International Journal of Advanced Research in Management and Social Sciences

ISSN: 2278-6236

UNDERSTANDING THE RUPEE ROLLER COASTER: HAS THE INTERNATIONAL MONETARY COOPERATION BROKEN DOWN?

Dr. Sunita Mishra*

Abstract: *Indian Rupee depreciated gradually against the US Dollar ever since the reforms initiated in 1991. However the rupee faced a record fall of about24% from May 2013 to August 2013. So why it is that Indian rupee has fallen so fast against dollar? Has the international monetary cooperation broken down? Under this backdrop, this paper talks about the dynamics of the rupee in the global environment and attempts to analyze the probable reasons behind long term fall of rupee. This paper considers the post-reforms period for analysis.*

Keywords: *Rupee Depreciation, Exchange rate, Balance of Payment, Current Account, Capital Account, Global Financial Crisis*

***Ex. Professor, M. M. University, Mullana (Ambala)

1. INTRODUCTION

Each country has its own currency except Europe where a group of countries have a common currency. The rate at which one currency can be exchanged for the other is called Forex rate. This rate changes on daily basis depending on the demand & supply of each currency.

A currency is said to have depreciated against the other currency when we have to pay more units of former currency in exchange of one unit of the latter. A currency depreciates when the value of that currency in the world market decreases because of decrease in demand for that currency in the world market. Some of the reasons that cause this decrease in demand are low exports (means foreign buyers need less of the country's currency to pay for these exports), deterioration of the economic health of the country (means decrease in employment rates and per capita income, which reduces the demand for the country's goods and services causing a reduction in the demand for the country's currency), low interest rates in the country (thereby making it unattractive for people to invest money in the country as they earn lesser interest) etc.

The depreciation of Indian rupee against US dollar has been witnessed since quite some time now. The rupee has come under severe pressure and been the worst performing Asian currency after the Federal Reserve disclosed intention to withdraw quantitative easing. The rupee has depreciated around 21% since April to its record closing low of 68.80 to a dollar on August 28. Not only India, but other countries like turkey, Brazil, South Africa & Indonesia have also been worst affected. The currencies of all these countries have been depreciated after the Federal Reserve disclosed intention to withdraw quantitative easing (Table 1).

Table 1: International comparison of Depreciation of Emerging market currencies in 2013

Currency	Rate/$	% depreciation
Brazilian Real	2.41	17.6
Indian rupee	66.19	20.7
Indonesian Rupiah	10,900	13.1
South African Rand	10.41	23.0
Turkish New Lira	2.03	14.0

Source: Times of India, August 28, 2013

From the Indian experience it is clear that the factors responsible for fall of rupee were getting built over a period of time. Rising current account deficit, high inflation and policy paralysis were the factors that triggered fall in the value of rupee all on a sudden, though they got built gradually over a period of time.

Under this backdrop, this paper attempts to explain and analyze the depreciation of rupee and its probable reasons in the post reforms period i.e. from 1991 to 2013.

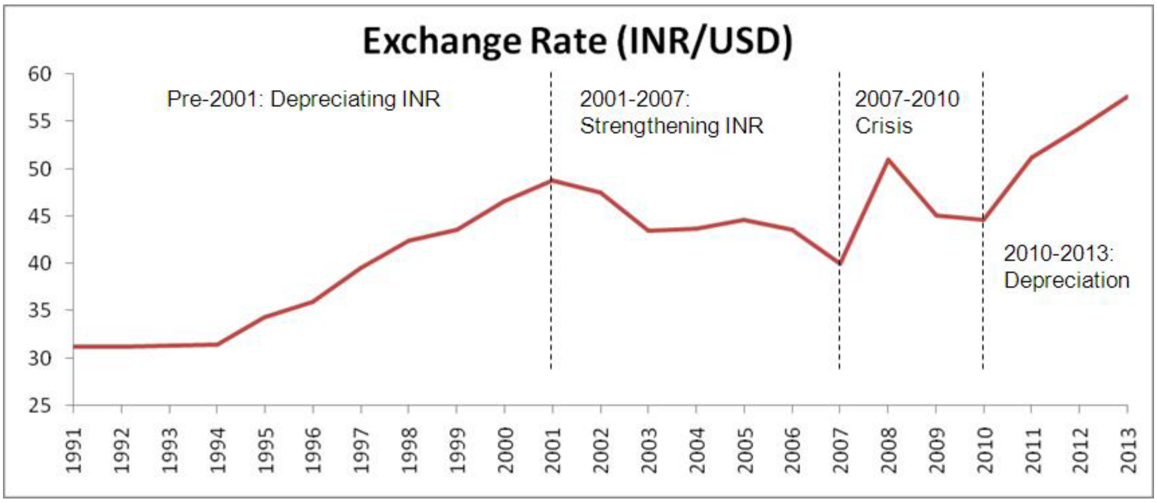
The post reforms period (1991 – 2013) has been divided into 4 distinct periods for analysis:

- Pre-2001: This period witnessed a characteristic depreciation of the rupee
- 2001-2007: This period enjoyed the appreciation phase of the rupee.
- 2007-2010: A period of uncertainty due to the global financial crisis. The rupee witnessed both appreciation and depreciation during this period
- 2010-2013: This period observed a sharp depreciation of rupee which has reached all time lows.

2. MOVEMENT OF RUPEE IN POST REFORMS PERIOD (1991-2013)

The movement of rupee from 1991 to 2013 is provided in the figure below.

Fig. 1: The movement of rupee from 1991 to 2013



Source: RBI website

Link http://thealphainvestor.files.wordpress.com/2013/06/inr-period.jpg as on 16-02-14

Before 1991, the Indian government was adopting a fixed exchange-rate system. However due to Balance of Payments crisis in 1990-91, the government had to shift to a floating exchange rate system to stabilize the foreign exchange market. India changed to Floating exchange system w.e.f. March, 1993(RBI Bulletins). While in a fixed exchange-rate system the worth of its currency is decided by the government concerned in terms of either a fixed weight of gold or a fixed amount of another currency or a basket of other currencies, in a floating exchange rate system the value of a currency is decided by market forces and not by the government.

Reserve Bank data shows that the period 1991-2001 shows a gradual depreciation of the rupee. The period 2001-2007 shows the appreciation phase of the rupee. 2007-2010 was a period of uncertainty due to the great crisis which had an extreme effect on the US dollar. However the period 2010-2013 has seen a sharp depreciation of rupee in terms of USD and the rupee has reached all time lows. The rupee has depreciated around 21% since April, 2013 to its record closing low of 68.80 to a dollar on August 28, 2013.

3. REASONS OF RUPEE DEPRECIATION

If we observe the period 1991-2013, it shows that the reasons for this rupee fall were both internal & external.

a) Internal reasons

i) Balance of payment crisis (1990-91)

ii) Shifting to Floating exchange rates (1993)

iii) Nuclear testing (1998)

iv) Persistent fiscal deficit and inflation ,

v) Indian politics and lack of reforms,

vi) Increasing CAD

b) External reasons

i) Gulf war (1991)

ii) The South-East Asian trade crisis (1997-98)

iii) Global Financial crisis,

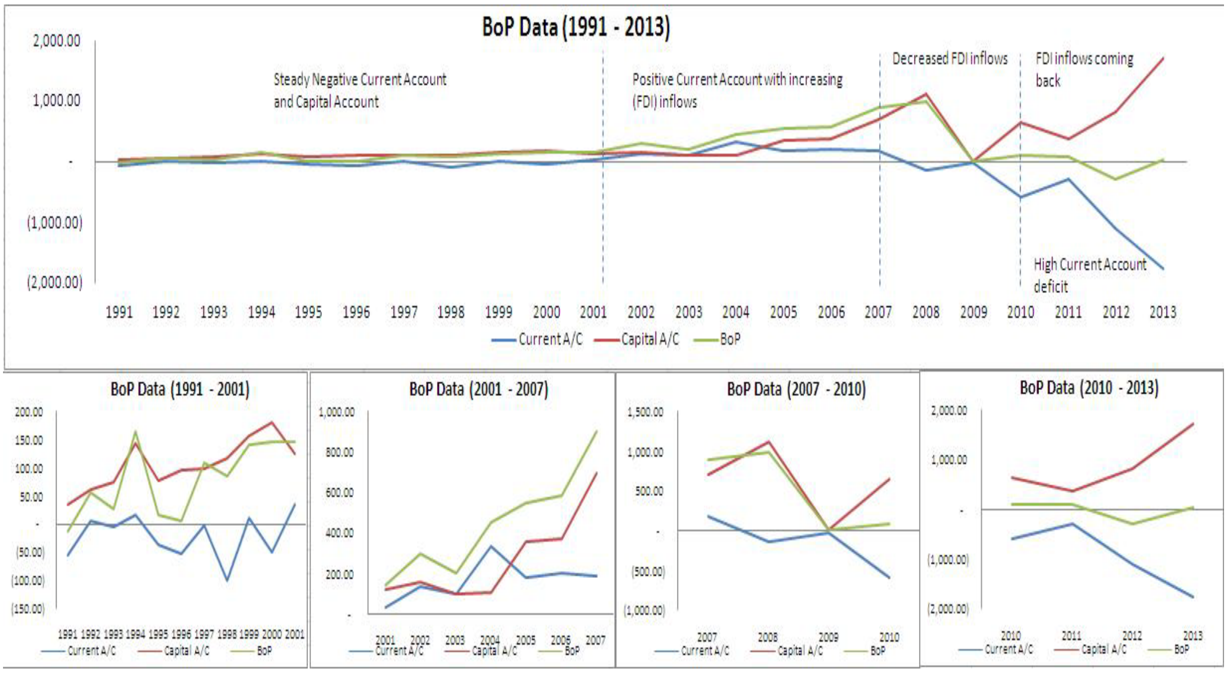
iv) US fed stimulus tapering

Whatever may be the factors, whether internal or external, their impact has ultimately been reflected in the BOP account of the country and ultimately on the value of rupee. India entered into the 1990s with a huge high current account deficit (about 3.2 per cent of GDP in 1990-91) mainly emanating from fiscal excesses of the previous decade (Jadhav, 2005). This harsh reality of the economy was exposed at the beginning of the 1990s by a spate of international events. The significant rise in oil prices, suspension of remittances from the Gulf region in the wake of the Gulf crisis, disruption of trade with the break-up of erstwhile Eastern Bloc, recessionary conditions in industrialized countries *etc*. were some of the events which led to severe balance of payments problems in India (Jadhav, 2005). The Gulf crisis led to a rise in oil import bill, partial loss of exports market in West Asia compounded by the drying-up of private remittances coming from that region. With the tightening of access to commercial banks and short-term credit, financing of the current account deficit became unsustainable leading to a crisis situation. To correct the situation, a series of steps were taken. Firstly, a two-step downward adjustment of 18-19 per cent in the exchange rate of the Indian rupee was made on July 1 and 3, 1991. The rupee depreciated against the US dollar from $ 1= Rs. 21.2 to Rs. 25.8 (RBI Annual Reports, EXIM Bank, 1993). This was followed by the Floating exchange rate system which was introduced by the government from March 1, 1993(RBI Annual Reports). It means the rupee was now subject to market forces and not controlled completely by the government. The result was obvious, the rupee started to depreciate. During The South-East Asian trade crisis in 1997-98, the current account deficit increased on the one hand from $4.6 billion to $5.5 billion, capital inflows declined from $11.4 billion to $10.1 billion on the other (Reserve Bank of India, Handbook of Statistics on Indian Economy, 2012-13), causing the rupee to depreciate. Another factor that led to rupee depreciation was reduction in foreign investments in India because of nuclear testing in 1998. With countries such as the U.S. and Japan imposing sanctions on India, capital inflows took a hit and rupee slid further. The combined effect of all these internal & external factors was that the rupee depreciated from about 17.9/$ in 1990-91 to about 45.7/$ in 2000-01 (Reserve Bank of India, Handbook of statistic on Indian Economy, 2012-13,).

While the beginning of the decade of 2000s witnessed marginal surpluses, from 2001-2004 India was running on current account surplus. The highest surplus was recorded in the year 2004 of 7.4 Billion US$ (www.rbi.org.in). During the period 2001-07, the Indian economy showed its marvelous performance on many fronts. While the IT sector showed an excellent performance in exports, flow of dollar in India was very high due to booming stock market. So the country enjoyed current account surplus on the one hand (for three successive years from 2001 onwards), it attracted huge amount of foreign capital inflows on the other showing solid positive entries in the capital account. Although the country faced current account deficit after 2004, the capital inflows were so strong to offset this meager deficit in the current account. Even during the US Financial crisis in 2007, the Rupee appreciated because the market saw the USD to be riskier and India continued enjoying foreign capital inflows. As a result rupee appreciated during 2001-08 from 45.7/$ in 2000-01 to 40.2/$ in 2007-08(RBI website)

However, this situation could not be sustained post 2008 crisis. Current Account Deficit began rising in the second half of the decade and almost hit the level of 3 per cent of GDP in aftermath of global financial crisis. During 2008-09 to 2010-11, although CAD was 2.7 per cent of GDP on an average, the situation didn't cause any stress as capital inflows have been more than adequate. The rupee was not affected during this period. Rather it appreciated from 47.4/$ in 2009-10 to 45.6/$ in 2010-11(Annual Average, Reserve Bank of India, Handbook of statistic on Indian Economy, 2012-13,). However, the situation deteriorated after 2011 as CAD exceeded the level of 4.0 per cent of GDP - 4.2% of GDP in 2011-12 & 4.8% of GDP in 2012-13 (Reserve Bank of India, Handbook of Statistics on Indian Economy, 2012-13). As a result rupee slid further from 45.6/$ in 2010-11 to 54.4/$ in 2012-13. (Annual Average, Reserve Bank of India, Handbook of statistic on Indian Economy, 2012-13). Finally the rupee stopped at 68/$ on 28th August, 2013. The trends in current account, capital account and Balance of Payment has been clearly shown in Fig.2

Figure 2: Movement of Balance of Payment account, current account & capital account during 1991-2013



Source: RBI website

Link: http://thealphainvestor.files.wordpress.com/2013/06/bop-data1.jpg as on 16-02-14

The RBI data shows that the reasons for this alarming increase in current account deficit after 2010 were also obvious. Import bill for petroleum and crude oil has been increasing from 2010 onwards. About 30% of India's energy needs are met by petroleum. But some 80% of this oil is imported — the major factor behind the country's ballooning trade and current account deficits.

The other compulsion that India has is to import coal. Although India has huge reserves of coal but due to environmental and other issues it is unable to explore its reserves to the full extent. This has lead to huge imports of coal by Power, Cement and steel manufacturers. With around 60 % to 70 % of the country's electricity being generated from coal, imports are expected to increase further in future due to domestic production constraints.

The next big cause of concern in Fertilizer imports. Due to huge regulation in the fertilizer segment India has been unable to increase its manufacturing capacity with the increasing demand. This has led to significant rise in fertilizer imports.

These three commodities would have a major impact on the CAD of the government. And finally, the announcement of Fed Tappering ultimately triggered the disaster and we saw the rupee tank.

4. STEPS TAKEN IMMEDIATELY BY THE GOVERNMENT & CENTRAL BANK

India took a lot of strong steps both on monetary and fiscal fronts to curb the free fall of rupee and she was more or less successful also in protecting the rupee from a further fall. The central bank worked to increase the inflows of dollar, the government tried to restrict the outflow of dollar.

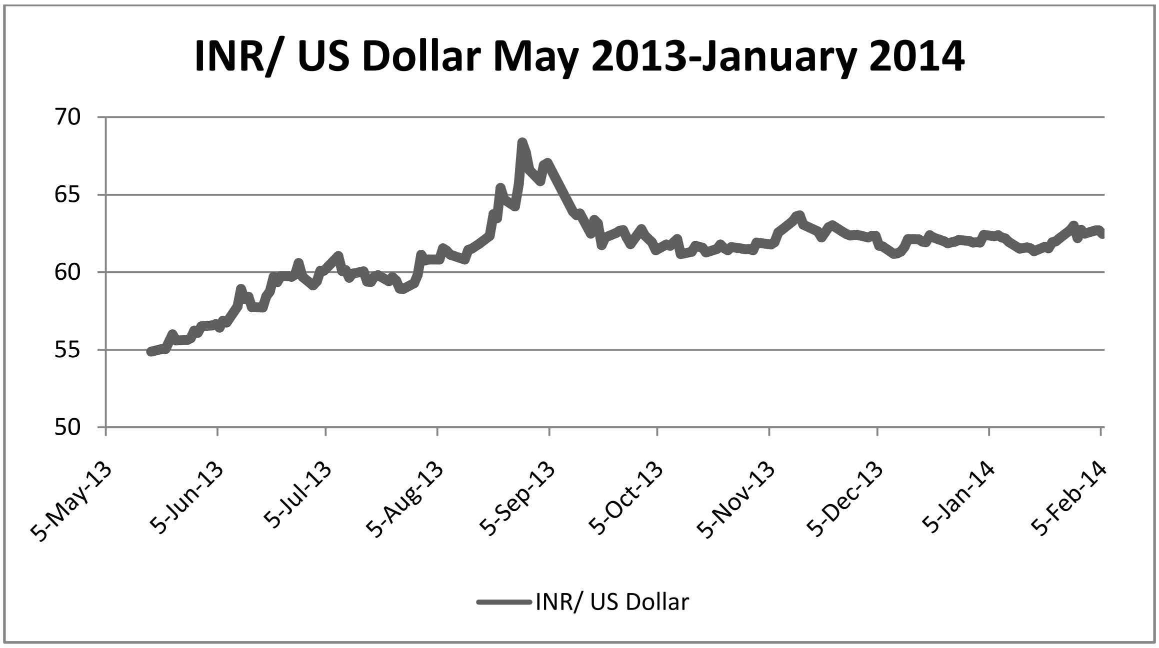
In monetary measures, The $34-billion (about Rs 2.1-lakh-crore) foreign assets that banks in India mobilized through the Foreign Currency Non-Resident (Bank), or FCNR(B), deposits from NRIs and banks' overseas borrowings partly helped strengthen the rupee from 69 to a dollar to the current level of above 62. And it is being hailed as a masterstroke by the RBI. (The Times of India, Dec. 9,2013).

At the same time, CAD also registered a significant fall after July 2013. With a pickup in the merchandise exports and a dip in imports, India's CAD shrank to 1.2 percent of GDP in July-Sept quarter of 2013-14, much lower than the CAD of 4.9 percent of GDP in the previous quarter (April-June 2013-14) (Business India, December 23, 2013 to January 5, 2014; p-38). CAD fell further to 0.9 percent of GDP in the next quarter i.e. October-December 2013-14, as compared to 6.5% for the same period a year earlier. (The Economic Times, March 6, 2014; p-7). The overall BOP ended in a surplus of $19.1 billion for the December 2013 quarter compared to a meager surplus of $781 million in December 2012. (The Economic Times, March 6, 2014 p-7).

India was highly appreciated for being successful in averting the disaster by taking strong measures both on monetary and fiscal front. Even IMF lauded India's ability to keep a tight rein on spending and its monetary policy (The Economic Times, Feb 21, 2014 p-13). Today our currency has been very stable. Unlike six months ago when India was at the forefront of the currency crisis, this time around India has had a rock solid currency and that is boosting investors' confidence. In 2014, most of the emerging markets - be it Argentina, Turkey, Korea or China – got hard hit, India seems to be outperforming this set. RBI's subsidy for NRI's US$ deposits here and curbs imposed by the government on gold imports resulted in India's CAD fell to its lowest in eight years (The Economic Times, March 6 ,2014 p-7).

It was due to the combined effects of Monetary & Fiscal Policy that the free fall of rupee was curbed and Rupee was ultimately stable at around 62/$ which is clearly highlighted in Figure 3. The fig 3 shows the movement of Indian rupee against US Dollar from 5th May 2013 to 5th Feb. 2014

Figure 3: Movement of Indian rupee against US Dollar May 2013-January 2014



Source: DBIE-RBI website of Indian Economy

5. CONCLUSION

Although India has managed to control its CAD and the rupee fall now, these measures are temporary which can't go a long way in solving the problems of CAD permanently.

In the recent G-20 meeting at Sydney in Feb, 2014, it was more or less clear that US was least bothered about the impact of their monetary policy on the economies of rest of the world. The US refused to accept Fed tapering decisions as the reason for the collapse of currencies of many developing countries including India. (The Economic Times, Feb. 21, 2014; p-8)

Even IMF pinned most of the blame for India's slowdown on domestic factors (The Economic Times, Feb 21, 2014 p-13). The need of the hour is to initiate strong structural reforms and not to depend on monetary policy alone. Corruption, poor governance in bureaucracy, poor infrastructure, underutilization of internal resources, poor manufacturing sector are some of the issues to be addressed immediately.

REFERENCES

1. Charles F. Kramer, Hélène K. Poirson, and A. Prasad(2008) **"**Challenges to Monetary Policy from Financial Globalization: The Case of India", IMF Working Paper WP/08/131
2. Dholakia , B.H. (1998), "Financial Crisis in East Asia: A Macroeconomic Perspective, Vikalpa,Vol. 23, No. 4, pp 35-50, October - December 1998
3. Jadhav, N. (2005), "Exchange Rate Regime And Capital Flows: The Indian Experience", Chief Economists' Workshop, April 4-6, 2005 Bank Of England
4. Mishra, S.(2011), "Has Our Monetary Policy Been Successful In Checking Inflation?" International Journal of Research in Finance & Marketing, Vol 2, issue 5, pp 10-15
5. Mohanty, D. (2011), "Monetary Policy Response to Recent Inflation in India" Speech delivered at Indian Institute of Technology (IIT), Guwahati on 3rd September, 2011
6. Subbarao, D. (2011), "Monetary Policy Dilemmas: Some RBI Perspectives**",** Comments at the Stern School of Business, New York University, September 26, 2011)
7. DBIE-RBI Database of Indian Economy, RBI Monthly Bulletin, August 12, 2013
8. RBI Handbook of Statistics on Indian Economy 2011-12
9. RBI Annual Reports

10. The Times of India, Dec. 9, 2013

11. The Times of India, August 28, 2013

12. The Economic Times, March 6, 2014

13. The Economic Times, Feb 21, 2014

14. Business India, December 23, 2013 to January 5, 2014

15. www.rbi.org.in

16. http://thealphainvestor.files.wordpress.com/2013/06/inr-period.jpg

17. http://thealphainvestor.files.wordpress.com/2013/06/bop-data1.jpg