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A STUDY ON INDIAN CURRENCY DEPRECIATION AGAINST THE US DOLLAR AND ITS ECONOMIC IMPACT

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Abstract

Devaluation is usually undertaken as a means of correcting a deficit in the balance of payments. Some analyst are of the view that weakening the value of currency could actually be good for the economy - since a weaker currency will boost exports, which in turn will lift employment and all this will set in motion economic growth and keep the economy going.

Introduction

Devaluation means decreasing the value of nation's currency relative to gold or the currencies of other nations. Devaluation occurs in terms of all other currencies, but it is best illustrated in the case of only one other currency. Devaluation is usually undertaken as a means of correcting a deficit in the balance of payments. Some analyst are of the view that weakening the value of currency could actually be good for the economy-since a weaker currency will boost manufacturing production, which in turn will lift employment and all this will set in motion economic growth and keep the economy going. But the dangers of a falling rupee too quickly, would be that the foreigners will stop investing in the country, which would make it impossible to finance the current account (trade) deficit. It will then be forced to push interest rates up to defend the rupee (crashing rupee stock and bond markets is supposed to make the rupee more valuable), and that could create recession.

Fluctuating of Currency:

To better understand the fluctuating dollar value against the rupee, let us get to know some basics:

Exchange rate - the rate at which a currency can be exchanged. It is the rate at which one currency is sold to buy another.

Foreign exchange market - Also known as "Forex" or "FX". It is a market to trade currencies

Indian foreign exchange rate system

India FX rate system was on the fixed rate model till the 90s, when it was switched to floating rate model. Fixed FX rate is the rate fixed by the central bank against major world currencies like US dollar, Euro, GBP, etc. Like 1USD = Rs. 40. Floating FX rate is the rate determined by market forces based on demand and supply of a currency. If supply exceeds demand of a currency its value decreases, as is happening in the case of the US dollar against the rupee, since there is huge inflow of foreign capital into India in US dollar. Why is the US dollar walking down? - When it comes to the US being a consumer, it has one of the largest appetites in the world. To keep up its demand for consumption, its imports are huge when compared to exports. This created pressure since there were more payments in dollars than receipt of any other currency, which made the supply of the dollar greater for imports payment and less receipt of foreign currency from exports. This resulted in the depreciation of the dollar's value, which again caused more outflow of dollar for import payments. This created a state of inflation and made consumables costlier to US. To control inflation US resorted to increase in interest rates to cool down pressure on demand side of consumption. This factor along with recession in all other sectors, particularly real estate, is causing the mighty US dollar to shake.

Impact of dollar fluctuations on the Indian economy:

Possible impacts of the devaluation on the economy could be the stimulation of merchandise exports, discouraging merchandise imports and thus improving terms of trade, increase revenue collection and savings in repatriation of profits and royalties by existing foreign investors, bringing illegal foreign exchange leakages into official channels and putting an end to gold smuggling. Inflow of foreign capital can be improved by devaluation only if prices do not rise. It is supposed to provide an escape from vexation import controls that prevent utilisation of full industrial capacity, stifle export drive, bestow monopoly profits on a few, inefficient market regulation and pressure on budget and domestic prices will sky rocket.

Balance of payment (BOP) of any country is the balance resulting from the flow of payments/receipts between an individual country and all other countries as a result of import/exports happening between an individual country, in our case India and rest of the world. This gap widened during Iraq's attempt to take over Kuwait. Thereafter, exports also contributed to FX reserve along with Foreign Direct Investment into the Indian economy and reduced the BOP gap

Indian rupee appreciation against dollar impacted heavily to the following:

1. Exporters
2. Importers
3. Foreign investors

Exports from India are of handicrafts, gems, jewellery, textiles, ready-made garments, industrial machinery, leather products, chemicals and related products. Since the 1990s, India is the world's largest processor of diamonds. The mentioned export items contribute substantially to foreign receipts. During the periods when the dollar was moving high against the rupee, exporters stood to gain, when \$1 = Rs. 48, was getting them Rs. 4800 for every \$100. Since the beginning of the year 2007, rupee appreciated by about 10%. With its value of rupee Rs. 39.35 = \$1 as on 16 Nov 2007, for every \$100, exporters would get only Rs. 3935. This difference is towing away the profit margins of exporters and BPO service providers alike.

Imports to India are of petroleum products, capital goods, chemicals, dyes, plastics, pharmaceuticals, iron and steel, uncut precious stones, fertilizers, pulp paper etc. With the same scenario as given for export, if we analyze - an importer is paying Rs. 3935 now instead of Rs. 4800 paid during yester years for every \$100. This gain on FX is likely to create savings in cost, which could be passed on to consumers, thereby contributing to control inflation.

Foreign investment into India is also contributing well to dollar depreciation against dollar. With the recent liberalized norms on foreign investment policy like - Foreign investment of up to 51% equity limit in high priority industries; foreigners & NRIs are allowed to repatriate their profits and capital with exception for Indian nationals who were allowed to do so only under special circumstances; allowing free usage of export earnings to exporters, made foreign investment in India very attractive.

Conclusion

The obvious consequence of devaluation in the short run would be to worsen the balance of payment position and raise the burden of India's foreign debt and debt service liability and foreign loans repayment would break the back of the budget, which would in turn increases the trade gap. It will upset all the cost price relationships in the economy, lead to galloping inflation, and will stall many ongoing projects due to rising costs. Conclusively, appreciation and depreciation of rupee cannot certainly be taken as beneficial to the Indian economy in general. On one hand the rupee appreciation will affect exporters, BPOs, etc., on the other, rupee depreciation will affect importers. So now it depends on what the future has to reveal for, how effectively the central bank can balance the FX rates with little impact to the relative areas of FX usage. Can the Dollar remain king or not, is no longer a million dollar question, but a million Rupee question!