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The Recent Depreciation of the INR against the USD: An Analysis of Currency Fluctuations

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Abstract

The exchange rate of the USD against the INR had been roughly steady at around 45.00 for a long period, until the subprime crisis of 2008. But post the crisis, some effects of the crisis, as well as some effects of the responses by regulatory authorities all over the world to the crisis led to a fluctuation in the currency exchange rates, causing it to go to almost as high as 70 over the past year. This has had serious ramifications for the Indian economy, as the US Dollar is one of the most widely used global currencies. This article tries to delve deep into the global economic environment after the crisis and analyze the various factors responsible for this significant fluctuation and depreciation in the value of the Indian Rupee against the US Dollar

Keywords: Recent, depreciation, INR USD currency, fluctuations.

Introduction

Over the past few months, the rupee had depreciated to an all-time low, hitting nearly one-seventieth of the US Dollar. The rupee was never highly valued in comparison to the dollar, but this sudden decrease in value has been a cause for concern as it has been consistent over the past 8 months.

There are many factors that affect foreign exchange rates – political situations, the availability of natural resources, value of education, wars, production levels, etc., but the main mechanism responsible is that of supply and demand. All the above factors, in some way, affect the supply or the demand of the currency, and this change invariably causes a change in the value of the currency.

A currency, whose value in the foreign exchange market is determined only by the supply and demand, is referred to as a floating exchange rate. In India, the central bank (RBI), buys and sells currency to stabilize its value, and protect people from the impact of immediate shocks. For example, if a particular wealth or hedge fund manager predicts a reduction in the rupee value and shorts the currency in massive amounts, then the RBI intervenes and buys back a large amount of the currency so as to limit the amount of devaluation caused[1].

Factors leading to the significant depreciation of the Inr against the USD

The Import-Export Imbalance: India imports a large amount of goods and services. Gold is one of the majorly imported commodities. India also imports a lot of coal, despite having the fourth-largest coal reserves in the world. This is because these reserves are not being used, due to issues regarding environment clearances. Exports are not high because production in India is of low quality due to lack of technological advancements, and Indian producers are unable to compete with the quality of foreign goods and services[2].Hence India's import value exceeds its export value by a large amount, thereby increasing the Current Account Deficit[3]. This increase in the deficit has propelled the value of the rupee downward to some extent. The initially caused INR devaluation also had a downward impact on the exports, further in-turn aggravating the situation[4].

Tapering of Quantitative Easing By The Us Federal Reserve: Quantitative Easing was initiated by the US Federal Reserve, and had reduced the cost of the US Dollar. There was higher scope for growth opportunities for investments in the emerging markets as a consequence[5]. Many investors during this time, invested in the emerging markets in search of higher returns than was available in the developed economies[6]. When the Federal Reserve announced tapering of the QE, these investors withdrew their investments, leading to heavy currency depreciation due to a surplus in supply.

USD on an All-Time High Due to Global Uncertainty: The performance of US equities had been on a record setting high, and the improvements in the labor market have also made people optimistic about the US. During this time, there was an economic crisis among major European countries, which was popularly known as the Euro-zone crisis[7]. As a result, the monetary policies were more along the lines of aggressive monetary easing measures such as introducing negative deposit rates[8]. Hence the US dollar looks like a very safe investment haven for investors.

Lower Than Expected Growth: The high growth rates in India had been attracting a lot of foreign investors in the past.But in the recent months, there has been a slowdown in growth[9]. Reducing the interest rates so as to accelerate growth may give a boost to inflation, which is currently at very high levels in the country[10].

Persistent Inflation: India has been experiencing nearly 8% inflation over the last two years.The Real Effective Exchange Rate (REER) index has fallen by 13.84% during the last year for India, it has fallen by 24%. REER index measure includes the level of inflation differences across nations; it reflects a country's competitiveness in international trade. Normally, such high levels of inflation are controlled by increasing interest rates. But this option may not work in the Indian circumstances, because the Indian interest rates are already very high, and increasing them further would affect the already declining growth rates.

Lack of Reforms: The Direct Tax Code (DTC), Goods and Service Tax(GST) and other key policy reforms have been waiting for years.The business community has strongly opposed the retrospective tax law (GAAR). Fiscal deficit is around 5% of GDP, a very high number by historical standards, despite attempts to control the subsidy bills. Investor sentiment has also been affected by a high level of opposition to the government’s change in FDI policy, both from opposition and allies.

A stable growth rate balanced with controlled inflation, and supported with steady and consistent government policies are likely to improve the investment climate in the country, and ensure that the INR is stable. There are a few steps the RBI can take, moving forward:

Forex Reserve Trading: The RBI can sell foreign exchange reserves and buy Indian rupee currency in large amounts, leading to an increase in the demand for the INR. But this involves a risk, as using forex reserves to buy Indian currency might result in loss of confidence in the ability of the government to pay off its short term obligations. Not using forex reserves to buy Indian currency at all on the other hand, might make the foreign exchange rate spiral out of control. There is a need to find a balance between the two, as both outcomes are not favorable.

Raising Interest Rates: Increase in interest rates might encourage foreign investors to invest in India, hence increasing the capital inflows. The problem here is that the interest rates are already very high, and hence increasing it further might reduce the already low growth rates even further. Nevertheless, a significant improvement in foreign investments could prove as the much needed fuel for the Indian economy[11].

Easing Capital Controls: India can encourage foreign investors to invest by increasing the market participation to support rupee. An increase in the limits in FII in corporate and govt. debt instruments might help this. The ceilings on external commercial borrowings can also be enhanced[12].

Conclusion

The global economic environment is going through a transition phase post the sub-prime crisis of 2008. The emerging markets in Asia have a very significant role to play in this period, and good policy-making and governance is very essential to make this transition smooth, and ensure the economic prosperity of India on the global scenario.

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