IJCSMS International Journal of Computer Science and Management Studies Vol. 13, Issue 06, August 2013
ISSN: 2231-5268
www.ijcsms.com

Impact of Rupee- Dollar Fluctuations on Indian Economy: Challenges for Rbi & Indian Government

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Abstract

This paper explores the impact of Rupee – Dollar fluctuation on Indian economy. The circumstances which has been created for the economy due to depreciation of rupee against dollar reveals that there has been a strong and significant negative impact of this currency volatility on many sectors. After Lehman Brother Crisis (2008) again year 2013 reported consequently some toughest move for RBI & Indian govt to defend rupee against dollar. During the six month Indian rupee weakens many times and reached to a level of 61.045 for a dollar. Since May, 2013 the local currency lost around 15 percent to the US currency. Indian economy which already suffered from large fiscal and current account deficit adversely affected by relatively exchange rate pressure. To track it again on the way many hard decisions were taken by RBI and Indian govt. This paper presents different challenges due to these fluctuation and steps triggered by central bank and govt to create stability.

Keywords: *Impact of Rupee, Dollar Fluctuations.*

Introduction

Exchange rate between two currencies is that rate at which one currency will be exchanged with another currency. It is also known as a **foreign-exchange rate**, **forex rate**. It is regarded as the value of one country's currency in terms of another currency.[I] The **spot exchange rate** is the current exchange rate. The **forward exchange rate** is that exchange rate which is quoted today but delivery and payment settlement will be held on a specific future date. A market-based exchange rate will change whenever the values of either of the two component currencies change. A currency tends to become more valuable whenever demand for it is greater than the available supply

Indian rupee was connected to British pound from 1950 to 1973. On 24th September 1975, the connection between Indian rupee and pound was broken down and rupee ties to the pound sterling were disengaged. A float exchange regime was established by India. Effective rate of rupee was placed on a controlled, floating basis and linked to a "basket of currencies" with trading partners of India. In 1993 Liberalized exchange rate system (LERMS) was replaced by the unified exchange rate system and a system of market determined exchange rate was adopted. However, the RBI did not relinquish its power to intervene in the market to control the Indian currency.

In India a series of economic reforms including liberalization of foreign capital inflows were initiated since the early nineties. Foreign exchange market has emerged as the largest market in the world and the breakdown of the Bretton Woods system in 1971 marked the beginning of floating exchange rate regimes in several countries. The focus was given to wide ranging reforms of widening and deepening the foreign exchange market and liberalization of exchange control. The Forex rates are determined by market forces and are based on demand & supply of these currencies. If supply exceeds the demand, the value of the currency depreciates.

Objectives of the Study

1) To understand the concept of Exchange rate and currency fluctuation.
2) To understand the causes for decline of the rupee against dollar.
3) To study the real implications of the depreciation of the rupee on the Indian economy
4) Different stringent measures by RBI & government to make rupee stronger
5) To propose potential suggestions to overcome the problem.

Concept of currency Appreciation and Depreciation

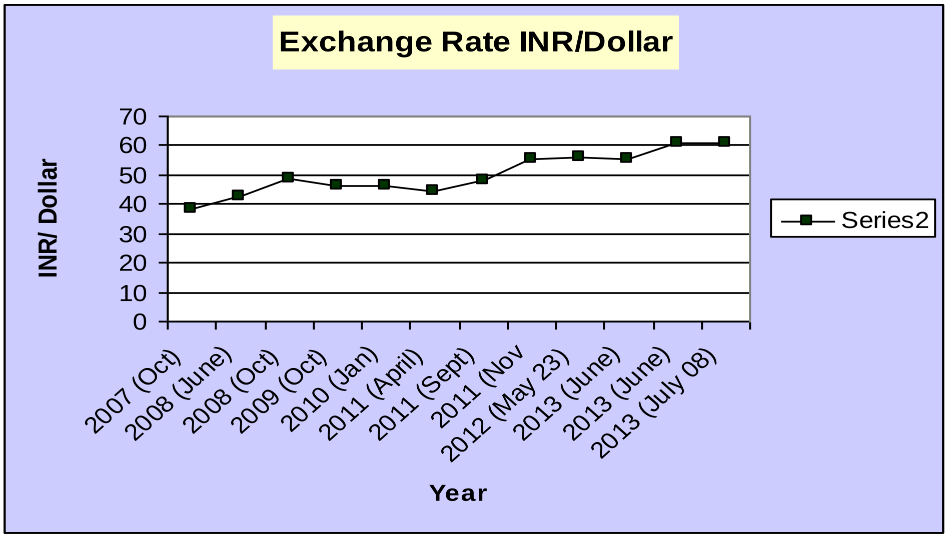
Impact on	It is called *Rupee DEPRECIATON* when value of a rupee declines as compare to dollar (For an example, when US$-INR moves from Rs.55/- to Rs60/	*Rupee APPRECIATES* when value of a rupee becomes high as compare to dollar (For example, when US$-INR moves from Rs60/- to Rs 55/-
Importers	Imports become costly as for each USD we have to pay Rs5/- more IMPORTS BECOME COSTLIER	Imports become cheaper as for each USD we have to pay Rs5 less IMPORTS BECOME CHEAPER
Exporters	Exporters will have higher revenue. For exports of each Dollar, the exporter will get Rs 5 higher EXPORTERS EARN MORE	Exporters will earn lower revenue. For exports of each dollar, now the exporter will get Rs 5 less. EXPORTERS EARN LESS
Indian Who Wish to Go on Holidays Abroad and for Education	For each dollar taken abroad for spending, the travelers has to pay Rs 5 more and thus this trip will become costlier Education & Holiday packages will COSTLIER	For each dollar he intends to take abroad for spending, the travelers has to pay Rs3 less and thus this trip will become cheaper. Education and Holiday packages will CHEAPER

Sinking Rupee as a big danger for Economy

The prevailing situation is creating internal as well as external threats for the economy. India may face worst financial crisis if it fails to stop the slide in the rupee. There is a difficult choice for central bank to best use its limited reserve and maintain the reliability among foreign investors. The table is showing the continuous depreciation of Indian rupee with US dollar.

Exchange Rate INR/ USD

2007 (Oct)	2008 (June)	2008 (Oct	2009 (Oct)	2010 (Jan)	2011 (April)	2011 (Sept)	2011 (Nov)	2012 (May 23)	2013 (June 22)	2013 (Jun 27)	2013 (July 08)
38.48	42.51	48.88	46.37	46.21	44.17	48.24	55.395	55.99	55.52	60.58	61.045



Source: on the basis of RBI exchange rate data.

There are many reasons due to which this critical situation came in to economy and grabbed more attention of RBI and Indian govt. towards this scenario. Some of the reasons are mentioned below. A number of factors can cause currency depreciation, i.e. economic, political, corruption etc., but some factors require greater attention and should be analyzed objectively than the others.

1. Dollar On A Strong Position in global market

The main reason behind rupee fall is the immense strength of the Dollar Index, which has touched its three-year high level of 84.30. The record setting performance of US equities and the improvement in the labor market has made investors more optimistic about the outlook for the US economy.

2. Recession in the Euro Zone Is Back on the move:

The rupee is also feeling the pinch of the recession in the Euro zone. From the past few months global economy is suffered from Euro crisis, investors are focused on selling Euros and buying dollars. Any outward flow of currency or a decrease in investments will put a downward pressure on the rupee exchange rate.

3. Decreasing rating by Rating Agencies & slow growth projection by IMF

Due to uncertainty prevailing in Europe and the slump in the international markets, investors prefer to stay away from risky investments. The credit rating agency such as Moody has downgraded the India to BBB with a negative outlook. IMF also signed 5.6% growth rate for the economy. This global uncertainty has adversely impacted the domestic factors and could lead to a further depreciation of the rupee.

4. Pressure of increasing Current Account Deficit:

The country with high exports will be happier with a depreciating currency India, on the other hand, does not enjoy this because of crude oil and gold consist a major portion of its import basket. Euro zone, one of India's major trading partners is under a severe economic crisis. This has significantly impacted Indian exports because of reduced demand. Thus India continues to record a current account deficit of around 4.3%, depleting its Forex reserves.

5. Impact of Commodity Prices in Global Market

As there was a sharp fall in the commodity prices (of gold and crude oil) in global market still a large part of the import bill is driven by other resources as well. The facts show that fertilizer imports surged by 30% in the last two years and coal imports have doubled. The falling commodity prices on the other hand have increased imports resulting in an imbalance in the rupee value.

6. Speculations from Exporter and Importer side.

The reason of fall in rupee can be largely attributed to speculations prevailing in the markets. Due to a sharp increase in the dollar rates, importers suddenly started gasping for dollars in order to hedge their position, which led to a further demand for dollars. On the other hand exporters kept on holding their dollar reserves, speculating that the rupee will fall further in future. This interplay between the two forces further fuelled the demand for dollars and a fall in rupee.

7. Unattractive Indian Market

FII's are a good source of dollars inflow into the Indian market. As per a recent report, the share of India's FII in the developing markets has decreased considerably. Unsuccessful auction of 2G have further rendered the Indian market unattractive for foreign investors. Strict political policies are also reasons of such lack of appeal.

8. Interest Rate Difference:

Higher real interest rates generally attract foreign investment but due to slowdown in growth there is increasing pressure on RBI to decrease the policy rates. Under such conditions foreign investors tend to stay away from investing. This further affects the capital account flows of India and puts a depreciating pressure on the currency.

9. Persistent inflation:

India has experienced high inflation, above 8%, for almost two years. If inflation becomes a prolonged one, it leads to overall worsening of economic prospects and capital outflows and eventual depreciation of the currency.

10. Lack of reforms:

Key policy reforms like Direct Tax Code (DTC) and Goods and Service Tax (GST) have been in the pipe line for years. A retrospective tax law (GAAR) has already earned a lot of flak from the business community. This has further made investors sentiment negative over the Indian economy.

Challenges in Front of RBI and Indian Govt.:

- **Bank rate :** Due to these fluctuation bank rate raised from 8.25% to 10.25% and Limit of lending overnight borrowing from RBI fixed to Rs75000cr. This was again a problem as cost of short term borrowing rise for corporate. This was done to tame inflationary expectations. So further raising interest rates would lead to lower growth levels.

year	Bank Rate
2/4/2000	7
22-07-2000	8
17-02-2001	7.5
2/3/2001	7
23-10-2001	6.5
30-10-2002	6.25
30-04-2003	6
14-02-2012	9.5
17-04-2012	9
29-01-2013	8.75
19-03-2013	8.5
3/5/2013	8.25
16-07-2013	10.25

- **Forex Reserves:** RBI can sell forex reserves and buy Indian Rupees leading to demand for rupee. But using forex reserves poses risk also, as using them up in large quantities to prevent depreciation may result in a deterioration of confidence in the economy's ability to meet even its short-term external obligations
- **Make Investments Attractive- Easing Capital Controls:** RBI can take steps to increase the supply of foreign currency by expanding market participation to support Rupee. RBI can increase the FII limit on investment in government and corporate debt instruments. It can invite long term FDI debt funds in infrastructure sector. The ceiling for External Commercial Borrowings can be enhanced to allow more ECB borrowings.
- **Increasing burden of servicing and repaying of foreign debt**: A major drawback of depreciation in the value of rupee is that it will enhance the burden of servicing and repaying of foreign debt of Indian Government (which has dollar denominated debt) and those companies that has raised dollar denominated debt. Most of the foreign loans which are denominated in dollars, will create a burden of costly short term debts with immediate effect.

Suggestions

- Government should take some measures to bring FDI and create a healthy environment for economic growth to loosen rules for portfolio investment in the Indian market, indicating its desire to sustain external inflows.
- There should be a ban on banks from taking proprietary position on currency future or currency options.
- The key to tackling the issue lies in attracting sufficient foreign flows and the best way of doing that is to make India an attractive destination with long term variety.
- Liberalising FDI ceilings is another way to face this situation with minimising procedural hassles and creating necessary infrastructure to make it easy to do bussiness.
- More and more plans should be launched for sovereign bond issue. It will raise the position of rupee in foreign market.
- Key policy reforms such as rolling of Goods and Services Tax (GST), Direct Tax Code (DTC), FDI in aviation and retail, Companies Bill and diesel decontrol should be initiated properly.
- Policies should be announced by govt for targeting a band for the rupee fluctuations.

Conclusion

The fall in the value of currency not only affects the pride of a nation, but also affects a lot of economic growth indicators. Depreciation of rupee reduces the inflow of foreign capital, rise in the external debt pressure, and also grow India’s oil and fertilizer subsidy bills. The most positive impact of depreciation of rupee is the stimulation of exports and discouraging imports and thus improving the current account deficit. But, even after significant increase in the exports and sales in this year, Indian companies are reporting huge foreign exchange losses due to the depreciation of Indian rupee. This declines the overall profitability of these companies. As far as imports are concerned, for a country such as India, imports are necessary.

Grim global economic outlook along with high inflation, widening current account deficit and FII outflows have contributed to this fall. RBI has responded with timely interventions by selling dollars intermittently. But in times of global uncertainty, investors prefer USD as a safe haven. To attract investments, RBI can ease capital controls by increasing the FII limit on investment in government and corporate debt instruments and introduce higher ceilings in ECB’s. Government can create a stable political and economic environment. However, a lot depends on the Global economic outlook and the future of Eurozone which will determine the future of INR. As far as future of rupee is concerned, it is expected that there will be a reverse trend with the steps adopted by central bank but it will impact for short term only.

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