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RESEARCH ARTICLE

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CAUSES AND CONSEQUENCES OF THE DEPRECIATING INDIAN RUPEE

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ABSTRACT

In 1944, delegates from 44 allied nations signed the Bretton Woods Agreement. The establishment of International Monetary Fund (IMF) and declaration of United States (US) dollar as world's reserve currency were its major outcomes although member countries too got some control over their currency. However, in 1960s, dollar started getting distressed and eventually it was de-linked from the fixed exchange rate regime, although it continued to be accepted worldwide in most of the international transactions. In the recent past, exogenous factors have imparted gained an unprecedented strength to US dollar leading to a fall in the value of other currencies of the world including Indian Rupee. But the fall in Indian Rupee is registered less vis-a-vis other countries. Despite this, the fallouts of depreciating Rupee remained catastrophic for the Indian economy. This study is undertaken to comprehend the causes of fall in Indian Rupee and the steps taken to arrest the fall in Rupee.

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INTRODUCTION

World War II eventually led the legendary economists to believe that gold standard system has remained too rigid for different currencies to function; floating exchange rate (of 1930s) has resulted in the destabilization of trade and investment; countries need to have a backing up of gold and silver to guarantee their currencies and an International Financial Institution should be established to regulate the monetary and economic affairs of different countries (Nathan, 2011; Rickards 2012). Aftermath of Great Depression promulgated the increasing role of government intervention to impart stability, growth and employment in any economy, hence governments of different countries too felt the need for an International Financial Institution to promote economic stability and political peace. With an intention to build an international economic system that could resurrect the war shattered economies, particularly, in Europe and East Asia, delegates from 44 allied nations in the year 1944 met at Mount Washington Hotel in Bretton Woods, New Hampshire for United Nations Monetary and Financial Conference and signed the Bretton Woods Agreement. Besides fixing up the problems related to rigidly fixed exchange rates, member nations also agreed to establish an International Monetary Fund (IMF) to ensure austerity plans, controlling inflation and provision of funds to the member countries whenever required.

During the World War II, US played a pivotal role in supplying the weapons and other artilleries to the Allies, and thus, turned out to be an economy having majority of world's gold at the end of the war. US dollar was declared the world's reserve currency owing to its largest reserves of gold. Member countries also got some control over their currency by way of depreciating or appreciating the value of their currency against the dollar whenever required. However, from 1960s onwards due to an increase in domestic spending on US President's Lyndon Johnson's Great Society programs alongwith a rise in military spending caused by the Vietnam war, there was an increased demand for paper money in US (https://www.imf.org/external/about/histend.htm retrieved on 17/8/2022). The quantity of dollars in the banks outside US increased suddenly and many banks in Europe started providing loans in US dollars which resulted in low and insufficient gold reserves with US Fed to convert them into dollars. With dollar getting distressed, many countries started converting their dollar reserves into gold. Ultimately, it compelled President Nixon to de-link US dollar from gold eventually putting curtains on the fixed exchange rate regime with a dawn of floating exchange rate that is existent even today. US dollar continued to be an undeclared global currency that is accepted worldwide in most of the international transactions in the emerging order (Kenen and Rodrik, 1986). Data released by the International Monetary Fund (Global Financial Stability Report, 2022) shows that in March 2022, of the total international foreign exchange reserves ($12550.12 bn) nearly 55 percent ($6877.56 bn) were held in the form of US dollars by the central banks of different countries. By July 2022, US dollar in circulation was to the extent of nearly $2.28 trillion, half of which is assumed to be in circulation outside US that shows the strength of US dollar (Ranade, 2022). In 2019, dollar remained the world's most dominant currency with 88 percent share in the world trade (https://www.bis.org/statistics/rpfx19_fx.pdf retrieved on 15/8/2022). With fortunes of the world primarily linked to US dollar, any movement in it is bound to shake the global financial position. Where a strong US dollar is expected to put a strain: on emerging economies in terms of loan repayment; a weak US dollar tends to increase investment in emerging economies (Khan and Ross, 1977). In the recent past, US dollar has gained strength against major currencies of the world, the reasons for which are discussed in the upcoming sections. To combat inflation primarily owing to the Russia-Ukraine war, the Federal Reserve has been aggressively increasing rate of interest. Resultantly, central banks in other countries of the world too followed the Federal Reserve by increasing rate of interest in their respective countries to tame inflation thereby invoking a *'reverse currency war.'* In league of increasing the interest rates, every central bank is striving to impart strength to its currency so that import of items ranging from food to appliances may be facilitated economically. It has imparted volatility to the currencies of different countries. The value of US dollar against major currencies of the world is highlighted in Table 1.

LITERATURE REVIEW

Verghese (1984) concluded that under apposite circumstances and appropriate policies, floating exchange rates are not only effective but efficient too. Singh (2005) categorically put it that countries maintain adequate foreign exchange reserves to have security in terms of import payment in conjunction with strong domestic currency. Adhiraj et al (2014) observed that differential interest rate and money supply also affects the currency of any economy. Fall in Indian currency in 2013 was attributed to the ending up of quantitative easing by US Fed. Abid and Jhawar (2017) discussed that foreign exchange reserves have significantly increased in the time period 2001-16 on account of better capital inflows and low current account deficit. Agarwal *et al* (2020) in their study discussed that holding of excess foreign exchange reserves have its costs and any government should maintain it in a way that benefits get optimized with minimum costs. From the above studies, it can be worked out that different authors have dwelled upon the deprecating Indian Rupee vis-à-vis US dollar form diverse viewpoints, but few scholars have attempted to study the recent depreciation in Rupee, particularly in the post covid regime. This study aims to fill the vacuum.

Table 1. Value of US Dollar vis-à-vis major currencies of the world

Month	Chinese Yuan	Swiss Francs	Euros	British Pounds	Japanese Yen
31 December 2021	6.36	0.91	0.88	0.74	115.11
31 January 2022	6.36	0.93	0.89	0.74	115.13
28 February 2022	6.31	0.92	0.89	0.75	115.08
31 March 2022	6.35	0.92	0.90	0.76	122.07
30 April 2022	6.61	0.97	0.95	0.80	129.79
31 May 2022	6.66	0.96	0.93	0.79	127.79
30 June 2022	6.70	0.96	0.95	0.82	135.79
31 July 2022	6.74	0.95	0.98	0.82	133.24
15 August 2022	6.77	0.95	0.98	0.83	133.15

Source: IMF Database

Table 2. Value of Indian Rupee against one US dollar

Month and Year	Value of Rupee
July 2021	74.44
August 2021	73.00
September 2021	74.12
October 2021	74.95
November 2021	75.09
December 2021	74.69
January 2022	74.79
February 2022	74.73
March 2022	75.75
April 2022	76.57
May 2022	77.69
June 2022	78.94
July 2022	79.98
Percent Change	7.44

Source: Reserve Bank of India

To the extent Indian Rupee is concerned, the fall in Rupee in past one year or so remained almost 7.4 percent (Table 2). Global factors like Russia-Ukraine war, record high crude oil prices and tightening financial conditions worldwide have led to the weakening of Indian Rupee. Policymakers in India are trying to defend the fall in Indian currency by comparing it with the currencies of other countries such as Euro, British Pound, and Japanese Yen, etc. that have weakened more than the Indian Rupee. To comprehend the paradoxical situation, the play of nominal effective exchange rate (NEER) and the real effective exchange rate (REER) needs to be understood. Indices of REER entail a basket of 40 currencies that yields the weighted average of Rupee in relation to 39 more currencies. Hence, it's quite possible that Rupee is sinking in terms of NEER, but in REER it may be emerging stronger. But the depreciating Rupee against dollar is compounding miseries in India by primarily increasing the inflation manifold. The efforts made recently by the Indian government and Central Bank to increase foreign exchange reserves are discussed in depth in this study.

Objectives of the Study: This study has attempted to find out the causes of depreciation in Indian Rupee and the steps initiated to stop this fall. More appropriately, the objectives of this study are:

- To assess the causes of fall in Indian Rupee vis-à-vis US dollar.
- To examine the steps taken by the Indian government to stop the fall in Rupee.

METHODOLOGY

To the extent this study is concerned, it is divided into five parts. Part I is introductory in nature. Review of literature is discussed in Part II. Methodology of this study with data sources is discussed in section III. Analysis part alongwith the steps initiated to mitigate the rupee deprecation are discussed in Section IV. Whole discussion is summed up in Section V.

Data Collection: For the purpose of data we have primarily relied on the published sources of renowned International Organizations. Largely, the data for Indian economy has been obtained from the published reports of Reserve Bank of India (RBI). India's central bank publishes and provides data on different aspects of the Indian economy in general, and banking and finance in particular. Apart from the RBI database, we have also relied upon National Securities Depository Limited (NSDL) that publishes data related to the securities in the capital markets, besides foreign portfolio investment and trade related data in India's primary and secondary market. For the international records, we collected the data from the database provided by International Monetary Fund and other leading International Organizations.

ANALYSIS AND DISCUSSION

Major reasons for the fall in Indian Rupee can be summarized into three categories viz. hike in prices of crude oil, outflow of foreign portfolio investment and strengthening of US dollar. The details of each of these factors are enumerated below.

Increase in crude oil prices: At the outset, an increase in crude oil prices may be attributed as a factor for Rupee depreciation. There is no denying the fact that Russia-Ukraine war and more appropriately, the economic sanctions on Russia, primarily by US and NATO countries have led to an increase in the prices of crude oil besides complete energy basket including natural gas, coal and other petroleum products at a time when the world had just begun recovering from covid-19. Statistically, the Brent crude that was sailing at $83.06 per barrel (pbl) on March 1, 2022 (just when the Russia Ukraine war broke out), reached $116.56 pbl on June 13 and sailing almost near or above $100 pbl since then. This increase in crude oil prices is not without its cascading effects and its spillover has made transportation, daily use consumer goods, essential items, and construction material, etc. costlier. In addition to this, higher oil bill has resulted in more outflows of foreign exchange thereby leading to the depreciation of Indian Rupee. Table 3 highlights how an increase in the value of imported goods led to an increase in trade deficit in India. Not only this, it has even overshadowed the increase in value of exports. Generally, when Rupee depreciates, the exporters stand to gain (Virmani, 1991). But in India's case, on account of more depreciation of currencies in the world economies vis-à-vis Rupee, and nature of Indian exports being such that there is a high element of imported raw material, exports failed to offer any appreciable inflow to the foreign exchange. Summarily, an increase in prices of crude oil led to a hike in the prices of many goods viz. fertilizers, coal, steel, aluminum & other metals and commodities in the international markets, thereby burning inflation at each and every quarter. As India is a net importer country, import of these items at higher prices led to more outflow of dollar from the foreign exchange reserves, testimony of which can be had from Table 3.

Table 3. Export and Import of Merchandise in India

(in US$ bn)

Month	Export of Goods	Import of Goods	Trade Balance	Foreign Exchange Reserves
2021				
July	35.52	46.14	-10.62	620.06
August	33.37	45.07	11.70	640.70
September	32.81	56.25	-23.44	635.36
October	35.72	53.60	-17.18	640.39
November	31.79	52.98	-21.19	637.99
December	39.26	60.29	-21.03	633.61
2022				
January	35.21	52.48	-17.27	629.94
February	37.14	55.82	-18.68	631.86
March	44.49	62.97	-18.48	607.30
April	39.72	60.19	-20.47	595.95
May	39.06	63.25	-24.19	601.05
June	40.13	66.31	-26.18	588.31
July	36.27	66.27	-30.00	572.97

Source: Reserve Bank of India

Outflow of Foreign Capital: Second major factor that has led to the deprecation of Indian Rupee is the outflow of foreign capital particularly, foreign portfolio investment. It can be seen from table 4 that net portfolio investment has remained negative since October last year and in the months of March and June, it was drastically withdrawn. It indicates the risk averting behavior of the foreign investors. Since January 1 this year till June 30, a total capital outflow of around $30 billion has taken place both from the equity and debt market in India. Weak macro-economic fundamentals, with growing inflation, anticipation of another hike in interest rates by the Reserve Bank of India and rolling back of liquidity from the market might be attributed to this risk averting behavior of the investors. It has led to a serious fall in the foreign exchange reserves of India the description of which can be had from table 4.

Table 4. Flow of Net Portfolio Investment in India

(in US$ bn)

Month	Net Portfolio Investment	Foreign Exchange Reserves
2021		
July	-0.99	620.06
August	2.23	640.70
September	3.77	635.36
October	-1.65	640.39
November	-0.32	637.99
December	-3.93	633.61
2022		
January	-3.81	629.94
February	-5.07	631.86
March	-6.56	607.30
April	-2.96	595.95
May	-4.73	601.05
June	-6.50	588.31
July	-1.04	572.97

Note: Negative (-) values in Net Portfolio Investment indicate outflow
Source: National Securities Depository Limited

Strengthening of US Dollar: Inflation level in USA soared to 9.1 percent in June 2022 (8.5 percent in July 2022) that remained the highest in past 41 years. Prices are rising in US both on account of increase in demand as well as supply. On demand front, it is the unemployment and salary protection benefits extended to the people of USA during covid -19 spread which is not letting the purchasing power go down, whereas on supply side, it is the shortage of commodities on account of Russia-Ukraine war and repeated lockdowns in China. To curb inflation, Federal Reserve has resorted to a series of aggressive interest rate hikes to slowdown the economic growth. This hike in interest rates has offered an opportunity to the investors to earn higher interest rate on their investment in US. Hence, the investors did not even wary of liquidating their investments in other countries, and channelized their savings towards US that led to an unprecedented demand for the dollar, thereby imparting an extraordinary strength to it.

Table 5. Value of US Dollar Index (in value terms)

Month	US Dollar Index
2021	
July	92.18
August	92.63
September	94.24
October	94.12
November	96.00
December	95.59
2022	
January	96.53
February	96.69
March	98.36
April	102.96
May	101.76
June	104.46
July	105.77

Source: IMF Database

One of the best parameters to gauge the strength of dollar is to measure the value of dollar index. Dollar index is a weighted average of six foreign currencies i.e. Euro, Japanese Yen, British Pound, Canadian Dollar, Swedish Krona and Swiss Franc. Strengthening of US dollar takes value of dollar index high and vice versa. It can be seen from table 5 that the US dollar index remained in triple digits since April 2022 thereby revealing the strengthening of dollar against other currencies. To sum up the above discussion, an increase in crude oil prices alongwith outflow of foreign capital and strengthening of dollar has led to the depreciation of Indian Rupee. In order to arrest the fall in Rupee, RBI has been continuously selling dollars in both the spot ($16 billion) as well as future market ($16 billion) right through April 2022. It has led to the depletion of India's foreign exchange reserves (Guru, 2022). In fact, fall in foreign exchange reserves stood at 9 percent approximately since January this year which is even more than the fall in Rupee (nearly 7 percent). A report by Standard Chartered has revealed that 45 percent fall in India's foreign exchange reserves has come from the strengthening of dollar, while 30% has come from selling/buying swap auctions in April and yet another 25 percent has come from an increase in import costs (https://economictimes.indiatimes.com/markets/forex/forex-kitty-may-fall-furtherbut-can-fund-9-mths-imports/articleshow/91754441.cms?from=mdr retrieved on 17/8/2022). Despite strenuous attempts, Rupee has failed to conform to the actions and breached Rs. 80 mark recently vis-a-vis one dollar. Resultantly, RBI and the Indian government are now making efforts from another front i.e. boosting the foreign exchange reserves the details of which are discussed below.

Steps Initiated to stop the depreciation of rupee

- **Increased import duty on gold:** Since July 1, the Indian government has increased the import duty on gold from 10.75 percent to 15 percent in order to arrest the import of gold and to narrow down the burgeoning trade deficit.
- **Windfall tax on oil producers:** Indian Government levied export duties (windfall tax) to the extent of Rs. 6 per litre on petrol and aviation turbine fuel (ATF), while Rs. 13 per litre on diesel beside a tax of Rs. 23,260 per tonne on crude production. Windfall levies were imposed since Russia's Rosneft propelled Nayara Energy and Reliance were importing cheap crude oil from Russia (offered at a discount) and exporting it to Europe after refining in India. It was estimated that it will yield revenue of Rs. 1 trillion and will be a compensation for the similar amount foregone by decreasing the excise duty of Rs. 8 on petrol and Rs. 6 on diesel announced in May 2022. The imposition of windfall tax nearly brought the realizes from petrol and diesel export to the near loss levels that severely affected the foreign exchange inflow. Accordingly, in three weeks the Indian government removed windfall tax on petrol while cutting down tax on and aviation turbine fuel (ATF) from Rs. 6 to Rs. 4, on diesel from Rs. 13 per litre to Rs. 11 per litre, beside a cut down of Rs. 6,000 per tonne from to Rs. 17,000 per tonne from earlier levied Rs. 23,260 per tonne on crude production. Later, with the softening of crude oil prices in international market, the government decreased export duty on diesel to Rs. 5 per litre while tax on domestically produced crude oil was increased from Rs. 17,000 per tonne to Rs. 17,750 per tonne.
- **Amendment in FCRA Rules:** Ministry of Home Affairs made changes to the Foreign Contribution (Regulation) Act 2011 wherein individuals/organizations in India are permitted to receive more money from the relatives. Precisely, the amended rules now allow relatives to send up to Rs. 10 lakh without any permission the government. If the amount exceeds this limit, then the individuals will have three months time to inform the government against 30 days earlier.
- **International Trade Settlement in Indian Rupee:** With an eye on saving foreign exchange, RBI enabled the banks to make arrangements for export and import transactions in Indian Rupee with prior approval. For this purpose, concerned banks will need to open a Special Rupee *Vostro* Account in the correspondent bank in the partner trading country. Thus, when the Indian importer will make payment in Rupee that will be credited into the *Vostro* account of the correspondent bank against the invoices received from the seller abroad. In the same way, Indian exporters, too, shall be paid the export proceeds in rupee from the balances contained in the *Vostro* account of the correspondent bank. The move is aimed not only at saving the foreign exchange, rather to usher in the internationalization of Indian Rupee too.
- **Relaxed norms for external commercial borrowings (ECB):** RBI under automatic ECB route allowed the eligible borrowers (corporates) to raise more funds through authorized banks without approaching the RBI. Temporary increase in limit under automatic route has been increased from US$750 million to US$1.5 billion till December 31, 2022.

Beside these major steps, minor attempts were also undertaken in the form of making Indian debt attractive, giving additional mobility to banks in handling foreign currency deposits and offering more deposits on Foreign Currency Non Resident Account (FCNRB) etc. On the whole, it indicates that policymakers in India, of late, are now geared up towards the robust positioning of the foreign exchange reserves to tame the falling value of Indian Rupee.

CONCLUSION

The above discussion sums up that a sturdy hike in rate of interest by the US Fed (to tame inflation) four times since March 2022 to August 2022 has led the central bank in almost every country to increase the rate of interest. It has triggered a situation of a '*reverse currency war'* wherein by increasing the interest rate, every central bank is striving to impart strength to its currency to facilitate low cost imports or to curb the outflow of foreign investment. Fed's decision has resulted in a stunning appreciation of US dollar vis-a-vis other currencies of the world. So far the fall in value of Rupee is concerned; it may be attributed to three factors viz. increase in crude oil prices, outflow of foreign capital besides strengthening of US dollar. In order to arrest the free fall of Indian Rupee, India's central bank has actively involved itself in selling/buying swap auctions. Despite RBI's attempts, Rupee has failed to cut short its deprecation thereby compelling the policymakers to make efforts from another front too i.e. boosting the foreign exchange reserves of India. Till the time, Indian Rupee continues to fall; it will persistently cast a double whammy in Indian economy, where amid high inflation, prices will continue to soar further.

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