# Depreciating Rupee



*The article 'Where goes the rupee?' appeared in The Hindu on September 17. It analyses the causes and implications of the rupee depreciation on the Indian economy and looks at the steps taken by the government to arrest it.*

The value of the Indian rupee against dollar has significantly declined to the level of Rs 72. Fall in the rupee has become a matter of concern as it can slow down the economic growth, corporate earnings, and can lead to market volatility. Currency depreciation for any developing economy could be a major stumbling block in its growth. It calls for measures to encourage exports and strengthen the manufacturing sector to reduce import overdependence.

Government has announced several steps including steps to curb the import of non-essential goods and encourage the export of domestic goods, which will help in addressing the country's burgeoning current account deficit. Other steps such as removing restrictions on foreign portfolio investments and encouraging Indian borrowers to issue rupee-denominated 'masala bonds' have also been announced to facilitate the inflow of dollars and to de-risk the economy from fluctuations in the exchange rate.

**Devaluation of currencies around the world:** the dollar has appreciated sharply against most of the other currencies in the world. For instance, it has moved up against both the euro and the pound. Developing countries have suffered the loss of portfolio investment because of their relatively unstable political and economic conditions. Historically, devaluation was used as a tool to curb the balance of payments deficit. The currency was devalued to decrease the price of exports by making them more competitive. Also, the imports in the country became more expensive and its volume got reduced in the economy.

## Causes for the Decline

- **Shift in the global capital:** After the massive decrease announced in corporate tax rates and the rising interest rates, U.S. economy has become a more attractive option for the investors of the global capital. Investors attracted by higher yields in the United States have been pulling their capital out of India at an increasing pace over the last few months.
- **Trade war:** The trade war between the US and China and the spat between Turkey and America is another cause of concern. It has weighed on not just the rupee, but most emerging market economy (EME) currencies. Any adverse economic/geopolitical development, in Iran or Turkey, triggers capital outflows from EMEs and investors seeking refuge in "safe haven" currencies such as the dollar and the Swiss franc.
- **The rise in international crude oil prices** is one of the reasons behind the rupee's decline as importers have had to shell out more dollars to fund their purchases. India imports about 80% of its petroleum needs. The country has been unsuccessful in finding sustainable domestic sources of energy to address the over-reliance on oil imports. This has meant that the rise in the price of oil has traditionally exerted tremendous stress on the current account deficit and the currency, as is happening now.

**Valuation of Rupee**

Any currency, say the rupee, can be overvalued or undervalued. Overvaluation of the currency means that its price in terms of foreign currencies is too high, compared to what it would be with a more appropriate exchange rate. This makes the exports expensive in foreign markets and the imports cheap in the home market. Undervaluation of the currency means the opposite. Its price in terms of foreign currencies is too low so that it discriminates against imports and in favour of exports.

## How does the depreciating rupee impact the economy?

- A depreciating rupee could put inflationary pressure on the domestic economy. The rising landed cost price of crude oil has resulted in the rise in prices of petroleum and diesel which in turn has increased the cost of transportation of goods that also include many food items.
- The devaluation will also increase the prices of imported inputs, particularly those for which there are no alternative domestic sources of supply. These import dependent sectors can face a rise in the cost of production which can affect output expansion. Many domestic companies that have taken dollar loans will also face significantly higher servicing costs.

**NOTE**:

Landed cost is the total cost of a commodity or a product when it lands at the ports of the country importing the commodity/product from another country. It includes the manufacturing cost of the product, all transportation costs, customs, duties, taxes, currency conversion, crating, handling charges and payments etc.

## Steps to be Taken: Corrective Actions

- **Lowering the duties:** Both the Central and State governments earn huge revenues from excise duties and value-added tax (VAT) on petrol and diesel. Now that the rupee cost of crude has increased, the Centre should lower duties. Rates of VAT should also be lowered by State governments. A small reduction in VAT may even be revenue neutral since VAT is levied as a percentage of the price paid by the dealer.
- **Boosting exports:** The government needs to think of a long-term plan to boost exports, preferably through steps that remove policy barriers that are impeding the growth of export-oriented sectors, in order to find a sustainable solution to the problem of the weakening rupee. Deep structural changes from infrastructure to trade policy are needed to boost export competitiveness while addressing problems related to the goods and services tax particularly faced by the exporters.
- **Encouraging FPI:** Portfolio investment flows have a significant impact on the exchange rate. These capital inflows drive prices up in stock markets and add to foreign exchange reserves. Large inflows lead to an appreciation of the rupee and large outflows lead to a depreciation of the rupee. The appreciating overvalued rupee erodes the price competitiveness of exports and enhances the price competitiveness of imports, which hurts the profitability of domestic firms and is bound to enlarge the trade deficit. At a macro level, this also leads to a contraction in aggregate domestic demand so that economic growth is slower than it would have been in the absence of an appreciating rupee.

## Way Forward

- The government can borrow from non-resident Indians (NRIs) by floating special NRI bonds that have to be purchased with foreign exchange, and with maturity periods of at least three years.
- Interest rates should be kept attractive, and investors must be protected from exchange rate fluctuations. Since this has been tried before (in 2013), it offers more certainty to the steps that can work.
- In the near future, the rupee is unlikely to return to anything below 70 to the dollar. This should not be cause for much concern because the economy will adjust to the lower value of the rupee. Much will depend on whether the economy can continue to grow at a reasonably high rate, for this will steady the nerves of portfolio investors and prevent them from pulling out of the Indian stock market.

### A Brief History of Rupee

- The word ‘rupee’ has been derived from the Sanskrit word rupyakam, meaning a silver coin. It owes its origin to rupiya, issued by Sher Shah Suri in 1540-45. Today, the Reserve Bank of India issues currency under the RBI Act 1934.

- The Paper Currency Bill was enacted in 1861 which gave the British government the sole right to issue notes.
- Britain (and France) declared war on Germany in 1939. In preparation, India's economy was geared up by the colonial government towards the war effort through the imposition of controls. The first was the exchange control. Completely convertible into any currency until then, the rupee was made inconvertible. Transferring money outside the sterling area required permission under rules that were laid down in London.
- Dollars for the war were also raised by selling silver bullion from India's reserves to governments outside the sterling area.
- Dollars could be spent on imports of essential consumables, not capital goods. What was essential was defined by the war requirements until 1946, when civilian requirements were included. The restrictions on capital goods imports continued because the BoE had blocked what was called India's sterling balances. By the end of World War II, India had accumulated a sizeable sterling balance of £1,300 million — India's earnings in foreign currency on its exports for the war, deposited in the Bank of England in the form of sterling to the credit of the Reserve Bank of India (RBI) account. The balance had grown with import controls limiting forex outflows. The corresponding increase in rupee circulation stoked war inflation in India.
- After the war ended, the transfer of the sterling balances was negotiated between India and Britain.
- The sterling was floated against the major international currencies in the early 1970s, the rupee as late as 1993-1994. The two currencies were delinked in 1975.