INDIAN RUPEE & INTERNATIONAL CURRENCY FLUCTUATION EXCHANGE RATE: IT'S IMPACT ON INDIAN ECONOMY

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Abstract:

This Article explores the impact of Rupee-Dollar fluctuation on Indian economy. The circumstances which have been created for the economy due to the depreciation of rupee against dollar reveals that there has been a strong and significant negative impact of this currency volatility on many sectors. The relationship between the values of local currencies in terms of foreign currencies and export competitiveness of any country is very complex. This relationship will become more complex if there is the heavy dependence on imported resources in the exported products. During last the one year Indian rupee weakens many times and reached to a level of 64.048 for a dollar in January 2017. Since January 2015, the local currency lost around 13 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 Indian govt. This paper presents different challenges due to these fluctuation and steps triggered by the central bank and government to create stability.

Keywords: Impact of Rupee, Dollar Fluctuations, Exchange Rate, Govt. Policies.

Introduction:

Currency fluctuations are a natural outcome of the floating exchange rate system that is the norm for most major economies. The 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. Exchange rate of one currency versus the other is influenced by numerous fundamental and technical factors. These include relative supply and demand of the two currencies, economic performance, outlook for inflation, interest rate differentials, capital flows, technical support and resistance levels, and so on. As these factors are generally in a state of perpetual flux, currency values fluctuate from one moment to the next. But although a currency's level is largely supposed to be determined by the underlying economy, the tables are often turned, as huge movements in a currency can dictate the economy's fortunes.

Objectives:

The main objective of this study is to understand the concept of Exchange rate and currency fluctuation and understand the causes for decline of the rupee against dollar. Study the real implications of the depreciation of the rupee on the Indian economy and also different stringent measures by Indian government to make rupee stronger.

Background of India's exchange rate policies:

India presents a unique case for studying the impact of exchange rate movements. Prior to the Balance of Payments crisis in 1991, Indian Rupee was pegged to a basket of currencies dominated by the US Dollar. The external payment crisis of 1991 forced the Reserve Bank of India (RBI) to implement a set of market-oriented financial sector reforms, and a paradigm shift from fixed to market-based exchange rate regime in March 1993. Institution of Current Account convertibility in August 1994, gradual liberalization of the Capital Account along with other trade and financial liberalization measures meant a rise in total turnover in the foreign exchange market by more than 150% (from $73.2bn in 1996 to $130bn in 2002-2003, and further to $1,100bn in 2011-2012). A direct outcome of these changes has been a rise in the volatility of Indian Rupee.

Against this backdrop, RBI's exchange rate management policy has aimed at maintaining orderly conditions in the foreign exchange market by eliminating lumpy demand and supply and preventing speculative attacks, without setting a specific exchange rate target. Towards this end, RBI has used a combination of tools including sales and purchase of currency in both the spot and the forward segments of the foreign exchange market, adjustment of domestic liquidity through the use of Bank Rate, Cash Reserve Ratio (CRR), Repo rate etc., and monetary sterilization through specialized instruments. An interesting feature of RBI's intervention during this period has been asymmetry during episodes of appreciation and depreciation. RBI has been intervening actively in the foreign exchange market during episodes of Rupee appreciation by purchasing foreign exchange, while following a hands-off approach during episodes of Rupee depreciation.

Fluctuations of Currency:

A market-based exchange rate will change whenever the values of either of the two component currencies change. A currency becomes more valuable whenever demand for it is greater than the available supply. It will become less valuable whenever demand is less than available supply (this does not mean people no longer want money, it just means they prefer holding their wealth in some other form, possibly another currency).

Increased demand for a currency can be due to either an increased transaction demand for money or an increased speculative demand for money. The transaction demand is highly correlated to a country's level of business activity, gross domestic product (GDP), and employment levels. The more people that are unemployed, the less the public as a whole will spend on goods and services. Central banks typically have little difficulty adjusting the available money supply to accommodate changes in the demand for money due to business transactions.

Currency Fluctuations Impact on the Economy:

Currency fluctuations are a natural outcome of the floating exchange rate system that is the norm for most major economies. The exchange rate of one currency versus the other is influenced by numerous fundamental and technical factors. These include relative supply and demand of the two currencies, economic performance, outlook for inflation, interest rate differentials, capital flows, technical support and resistance levels, and so on. As these factors are generally in a state of perpetual flux, currency values fluctuate from one moment to the next. But although a currency's level is largely supposed to be determined by the underlying economy, the tables are often turned, as huge movements in a currency can dictate the economy's fortunes. In this situation, a currency becomes the tail that wags the dog, in a manner of speaking.

A currency's level has a direct impact on the following aspects of the economy:

Merchandise trade: This refers to a nation's international trade, or its exports and imports. In general terms, a weaker currency will stimulate exports and make imports more expensive, thereby decreasing a nation's trade deficit (or increasing surplus) over time.

Economic growth: The basic formula for an economy's GDP is C + I + G + (X – M) where:

C = Consumption or consumer spending, the biggest component of an economy

I = Capital investment by businesses and households

G = Government spending

(X – M) = Exports minus imports, or net exports.

From this equation, it is clear that the higher the value of net exports, the higher a nation's GDP.

As discussed earlier, net exports have an inverse correlation with the strength of the domestic currency.

Capital flows: Foreign capital will tend to flow into countries that have strong governments, dynamic economies and stable currencies. A nation needs to have a relatively stable currency to attract investment capital from foreign investors. Otherwise, the prospect of exchange losses inflicted by currency depreciation may deter overseas investors.

Capital flows can be classified into two main types – foreign direct investment (FDI), in which foreign investors take stakes in existing companies or build new facilities overseas; and foreign portfolio investment, where foreign investors invest in overseas securities. FDI is a critical source of funding for growing economies such as China and India, whose growth would be constrained if capital was unavailable.

Inflation: A devalued currency can result in "imported" inflation for countries that are substantial importers. A sudden decline of 20% in the domestic currency may result in imported products costing 25% more since a 20% decline means a 25% increase to get back to the original starting point.

Interest rates: As mentioned earlier, the exchange rate level is a key consideration for most central banks when setting monetary policy. A strong domestic currency exerts a drag on the economy, achieving the same end result as tighter monetary policy (i.e. higher interest rates).

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 (RBI exchange rate data).

Table 1. Exchange Rate INR/ USD

2006 (April)	2007 (April)	2008 (April)	2009 (April)	2010 (April)	2011 (April)	2011 (Aug.)	2011 (Dec.)	2012 (April)
45.15	41.04	39.85	49.96	44.64	44.52	45.249	54.235	51.659

2012 (Aug.)	2012 (Dec.)	2013 (April)	2013 (Aug.)	2013 (Dec.)	2014 (April)	2014 (Aug.)	2014 (Dec.)	2015 (April)
55.989	54.629	54.626	61.819	62.102	60.262	61.058	62.652	62.402

2015 (Aug.)	2015 (Dec.)	2016 (April)	2016 (Dec.)	2017 (August)	2017 (Dec.)
65.22	67.043	66.666	67.832	63.997	64.281

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.

Dollar on A Strong Position in global Market: The main reason behind rupee fall is the immense strength of the Dollar Index. 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.

Recession in the Euro Zone: 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.

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.

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.

Unattractive Indian Market: Foreign Institutional Investor's (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. Strict political policies are also reasons of such lack of appeal.

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

Challenges in Front of Indian Government:

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.

Policy implications:

For policymakers trying to assess the impact of exchange rate movements on the real economy, these results provide various important insights. Firstly, the short-run impact of a real depreciation on firm's output growth is likely to be negative since it is the import cost channel that dominates in the short run. Further, the impact is asymmetric, with real depreciation having a stronger impact as compared to real appreciation.

At the same time, maintaining a competitive real exchange rate is imperative for boosting intermediate and long-term economic growth and maintaining the external balance. Thus, using scarce foreign exchange reserves to prevent currency depreciation in the face of sustained downward pressure on the currency due to growing fiscal deficit and/ or massive capital outflows would be problematic, apart from being unsustainable.

On the whole, for countries relying on volatile foreign capital inflows to finance their consumption and investment needs, a careful reserve management policy along with a sound fiscal policy are necessary to balance the multiple objectives of stable growth and external sector balance in the long run.

Conclusion:

Currency moves can have a wide-ranging impact not just on a domestic economy, but also on the global one. Investors can use such moves to their advantage by investing overseas or in U.S. The fall in the value of currency 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.

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