

# The indian rupee crisis economics essay



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In this paper we are going to examine the cause and the impact of rupee depreciation on the Indian economy. Since last few months Indian rupee came under great stress as overseas investors are paring their exposure to Asia's third-largest economy amid international uncertainty and mounting worries over the domestic economy. In 2009 - 2010 the exchange rate was hovering around the 43 - 45 rupees per US Dollar level. And now it is around 55 - 56 levels, the main reasons to examine are increase in import bill, higher inflation, fiscal mismanagement and all resulting in higher cost of borrowing. The rupee has lost more than 15% of its value this year, making it one of the worst performing currencies in Asia.

This paper reviews the probable reasons for this depreciation of the rupee and the outlook for the same. It also reflects on the policy options to help prevent the depreciation of the Rupee. This paper will firstly discuss about the economy of currency to give an overview of the problem and the factors related to it.

Afterwards it will be examining the causes of the Indian rupee depreciation with respect to the Indian economy and the global economy. And after that it will analyse the impact of the same on trade and business. Finally, recommending the policy actions in response of the falling currency.

## **II. LITERATURE REVIEW:**

These papers include the work which have been used as a basis or reference for formulating the policies regarding ' The Indian Rupee Crisis'.

Singhal, Shelly (2011), " AN ANALYTICAL STUDY ON INDIAN CURRENCY RUPEE DEPRECIATION AGAINST THE US DOLLAR AND ITS ECONOMIC

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IMPACT”, Arth Prabhand: A Journal of Economics and Management, Vol. 1 Issue 1, April 2012, Pp. 73-83.

This paper mainly takes into account the Indian Rupee Crisis mainly during the last quarter of 2011 & the impact it had on the Indian Economy then & now. The paper first summarizes the outlook of the Indian Economy, its economical & financial history. It shows how the trend of the Indian rupee has been from 1991 to 2011 & the main reasons behind the fluctuations in the Indian Rupee.

After determining the reasons behind the fluctuations it talks about the depreciation in the Rupee against the Dollar over the last financial year (2011-12). Basic reasons identified in the paper are:

Persistent Inflation

Persistent Fiscal Deficits

Lack of Reforms

Global Economic Scenario

After the reasons of the downfall are determined, policy measures\* have been identified in order to control the depreciation of the Indian Rupee. Moreover the role of RBI has also been identified as to what all measures can be taken by them to curb the situation.

Rupee Exchange Depreciation: Impact Analysis available at [http://www.assochem.org/arb/general/Rupee\\_Exchange\\_Depreciation\\_Impact\\_Analysis-2012.pdf](http://www.assochem.org/arb/general/Rupee_Exchange_Depreciation_Impact_Analysis-2012.pdf) (Accessed on 8th October 2012).

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This paper assesses the impact Indian Rupee Depreciation have had on different sectors of the Indian Economy. It mainly takes into account the imported goods as the main areas which have been impacted by the fall in the Indian Rupee against the US Dollar.

India is poor in oil resources and is heavily dependent on coal and foreign oil imports for its energy needs. Thus, oil imports & other imports form a major source for India when it comes to its energy requirements. Other imported products are: machinery, gems, fertilizers and chemicals. Main import partners are European Union, Saudi Arabia and United States.

The paper also discusses the impact of depreciation on the industry, the importers & the industry players. India being a major importer has various firms which have huge imports on account of the raw materials. With the depreciation in Indian rupee these firms have incurred huge forex losses. Thus, in order to control their losses these firms are increasing prices of the goods they sell which in turn has led to rise in inflation. Moreover, the economic growth in India has slowed down with these factors playing a major role in it. Thus, Indian Rupee depreciation has led to the slowing down of the economy as whole.

Exchange Rate Slide – What Impact Is It Having available at [http://www.assochem.org/arb/general/Exchange\\_Rate\\_Study.pdf](http://www.assochem.org/arb/general/Exchange_Rate_Study.pdf) (Accessed on 8th October 2012).

This paper also accounts for the impact that the Indian Rupee has had on the Indian Economy. It has shown the fluctuations of the Indian Rupee with respect to various major currencies like the USD, Pound Sterling, Japanese <https://assignbuster.com/the-indian-rupee-crisis-economics-essay/>

Yen & the Euro. The impact of depreciation on the imports have also been considered in the paper. The consequences these impacts will have on the Indian Economy forms the next part of the paper. Moreover, impact on the debt in the corporate sector has also been considered. Similar to the previous papers a brief analysis of the impact has been done & in the end policy measures\* have been discussed to curb this critical situation.

(\*The policies recommended in the paper have been discussed in the Policy Recommendations part below.)

### **III. WHAT ARE THE FACTORS AFFECTING THE CURRENCY RATES:**

In any country, determining the currency rates fluctuations is a very tough task. Thus, there are various factors which can be considered in order to determine the reasons behind such fluctuations of the home currency. Some of those factors are:

**Current Account Surplus/Deficit:** A country having more exports than its imports has a current account surplus. In such economics the currency appreciates while in deficit countries, the currency depreciates.

**Interest Rate Differentials:** This is based on interest rate parity theory. According to this factor, countries having higher interest rates have a depreciating exchange rate. If it does not happens, there is a case for arbitrage for foreign investors till the arbitrage opportunity disappears from the market.

Inflation: Higher inflation leads to central banks increasing policy rates which invites foreign capital on account of interest rate arbitrages. This leads to further appreciation of the currency. However, over short-term foreign investors see inflation as a temporary problem and still invest in the domestic economy. If inflation becomes a prolonged one, it leads to overall worsening of economic prospects and capital outflows and eventually depreciates the currency. Apart from this, inflation also helps understand the real changes in a value of currency.

Global economic conditions: Barring domestic conditions, global conditions impact the currency movement as well. In times of high uncertainty as seen lately, most currencies usually depreciate against US Dollar as it is seen as a safe haven currency.

Keeping the above factors in mind we have determined as to what all are the possible reasons for the depreciation of the Indian Rupee against the US Dollar over the last financial year.

#### **IV. RUPEE DEPRECIATION: CAUSES FOR THE DECLINE**

The Indian Rupee has depreciated significantly against the US Dollar marking a new risk for Indian economy. Till the beginning of the financial year very few had expected Rupee to depreciate with most hinting towards either appreciation in the rupee levels. Those few who had even anticipated may not have imagined the scale of depreciation with rupee touching a new low of around Rs 57 to the US Dollar.

Fig: The Depreciating Indian Rupee against

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## The US Dollar (Oct'11- Oct'12)

The graph above shows that the Indian Rupee was near the Rs49/USD exchange rate during October 2011. This part examines the main reasons behind the fall from Rs49/USD in October 2011 to Rs57/USD in June 2012.

**High fiscal deficits:** In the last financial year (2010-11), the fiscal deficits remained high. The government thus, projected a fiscal deficit target of 4.6% for 2011-12 but considering the economic condition it is likely to be much higher on account of higher subsidies. The target figure was again questioned by the markets just after the budget and projected the numbers could be much higher. Thus, this has become an important issue for the Indian Govt.

**High inflation:** Inflation in India has remained around 9-10% for almost two years now. Inflation still remains high with core inflation itself around 8% levels. In 2007-08, despite high inflation and high interest rates, capital inflows were abundant because markets believed inflation was temporary. As India recovered from the Global Financial Crisis, the same was assumed by the investors. However, as inflation remained persistent and became a more structural issue investors reversed their expectations on Indian economy.

**Lack of reforms:** There have been very few meaningful reforms in the last few years in Indian economy. The government tried to reverse this perception for which it announced FDI in retail but had to hold back amidst huge furor from both opposition and allies. This has further made investors negative over the Indian economy. As FII inflows are going to be difficult given the uncertain global conditions, the focus has to be on FDI.

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Continued Global uncertainty: With the global economy continuing to remain in a highly uncertain zone, pressure on most currencies against the US Dollar has increased. The Euro Economic Crisis is one of the main reasons for the depreciation of many currencies with respect to the US Dollar as large institutional investors have moved out of the Euro and into the Dollar. In spite of the fact that the debt of the US government (\$14.6 trillion) is almost equal to its GDP (\$15 trillion), the world at large is considering the dollar to be a safe haven and moving money into it by buying US treasury bonds. Thus, the countries that have lost value against the USD have lost it in varying degrees.

All these reasons together have led to sharp depreciation of the rupee. The rupee has depreciated by nearly 15% against USD from Oct'11 to Oct'12.

## **V. IMPACT ANALYSIS OF THE INDIAN RUPEE CRISIS**

India is poor in oil resources and is currently heavily dependent on coal and foreign oil imports for its energy needs. Thus, oil imports & other imports form a major source for India when it comes to the energy requirements. Other imported products are: machinery, gems, fertilizers and chemicals. Main import partners are European Union, Saudi Arabia and United States.

### **POSITIVE IMPACT:**

Companies using domestic inputs & exporting majority of their output to the US benefited the most due to the fall in the rupee against the dollar.

Companies having high level of imports & exports to USA, with the exports exceeding the imports benefited as well.



**NEGATIVE IMPACT:**

India's oil import bill rose by 43% at Rs 726, 386 Crores against crude oil and fuel product imports of 186. 7 million tonne in FY-2012.

Importers were required to pay more for the same quantity being imported. For example, the quantity ordered at the exchange rate in March 2012 was costing higher in June 2012 due to the fall in the Rupee.

The firms which were dependant on the imported resources incurred huge foreign exchange losses because of the fall in the rupee against the dollar goods they imported.

Firms had increase in their expenses on account of the falling rupee, thus, in order to retain profit margins, prices of commodities related to oil & other commodities increased.

Increase in import prices of essential commodities such as crude oil, fertilizer, pulses, edible oils, coal and other industrial raw materials increased the prices of the final goods. Thereby making it costlier for the consumers and hence inflation pushed up further.

The figure shows the price hike in petrol after the rupee fall i. e. end of Nov 2011 – April 2012.

The falling rupee also took away much of the benefits of the declining international crude oil prices.

The falling rupee overall hit the economic growth of India as inflation remained high because of the rise in prices of goods having imported raw materials.

## **VI. POLICY RECOMMENDATIONS:**

The Research papers discussed earlier have looked upon various policy recommendations which can be used to curb the current exchange rate problems being faced by the Indian Economy. Some of the policies discussed in the papers are:

Oil import demand could be staggered and purchases co-ordinated so that at no point there is undue bundling of imports.

The government can take initiatives which encourage and increase the flow of foreign investments into India. Three recent steps taken by the government be it the pension fund FDI limit or the increase in the investment limit investors in government security and corporate bonds are the steps in the right direction.

The government can make investments attractive and invites long term FDI debt funds in infrastructure sector.

Government can consider temporary import compression.

FDI in the aviation & retail industry can also attract foreign investors.

## **VII. REFERENCES:**

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