

# Depreciation of the Indian Currency: Implications for the Indian Economy

**Abstract:** The Indian currency has depreciated by more than 20 per cent since April 2008 and breached its crucial 50-level against the greenback on sustained dollar purchases by foreign banks and stronger dollar overseas. The fall in the value of Indian rupee has several consequences which could have mixed effects on Indian economy. But, mainly, there are four expected implications of falling rupee. First, it should boost exports; second, it will lead to higher cost of imported goods and make some of the capital intensive projects more expensive to execute; third, it will increase the cost of dollar loans taken by companies and increase the foreign debt and fourth, it will slow-down the overall economic growth by increasing the interest rate and dissuade flow of FIIs. This paper studies the real implications of the depreciation of the rupee on the Indian economy and shows that in the long run, the Indian economy has more to lose and less to gain with weaker rupee.

**Keywords:** Depreciation, Rupee, Dollar, FIIs, RBI

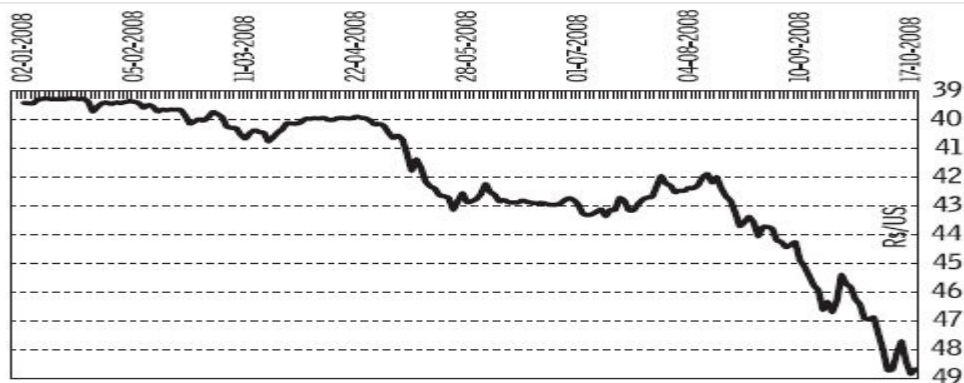
**JEL Codes:** G01; G18; E22; E31

The outlook for the Indian currency (INR) has gone through a drastic change in the last few months. The sudden upsurge in the value of Indian rupee in the closing of the financial year 2006-07, which took most market players by surprise and proved one of the best performing Asian units, has now lost its ground and suffered one of its steepest slides versus the greenback. On April 16, 2007, the rupee quoted its nine year high against the dollar at 41.86. Surprisingly at the end of May 2007, the dollar strengthened quite significantly against almost all currencies, but failed to impress the rupee. By mid-October, the Indian rupee had appreciated by 20 percent from Rs.49 a dollar 2002 to Rs 39 a dollar. Most of the appreciation (11 percent) has occurred since March 2007 (Sumanjeet, 2008). While economists and experts were predicting an even stronger rupee in 2008, the trend reversed since the beginning of this year. The rupee has depreciated<sup>1</sup> more than 20 percent in 2008. The massive 20 per cent depreciation of Indian rupee in the current fiscal year against the US dollar can be divided into four distinct phases: In April, rupee/dollar hovering around 40; end -April to mid May, sharp depreciation of 5 per cent-rupee reaches around 42 within two weeks; mid May to August: rupee remained broadly within 42-43; and August onwards rupee again depreciating more than 11 per cent till mid October. Graph 1 indicates the declined value of Indian rupee to US dollar.

## Graph1: Depreciation of Indian Rupee since the Beginning of 2008

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<sup>1</sup> Currency depreciation is the loss of value of a country's currency with respect to one or more foreign reference currencies, typically in a floating exchange rate system. It is most often used for the unofficial increase of the exchange rate due to market forces, though sometimes it appears interchangeably with devaluation. Its opposite is called appreciation.



On October 17, the Indian rupee fell to its lowest in more than 6 years. The Indian rupee ended at 48.8775 on 25<sup>th</sup> June 2002 and almost same (48.88) as on October 17, 2008. On 22 October, the rupee fell as low as 49.50, at which point it was down 20.4 percent in 2008. The rupee on 24<sup>th</sup> October breached its crucial 50-level against the greenback on sustained dollar purchases by foreign banks and stronger dollar overseas. The rupee tumbled to 50.05 levels after resuming weak at 50.00/01 a dollar ahead of Reserve Bank's mid-term review of monetary policy<sup>2</sup> later in the day. Interestingly, the rupee has depreciated against the dollar more than most other currencies in Asia in 2008-09. Table 1 indicates the moment of Asian currencies' against the US dollar in 2008-09.

**Table 1: Moment of Asian Currencies against the US Dollar**

Selected Asian Countries		Value of Currency	
Jan. 2008	Sept. 11, 2008	% Changes	
Korean Won	936.95	1109.20	-24.77
Thai Baht	29.75	34.78	-18.38
Indian Rupee	39.44	45.53	-16.91
Malaysian Ringgit	3.31	3.47	-15.45
Indonesian Rupiah	9368.00	9440.00	-4.83
Singapore Dollar	1.44	1.45	-0.54
Hong Kong Dollar	7.81	7.80	0.17
Taiwan Dollar	32.45	32.08	1.67
Japanese Yen	109.66	106.58	1.16

Further, it has been observed that Indian currency has depreciated not only against the US dollar in 2008, but also against the other strong currencies like Euro and Yen. On January 1, 2008,

<sup>2</sup> Following are the highlights of the mid-term review of the RBI's monetary policy for 2008-09: 1. CRR kept unchanged at 6.5 per cent. 2. Repo, reverse repo rates kept unchanged at 8 per cent and 6 Per cent respectively, 3 Bank rates unchanged at 6 per cent. 4 GDP projections lowered to 7.5-8 per cent for FY 09 5. Inflation to be brought down to 7 per cent by March 2009, 6. RBI aims to bring inflation down to 5 per cent at the Earliest, 7 Medium term inflation target 3 per cent., 8 Double-digit inflation still a matter of concern, 9 Enough liquidity in the banking system after recent infusion.

Indian rupee opened at 57.51 and 35.29 against the Euro and Yen (This moment is against 100 Yen) respectively and ended at 67.95 and 43.85 on September 26, 2008. Thus, the Indian rupee has shed more than 15 per cent against the Euro and Yen since the beginning of the year.

### **Causes of Depreciation of Indian Rupee**

As Indian currency has sharply depreciated not only against the US dollar, but also against the other currencies of the world, it is imperative to understand the factors contributing to depreciation of Indian rupee in the global market. A myriad 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. There are four key factors behind the recent depreciation: (Akinlo, E. A. 2003) flight of foreign funds from the Indian market; (Dagar, S. Shalini 2008) slowdown in the capital inflows, which decreases the supply of dollar (Iyer, Shriram 2008) higher global crude oil prices, which widen the current account deficit and also increase dollar buying by oil companies and (Jaleel, K. Tania 2008) recovery of US dollar.

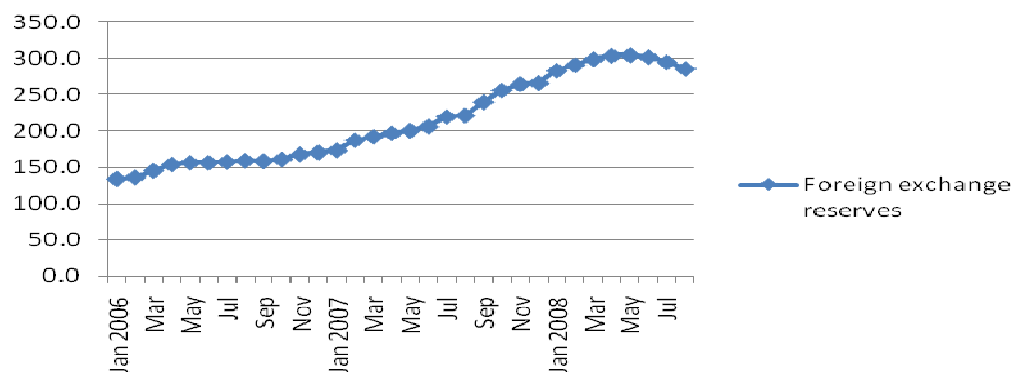
First, the main reason behind the fall in the value of rupee is flight of foreign funds from the Indian market. Since the May 2008 to August 2008, foreign exchange reserves are down as much as \$ 25.87 billion taking into account the actual position and the account the effect of appreciation and depreciation of non-US currencies like, Euro, Pound-Sterling and Yen, held in reserve. Between September 26 and October 24, foreign exchange reserves have fallen by \$33.4 billion as RBI has intervening heavily in the forex markets to supply dollars. Foreign exchange reserves had peaked at \$ 316.17 billion during the week ended May 2008 (see Graph 2) and have falling constantly since then (see Graph 2). Forex reserves dipped by \$15.4 billion for the week ending 24 October 2008 to touch \$ 258.4 billion. One of the main reasons for the depletion<sup>3</sup> can be attributed to the net sales in equity markets<sup>4</sup> by foreign funds, which sold equity worth \$ 500 million on 10<sup>th</sup> October, 2008. This was one of the highest single day liquidation of equities by the FIIs in the recent times.

### **Graph 2: Fall in Foreign Exchange Reserves of India**

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<sup>3</sup> The fall in the reserve is also due to the revaluation of US \$ against the other international currencies.

<sup>4</sup> There is fear and panic on the Indian stock market. The bourses suffered heavy losses today on the back of global sell-off and on data showing dismal industrial production growth in August 2008. The BSE 30-share Sensex lost 800.51 points. On 10<sup>th</sup> October, the BSE 30-share Sensex ended down 800.51 points or 7.07% to 10,527.86. The index plunged 1,088.50 points at the day's low of 10,239.76 at the onset of the trading session, its lowest level since 24 July 2006. The Sensex fell 424.33 points at day's high of 10,904.13, in early trade. The S&P CNX Nifty was down 233.70 points or 6.65% to 3,279.95. Nifty hit a low of 3,198.95 in early trade, its lowest level since 9 August 2006. From the recent high of 13,055.67 on 1 October 2008, the Sensex has lost 2,527.81 points or 19.36%. The barometer index Sensex is down 9,759.13 points or 48.1% in the calendar year 2008 so far from its close of 20,286.99 on 31 December 2007. It is 10,678.91 points or 50.35% below its all-time high of 21,206.77 struck on 10 January 2008.



FII's had stepped up selling from the beginning of September as major investment banks such as Lehman-Brothers and Merrill-Lynch plunged into deep trouble which was followed by others such as AIG, Morgan Stanley and Goldman Sachs. The net sales by foreign institutional investors (FIIs) amounted to \$ 932.8 million during the month of September and \$ 13.00 billion during the year, according to SEBI.

Second, demand for rupee has simultaneously, has dipped because capital inflows are down. Further, it is expected that global financial crisis will hit the capital inflows in India (Dagar, 2008). The quantum of FII money in the Indian stock market has played a significant role in the movement of exchange rate. In fact, in the last couple of years, despite the trade deficit, the value of Indian currency has been rising mainly due to the surge in FII inflow into the country. Decline in External Commercial Borrowings<sup>5</sup> (ECBs) is another reason behind rupee depreciation. As per the study of ASSOCHAM, the total fund raised through ECBs by companies in India declined substantially from \$ 11.85 billion in April-July 2007-08 to \$ 6.53 billion in the corresponding period of 2008-09, recording a negative growth rate of 44.95 per cent. The study also showed a decline in companies raising capital through ECBs by 54.29 per cent from 280 companies in the first four months in the last fiscal to 128 in the corresponding period this financial year.

Third, the deficit in the current account of the country's balance of payments has widened further as oil import bill<sup>6</sup> has grown faster than income from software services exports and remittances from the Indian diaspora. The latest figures released by the Reserve Bank of India indicate the current account deficit amounted to \$10.72 billion during the quarter ended June '08 as compared to a deficit of \$6.3 billion in the quarter a year ago. The current account in the balance of payments measures the net position of a country's exports and imports of goods and services. This is despite the surplus in the invisibles comprising services income and remittances among others being higher at \$20.8 billion (\$14.4 billion) to absorb the trade deficit of \$31.6.79 billion (\$20.7 billion) during the quarter. While oil imports recorded a significant growth of 50.4% in Q1 of 2008-09 (23.9% in Q1 of 2007-08), non-oil imports showed relatively a modest growth of 20.9% (45.1% in Q1 of 2007-08). The Reserve Bank of India has said that the sharp increase in oil imports reflected the impact of increasing oil price of the Indian basket of international crude

<sup>5</sup> In 2007, India's central bank had tightened norms, restricting the use of ECB funds for rupee expenditure such as capital goods, new projects, and modernization and expansion in the manufacturing and infrastructure sector. As per its directive, ECB money could be used for rupee expenditure only up to \$ 20 million and only after RBI's permission. The \$ 20 million restriction was later relaxed to \$ 100 million for other firms. According to a government official, further ECB relaxation will likely be based on credit requirements of productive sectors.

<sup>6</sup> This is one of the key factors that led to the depreciation of the rupee is the impact of the high crude prices on the merchandise account.

(a mix of Oman, Dubai and Brent varieties), which increased to \$118.8 per barrel in Q1 of 2008-09 from \$66.4 per barrel in the corresponding quarter of the previous year.

Fourth, general strengthening of US dollar against major global currencies like Euro and Pound<sup>7</sup>. After a sharp depreciation of dollar in the last fiscal, dollar has recovered significantly and today, the US dollar is higher against most major currencies setting a new high for the year against the euro with little sign of a pullback so far. Part of the dollar's strength appears tied to settlement of the \$400 billion of Lehman Brothers credit default swaps with the euro and especially sterling hit hard (Joshi, 2008). Meanwhile, the yen is again the exception, as it continues to benefit from weakness in the euro and other crosses. The U.S. dollar is down 0.79 to 101.07 against the yen, while the euro is down 0.0165 to 1.3179 and the pound sterling is down 0.0195 to 1.6959, both against the U.S. dollar. The U.S. dollar is up 0.0173 to 1.2084 against the Canadian dollar, with its session high of 1.2138 corresponding to new three-year lows. The loonie began selling off in dramatic fashion after the Bank of Canada opted to cut interest rates to 2.25%.

There is also relationship between high inflation and depreciation of currency (Akinlo, 2003; Stockman, 2004; Mark, 1996; Zanna, 2005). Generally, high inflation and uncertainty about future inflation discourage investment and savings. As high inflation raises uncertainty in the economy, therefore higher inflation also leads to lower equity value. It is one of the reasons why Indian stock market is declining day-by-day since the beginning of year. On 27<sup>th</sup> Indian stock market crashed<sup>8</sup>, with the benchmark Sensex plugging below the psychosocial 8,000 level. Tracking the weak global trend<sup>9</sup> (see table 2), the benchmark Sensex lost over 750 points to hit an over three year low of 7,939; 7,939.02, a level last seen in November 2, 2005.

**Table 2: Bear Assault in the Emerging Markets**

Name of Index	As on Oct. 30, 2008	% fall
Russia RTS	758.71	36
Dubai Financial Market	2942.03	28.7
Nifty	2885.6	26.9
Sensex	9788.6	25.02
Bovespa	37449	24.7

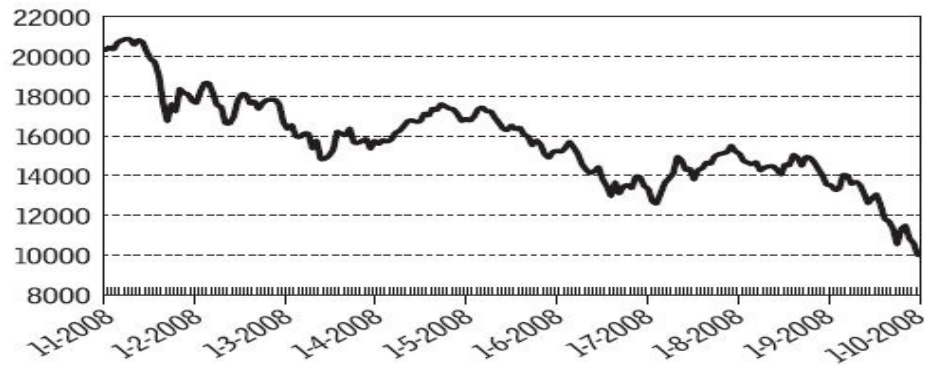
<sup>7</sup> Appreciation or depreciation of currencies (e.g. rupee), is influenced by the strength and weakness of competitive currencies (e.g. US dollar). The dollar is strengthening against the many emerging and development market currencies. Thus the weak Indian rupee can largely be attributed to strength of US dollar against most developed countries like Euro and Pound.

<sup>8</sup> It is also interesting to find out that the stocks in which the FIIs have lent the most quantity of shares overseas are also among the worst affected in the recent stock market slide. On 31<sup>st</sup> October 2008, SEBI issued a list of position of Indian securities lent overseas by FIIs as on 9<sup>th</sup> October 2008.

<sup>9</sup> Investors across the globe are now sobbing at the sink. Investors in the emerging markets have suffered more than those in the developed world, a comparison of benchmark indices indicates. In October Russia's RTS has shed 36 per cent; Brazil's Bovespa lost almost 25 per cent and Korea's Kospi came down 24.6 per cent. In India, the 30 share Sensex has fallen close to 24 per cent and broader Nifty almost 27 per cent. Dubai Financial Market has dropped more than 28 per cent. The fall is less stark in the developed markets. The Dow Jones Industrial Average has shed only 15 per cent in October. Nasdaq has fallen 18 per cent, London's FTSE shed 13.4 per cent, Germany's DAX lost 16 per cent, Australia's ASX 200 came down 12.6 per cent and the Nikkei and the Hang Sang have declined 20 per cent each. When the going was good till December last year, the emerging markets topped the list of gainers. Last year, China's Shanghai Composite, Sensex, Bovespa, Kospi and Russia's RTS had gone up between 20 per cent and 97 per cent, whereas the markets such as Hang Seng, Dow Jones, Nikkei and FTSE posted returns of between 11 per cent and 39 per cent. (Jaleel, 2008)

Kospi	1084.72	24.6
Hang Seng	14329.85	21.3
Nikkei	9020.76	20.5
Nasdaq	1698.52	17.9
DAX	4869.3	16.1
DJ Industrial Average	9180.69	15.2
FTSE	4291.6	13.4
Australia	4018	12.6

**Graph 3: Performance of Indian Stock Market since the beginning of Year**



In short, it has become a moving target, shifting downwards constantly as sellers desperately dump stocks. Declined stock market is associated with flight of foreign funds from the Indian market. Further, the high prices of wheat and palm oil have also inflated the import bill, which was already under stress due to soaring crude prices in the international market. Last but not the least, there are policies of (Reserve Bank of India) RBI<sup>10</sup>. In comparison to the currencies like dollar and euro, which are determined by market moments, the Indian rupee is partially managed by RBI. The balance of payment crisis<sup>11</sup> in 1990s, when the rupee was devalued is a case in point.

## Consequences of Depreciation of Rupee

<sup>10</sup> Generally, RBI intervenes in the Indian currency market whenever the rupee exhibits signs of extreme volatility. Although the exchange rate system in India is supposed to be a full float, the RBI intervenes in the market at regular intervals to direct the movement in rupee values (thus the term "managed float"). The intervention by the RBI in the market could be passive (whereby the apex bank engages in off-market deals) or active (whereby it purchases or sells dollars). Intervention could also be made through statements (to the press or otherwise) in times of exchange rate crises, or in extreme circumstances, through a package of monetary and other measures. Therefore, it may well be stated that the exchange rate system in India is not exactly full float.

<sup>11</sup> The devaluation of the rupee in 1991 brought about a sharp drop in its value against the dollar. The rupee was totally devalued around 22 per cent in a year. The decline was hardly surprising, given the great strain on the economy during the 1990s, what with the external account perilously close to breaking point. A host of factors, including domestic political crises and increase in oil prices, contributed to the decline in the rupee value. India's credit rating was downgraded twice (with the second downgrade placing the country in the "speculative grade") and with installment payments against some foreign loans coming due, the economy nearly collapsed.

The fall in the value of Indian rupee has several consequences which could have mixed effects on Indian economy. But, mainly, there are four expected implications of falling rupee. First, it should boost exports; second, it will lead to higher cost of imported goods and make some of the capital intensive projects more expensive to execute; third, it will increase the cost of dollar loans taken by companies and increase the foreign debt and fourth, it will slow-down the overall economic growth by increasing the interest rate and dissuade flow of FIIs. Therefore, it is imperative to study the consequences of fall in rupee with these four aspects.

1. The most possible impact of the devaluation of currency could be the stimulation of merchandise exports. Merchandise exports, particularly in the textiles, leathers and handicrafts sectors, which were, till recently, reeling under the impact of a rising rupee, are relieved. The falling rupee is a big relief at a time when our traditional markets in US and Europe are slowing down. According to industry estimate, about 25 per cent of order book right now is due to currency advantage Indian companies enjoying over the other countries like China.

Amid the global meltdown, India's export oriented commodities continue to perform better with prices of cotton, sugar and sesameseed. Table 3 indicates the price performance of various export oriented commodities in international market.

**Table 3: Performance of Various Export Oriented Commodities**

Commodities	November 8, 2007	October 27, 2008	% Change
Cotton Shankar (Rs/Qtl.)	5343	6327	18.42
Sugar M30 (Rs/Qtl.)	1452.50	1847.50	27.19
Sesameseed (Rs/Qtl.)	3500	6550	87.14
GN Oil (Rs./10 Kg.)	650	610	-6.15
Ref. Soya Oil (Rs./10 Kg.)	505	338	-5.94
Copper (\$/Tonne)	7021	3721	-47.0
Aluminum (\$/Tonne)	2565	1876	-26.86
Zince (\$/Tonne)	2720	1062	-60.93
Lead (\$/Tonne)	3505	1140	-67.47
Nickel (\$/Tonne)	32100	8810	-72.55
Brent Crude (\$/bbl)	93.24	59.20	-36.71
Gold (Rs./10gms)	10605	11855	11.79
Gold London (\$/oz)	841.10	723.09	-14.03
US Dollar	39.33	49.87	-26.80

However, globally, commodities including base metals, precious metals, edible oils and crude continued to move in tandem with international prices.

Other export oriented sectors like IT sector<sup>12</sup> and auto components, have gained (Lavanya, 2008). In 2006 when the rupee was depreciating infotech companies were making most of a depreciating rupee and have systems in place to hedge the risk inherent for forex earnings. With over 90 per cent of the revenue of IT companies coming from abroad, the rupee downward trend over the past few quarters is boosting the power packed results of the sector. The June quarter results were in case in point and were in line with the good quarters witnessed so far. On an

<sup>12</sup> Technology has seen among the most sensitive sectors, having a close relation with the rupee-dollar movement. Hence, the recent decline in the rupee value is good news for companies; information technology companies' top lines should move higher as they earn more rupees for every dollar they earn.

average, 1 per cent depreciation in the rupee boosts the operating margin of the Indian IT sector by 25-30 BPS. However, some of these gains could be offset by hedging by these companies. According to the Society of Indian Automobile Manufacturers, Hyundai is India's largest car exporters with the company witnessing a growth of 25.03 per cent in exports at 1,44,439 units in 2007-08. Maruti, a distant second, has registered a growth of 31.49 per cent in exports in the last fiscal at 51,669 units. The company's exports for April and May 2008 grew by 48.68 per cent at 7,654 units. However, it is not smooth sailing. (Table 4 indicates the export growth of automobile sector).

**Table 4: Total Automobile Exports between April and September**

Vehicles	2007	2008	Growth (%)
Passenger Vehicles	1,03,117	1,57,611	52.76
Commercial Vehicles	10,724	9,487	11.53
Three- Wheelers	68,728	69,879	1.67
Two Wheelers	4,09,038	5,19,684	27.05
Total	6,07,915	7,74,368	27.38

Source: SIAM

However, this export growth was not only because of depreciation of rupee, but also because of growing demand for Indian vehicles in the overseas markets.

Exporters now have to contend with clients who want to renegotiate the contracts due to softening rupee. In many cases, they have had to pass on 20-25 per cent of the exchange rate gains to the clients. Overall exports though have still been clocking an impressive growth of 25 per cent and are expected to touch the target of \$200 billion this fiscal. This rise in export will give a boost to the recovery of economic growth.

2. While falling rupee makes exports competitive, it makes imports costlier. This should, theoretically, curb imports and improve the trade balance. However, imports of commodities like oil, whose demand is relatively inelastic, could prove to be spoiler. It is tough time for Indian industries as these industries are heavily dependent on imported raw materials (see table 5) for industrial goods and capital goods and components, and their access to many advanced countries are blocked by quotas and tariffs. Any rising of prices of such inputs through devaluation, would raise industrial costs and reduced the intensity of capacity utilization. According to Industry sources, import of Chinese tyres for commercial vehicles has come down by approximately 40 per cent from as high as 1.5 lakh to 1.05 lakh tyres a month during January-June 2008. The fall was attributed to a sharp depreciation of rupee against dollar. Imports of radial tyres has now come down from as high as 1.20 lakh tyres ago this year to a mere 90,000 a month. Imports of cross-ply or BIAS tyres dropped approximately 30,000 to 15,000 a month. A drop in value of the rupee against the dollar and other major currencies may hurt Maruti- Suzuki, the country's biggest producer of passenger cars, as it is slated to import as much as Rs 2,000 crore of auto parts in this financial year.

**Table 5: India's Trade with Asian Countries (in \$ billion)**



Time	Exports	Imports
2003-04	5.82	7.4
2004-05	8.42	9.11
2005-06	10.41	10.88
2006-07	12.60	18.08
2007-08	16.37	22.66

3. A major drawback of depreciation in the value of rupee is that it will increase 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<sup>13</sup>. This drawback is all the more amplified in the case of short term debt as the burden is immediately felt. Most corporate loans are denominated in dollars, and the rupee has depreciated significantly against the dollar, as a result large numbers of companies are reporting losses. Notwithstanding the increase in sales, tractor and utility vehicle major Mahindra posted a 21 per cent drop in net profits at 227 crore for the quarter ended on 30th September 2008. The lower profits are largely on account of foreign exchange loss of 117.8 crore, due to depreciation of rupee. The exchange loss includes a notional loss of Rs. 96.7 crore on account of the revaluation of the company's net foreign currency borrowings. Bharat Petroleum Corporation Ltd. (BPCL) had also suffered an exchange rate loss of Rs. 714 crore during the quarter. Average price for Brent crude for the second quarter was \$116 a barrel. According to analysts, the benefit of lower crude price is more or less nullified by the weakening of rupee. Oil and Natural Gas Company (ONGC) has reported a 6 per cent dip in net profits due to weakening of rupee. Due to a Rs. 81.57 crore hit on account of resettlement of foreign currency loans, Orchid chemicals and pharmaceutical reported a loss of Rs. 40.66 crore for the July- September quarter. Ranbaxy posted a \$ 73 million loss of its foreign currency debt because of the adverse movement of rupee and wrote down the value of its inventories by \$ 57 million after the US import ban. Tata Motors also recorded the biggest forex loss of Rs 285.02 crore of the auto industry on revaluation of foreign currency borrowings, deposits and loans, which eroded its margin significantly. Same has been observed in the case of Jubilant Organosys Ltd. and Bicon Ltd.

4. Another fallout of weaker rupee could be higher interest rates in the economy, with the help of which RBI/government might want to fight off the pressure of depreciation in the value of domestic currency. Higher interest may also deter investment expenditure which will have adverse effects on growth both in the short run and in the long run, because the creation of new capacity will be stunted (Iyer, 2008). Therefore, with respect to depreciation, the government appears to be in a "damned if you do, damned if you don't do" situation. This is reinforced by the compulsion to raise the petroleum prices across the board, which will have its own constraining effects on growth. Further, the prospects of weaker currency could also lead to rush

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<sup>13</sup> For instance, if a borrower borrows \$100 when the exchange rate was Rs 45 to a \$, his/her original borrowing stands at Rs 4,500. After rupee depreciation to Rs. 48 a \$, the same loan amount to Rs. 4,800. If the interest rate is 10 per cent, the additional interest turns out to be Rs. 30 and an addition of 0.67 per dollar borrowed (30/45). Thus, the rupee depreciation results in an incremental outflow of \$7.34 (6.67+0.67) for the borrowers.

for repatriation of FIIs<sup>14</sup> (Reinhart, 2000). India has witnessed the impact of falling rupee on FIIs (Srinivas, 2008). Table 3 shows FII data since 2003.

**Table 3: FII Data Since 2003**

Year	FIIs in \$ billion
2003	6.59
2004	8.52
2005	10.7
2006	7.99
2007	17.33
2008	-10.5 (as on Oct. 9, 2008)
2008	13.00 (as on Nov. 1, 2008)

Source: SEBI

Thus, since the beginning of year 2008, FIIs have till date sold \$ 13.00 billion- a far cry from inflow of \$ 17.23 billion and \$ 8 billion in 2007.

Further, depreciation of rupee may increase the level of inflation in the economy. Products that are directly imported, such as crude oil, fertilizers, pharmaceuticals products, ores and metals, or use imported components such as Personal Computer and laptops become more expensive following the rupee depreciation. A major chunk of components in computer viz., processor, hard disk and motherboard, is imported. Products such as keyboards, mouse and monitor would also witness a discernible impact on their prices on the account of rupee depreciation. As the input costs increase, inflation may rise in the economy. Finance Ministry is also worried about what rupee depreciation is doing to the oil pool deficit. The oil pool account is facing double whammy. For the next two years, until this artifice is dismantled, the government will have to find the balance between higher prices and higher deficits. Of course, the Finance Ministry also has to take into account the possible effects of resisting the depreciation. Raising interest rates to counteract the depreciation will add to its interest costs. This may also dampen has appear to be healthy growth impulses and thus lower the revenue collection.

Last but not the least, as rupee falling makes U.S. an expensive destination to study<sup>15</sup>, together with the current U.S. economic crunch, education industry experts foresee the students may look at new destination like UK<sup>16</sup> and Australia<sup>17</sup> for higher studies. Indian rupee fall against the dollar has caused a huge increase in the expenses for Indian students who study in various U.S. universities. On the contrary, rupee is still strong against the Euro and Australian dollar, which may prompt many Indian students to shift focus to these countries. Students and parents fear that if rupee falling continuously they will have to pay over 20 per cent more.

<sup>14</sup> The FIIs are permitted to transfer money in and out of the country at will and therefore if there were a legitimate fear of large fall in the value of currency, they may be tempted to repatriate a part of their funds. This could result in a sell off in the capital market.

<sup>15</sup> India sent around 83,833 students to the US during 2006-07.

<sup>16</sup> The Higher Education Statistics Agency in the UK reports that over 23,800 students visited UK for higher education in the year 2006-07.

<sup>17</sup> Australia is the second most popular international education destination for the Indian students behind the US. According to data from Indo-Australian Education Counselors over 63,000 Indian students went to Australia for higher studies in 2007.

## Concluding Remarks

The fall in the value of currency not only hurts the national pride, but also carries other risks as well. Depreciation of rupee dampens the inflow of foreign capital, rise in the external debt burdens, and also mount India's oil and fertilizer subsidy bills. The most positive impact of depreciation of rupee is the stimulation of merchandise exports and discouraging merchandise imports and thus improving the terms of trade. 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. India imports many essential goods like crude oil, fertilizers, pharmaceuticals and many capital goods. Thus, the argument that depreciation is good as it discourage India's import does not make any sense. Further, software or other exports also do not depend on the rupee's value only, but most on the quality and reputation of the product. This is the reason, even in the phase of appreciation of Indian rupee, India has achieved significant export growth of 27 per cent in the last fiscal and even after depreciation of rupee, the month of September 2008 registered the export growth of only 10.4 per cent and import growth is 43.3 per cent<sup>18</sup>. But, given the slowdown in FII inflows in the last few months, the trade deficit and many other reasons, it is believed that the fall in the value of the rupee was inevitable. Therefore, in such a scenario, while it is not possible to completely eliminate forex risks, those companies that adopt prudent hedging strategies will have that extra edge over their peers.

As far as future of rupee is concerned, it is expected that there will be a reverse trend by the end of the December. In fact, now there are not so many reasons for the dollar to be stronger. The liquidity injected by the \$700 billion bailout package for the US financial system itself will put the pressure on the dollar to depreciate. Then substantial inflows of dollar in the capital account are likely over the next few months through FDI<sup>19</sup>, debt and private equity. Easing of international commodity prices itself is likely to ease the pressure on India's current account and rupee significantly. RBI has already taken number of measures in this direction. Interest rate ceilings have been hiked in case of certain NRI deposits. ECB norms have been liberalized. ECB limits for the rupee expenditure for infrastructure companies have been raised from \$100 million to \$500 million per borrowers per financial year. Further, RBI is looking at easing ECB and FDI norms to attract more overseas investment in the country. This suggests strong possibility of strengthening of rupee from the current level. But rupee volatility is here to stay in the medium to short terms. Still, a good policy should be proactive than reactive, time has come to directly intervene by RBI as with the depreciation of rupee Indian economy has more to lose and very little to gain.

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<sup>18</sup> India's trade deficit has shot up by 53 per cent in April-September 2008 to \$60 billion as against \$39 billion in the corresponding period last year, according to official data released on 3<sup>rd</sup> November 2008. The impact of falling exports on the rupee is likely to be offset somewhat by falling imports, pressure on the rupee weaken in the near term remains, not only due to portfolio outflows, but mainly due to corporate and banks swapping rupee for dollar. Imports increased by 43 per cent to \$24.4 billion, widening the trade deficit to \$11 billion. The global financial and economic headwinds adversely affected foreign demand for Indian manufactured goods.

<sup>19</sup> India has received \$14.6 billion FDI during April-August 2008. FDI to India surged to \$2.56 billion in September, up 9 per cent over the same month last year.

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