only appropriate that the developed countries - in pursuing their fiscal and monetary policies - should take into account the repercussions on the economy of emerging countries," he said.

The Indian government has raised the import duty on gold and increased deposit rates to stem the outflow of money.(India's GDP shows continuing slowdown, 2013)

"A country that sells more goods and services in overseas markets than it buys from them has a trade surplus. This means more foreign currency comes into the country than what is paid for imports. This strengthens the local currency," says Kishore Narne, head, commodity and currency research, Anand Rathi Commodities, a brokerage house.

Income levels influence currencies through consumer spending. When incomes increase, people spend more. Higher demand for imported goods increases demand for foreign currencies and, thus, weakens the local currency.

"Some ways through which the RBI controls the movement of the rupee are changes in interest rates, relaxation or tightening of rules for fund flows, tweaking the cash reserve ratio (the proportion of money banks have to keep with the central bank) and selling or buying dollars in the open market," says Brahmbhatt of Alpari.

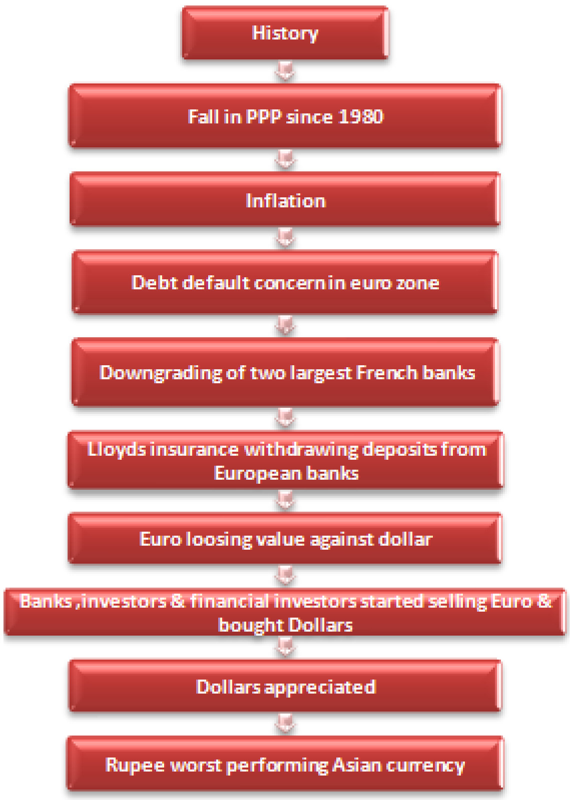
The RBI also fixes the statutory liquidity ratio, that is, the proportion of money banks have to invest in government bonds, and the repo rate, at which it lends to banks.

While an increase in interest rates makes a currency expensive, changes in cash reserve and statutory liquidity ratios increase or decrease the quantity of money available, impacting its value. (Hans, 2012)

Nearly $7.5 billion has been shaved from the current financial year's allocation of $37.7 billion for defense spending. In February, $1 equaled 54 rupees, and that number has risen to 68 rupees.

Since overseas weapon and equipment purchases are made in US dollars, more Indian rupees are needed to make those buys.(RAGHUVANSHI, 2013)

Figure 3 The Why and How of the present Situation



The weakening of the rupee can be traced back to the fall in purchasing power parity which can be defined as the relative worth of the basket of essential goods. Historically the PPP was always higher than the economic growth. While the PPP was 15 around 1982, the actual exchange rate was Rs 9.30 per US Dollar. It is the inflation that negatively impacts PPP and pushes a currency down. (Falling rupee adds fuel to India's crisis, 2013). This gap in purchasing power and economic growth results in inflation. This is due to the fact that as the economic growth is less than the purchasing power signifying that there is more money and less goods in the economy as such the prices of goods rises leading to inflation. This slow economic growth was followed by the debt default concerns of the euro zone leading to withdrawal of USD from euro zone due to apprehension. When two of the largest French banks were further downgraded, some of the major institutions started withdrawing deposits from the European banks, and started selling Euros. With this the demand for USD further increased leading to the strengthening of the currency against all other currencies.

Reasons of weakening

1. Law of demand and supply : The basic law of economics state that when demand of any commodity is more than its supply its price/worth is bound to go up. Same is the case with USD in India. So the question arises who ardently needs dollars – importers. They are being supplied with the USD by exporters and foreign institutional investors. It's been seen that the exports have not been able to bring in sufficient USD in India and the FII too are looking for greener pastures outside India as such the USD is also moving out.

2. "Rude" oil : In spite of having oil reserves India has to imports majority of its oil requirement from outside. Crude oil constitutes a major import item in the list. The ever increasing oil demand within India is also putting pressure on the Indian currency as world over the prices of oil are given in dollars.

3. **Performance of dollar with respect to other currencies :** The central banks across Japan and countries in the Eurozone have been bringing out a lot of money and this has meant that both Yen and Euro have lost their value. Compared to this the US Federal Reserve is giving hints that it will end the fiscal stimulus so that the dollar becomes stronger with respect to other currencies such as the Indian Rupee at least for the time being. Till now in 2013, the US dollar index has become stronger by 1.91%.

In an interview with the Economic Times, the CO-CIO of Birla SunLife Mutual Fund, Mahesh Patil has stated that the increase in worth of USD is the major reason behind the depreciation of the INR. The Federal Reserve's decision to reduce its Quantitative Easing has also contributed to the present situation as every asset class has been affected by the decision.

4. Dwindling equity: The instability in the equity market is another reason as to why the FII had taken out their money (in USD). This amount was estimated to be a record high of INR44,162 crore in June 2013. This had also led to an increase in current account deficit.

5. Poor current account deficit: A big reason as to why the fall in the Indian currency could not be checked appropriately by the government can be claimed by CAD. The current account deficit as on april june quarter of the fiscal year stood at 4.9 % of the GDP. "The trade deficit, coupled with a slow recovery in net invisibles (income and services), led to widening of CAD to USD 21.8 billion in Q1 of 2013-14 from USD 16.9 billion in Q1 of 2012-13," RBI said in its Balance of Payments statement. (Current account deficit increases to 4.9% of GDP in India: RBI, 2013) . Other reasons for a poor CAD are

- Reduced exports
- Lack of new export avenues
- Increased gold and oil imports
- The lack of one window for clearance purposes and procedural delays FDI

6. **Withdrawal of investors:** Recently ArcelorMittal and Posco decided to pull out from their projects in India. Posco did not go ahead with a steel plant worth INR 30,000 crore that was supposed to be built in Karnataka and ArcelorMittal withdrew from setting up a steel plant in Odisha that was supposed to cost around 52,000 crore. There were lot of delays and problems related to acquiring land for the project. In fact in 2012-13 the Indian companies have spent more outside India compared to FIIs in India. (Samudranil, 2013)

7. **Downgrading of Indian stocks :** Goldman Sachs, one of the leading banks in the world, has rated Indian stocks as being underweight. It has also asked investors to be careful given the concerns surrounding the recovery of the growth of Indian economy. (Samudranil, 2013)

8. Depressed growth : A meagre growth was seen in the various important sectors of the economy which include, manufacturing, agriculture and mining in 2013. Further adding insult to injury to the situation aws the fact that this had made these sectors less appealing to investors During June 2013, the aggregate industrial production in India reduced by 2.2 per cent and in July 2013 the RBI predicted that in the present fiscal there would be a growth of 5.5% which was lesser than its previous prediction of 5.7%. (Samudranil, 2013)

9. **Policy Inaction:** Perception of lack of clarity on policy front is also fanning speculative demand wherein the Reserve Bank of India (RBI) on one day said it will tighten liquidity and on yet another said it will inject $1 billion into the market.

10. **Falling Forex Reserves:** India's foreign exchange (Forex) reserves are enough to cover imports of seven month only. The forex reserves have steadily declined in the recent months, due to which the RBI can't intervene aggressively sell dollars to prop up the rupee.

11. Inefficient policy measures: In the wake of the situation RBI followed capital control measures and imposed restriction on capital inflow for a brief period. Though this measure restricted the capital outflow but also dampened the capital inflow which could have brought the crucial USD.

12. Developing currency India is a developing economy and as such the rupee is flowing a trend that is but obvious for a developing economy currency , moreover except for china it is pursing the same lines as other developing emerging economies like Russia, brazil, south Africa and Indonesia.

13. Speculation: The speculation in the currency market is putting pressure.

Figure 4 Requirements for Improvement

Recommendations

1. The policy indecision and then hasty action showed lack of government confidence which created much confusion and speculative trading. A more decisive and controlled approach could have increased the confidence level of domestic & foreign investors. And restricted the outflow of much required USD.
2. The presence of the external factors like peripheral shocks and international liquidity conditions will always be there; as such the requirement is to be internally strong. This again requires critical analysis of the various policies and measures adopted by the Indian government.
3. A proactive approach rather than a reactive approach is required on all economic fronts.
4. Prioritisation of imports can be another policy measure to be adopted during crises times.
5. Crude oil takes up an important portion of imports as such long term methods to control this situation need to be devised. New oil field and offers needs to be explored.

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