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LOOMING ELECTIONS INSTRUMENTAL IN INDIAN RUPEE'S FALL?

1. Partially Convertible Indian Rupee has experienced its biggest sharp fall in the last twenty years. Thomson Reuters data suggests that the Rupee fell by 2.9 percent on 26th August, 2013 which is the biggest single-day percentage fall since October 1995. There is divergence of opinion among the general public and experts in regard to the reasons for depreciation in the exchange rate of the Rupee. This paper examines succinctly the reasons for depreciation in exchange rate of the Indian Rupee.

2. A currency is just like any other commodity and its value too is driven by demand and supply factors. If the demand goes up, the value of the currency also goes up. If there are a large number of buyers with no increase in supply, this drives up the value of the currency. Similarly, when the demand declines due to few buyers in the market, it pushes down the value of the currency. Table 1 below shows percentage change or depreciation in the value of the Indian vis-a-vis Major Currencies. The Indian Rupee has experienced deterioration in its value by a significant percentage change against all major currencies.

Table 1 - Indian Rupee v Major Currencies

Currency	Percentage Change (Since last year)
US Dollar	(-) 21%
British Pound	(-)19.5%
Euro	(-) 28.8%
Yen	(-) 2.4%

(Source: Reserve Bank of India)

6. The debate for the causes in fall in Rupee's value has assumed added significance in the light of looming general elections in India. Some argue that the populist measures like Food Subsidy Bill worth $20 billion approved by the Parliament is primarily instrumental in causing the downfall of Indian currency. Let's discuss some of the reasons for fall in the exchange rate of the Indian rupee.

Table 2 - Indian Economy: Some Indicators

Indicators	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
Fiscal Deficit (% of GDP)	-3.88	-4.00	-3.30	-2.50	-6.00	-6.50	-4.90	-5.90	-5.90
Inflation (CPI)	3.9	4.2	6.8	6.2	9.1	13.0	9.5	9.0	8.0
Current Account Deficit	-0.3	-1.2	-1.0	-1.3	-2.3	-2.8	-2.7	-4.2	-3.7
External Debt (US$ BN)	134.0	139.1	172.4	224.4	224.5	260.9	305.9	345.4	360.4
Growth Rate	6.97	9.48	9.57	9.32	6.72	8.59	9.32	6.21	4.96
Debt-Service Ratio	5.9	10.1	4.7	4.8	4.4	5.8	4.3	6.0	4.5

(Source: RBI, CSO, GOI, Planning Commission)

6.1 Fiscal Deficit

The Congress Party won the last elections mainly due to promotion of Mahatma Gandhi Natural Rural Employment Guarantee Programme (MGNREGP). The key strategy for the next elections ostensibly includes providing subsidized food to the BPL (Below Poverty Line) families and others which constitute 67% of the country's population. The critics argue that the Food Security Bill will lead to country not meeting the fiscal deficit target. The Government has committed around $21 Billion for this Scheme. India's fiscal deficit has been consistently high compared to other developing countries raising alarm bells in the corridors of the Government although it promises that the target rate of 4.8% is a red line which is unlikely to be crossed.

Let's discuss how growing fiscal deficit causes depreciation in exchange rate. Fiscal Deficit is the difference between Government's expenditure and income e.g. in the Annual Budget. Cyclical fiscal deficit (accumulation of annual deficits in the Budget) causes upward trend in the national or foreign debt. The Government can either meet the shortfall by raising taxes or raising money in the domestic or international markets. These steps lead to rise in rate of inflation and debt-service ratio leading to depreciation in exchange rate. It is, however, a matter of debate whether high fiscal deficit has any significant impact on exchange rate in the shorter run. In the longer run, there is conclusive evidence that the exchange rate is adversely impacted by high fiscal deficit. There does not seem to be any connection between the announcement of populist measures by the Government and decline in the value of the Rupee immediately.

Table 3 - US$ v BRICS Currencies

BRICS Currency	Percentage Change (since last year)
Brazilian Real	(-) 15%
Russian Ruble	(-) 24%
Indian Rupee	(-) 21%
Chinese Yuan	(-) 2.3%
South African Rand	(-) 20%

(Source: Thompson Reuters)

6.2 Withdrawal of stimulus package by the Federal Reserve

One of the factors contributing to the fall of major currencies including Indian Rupee (See Table 3) is that US Federal Reserve is to withdraw the stimulus package for boosting economy which was expected to increase liquidity in the international market. With the possible liquidity crunch in the market, the FIIs have started withdrawing their funds from the emerging markets compounding the problem. BRICS and other emerging economies are hit hard by this decision. This has led to chain reaction. Since the supply of US Dollar has dried up, it has led to its appreciation in the exchange rate vis-a-vis other currencies in the foreign exchange market. The imports which are invoiced in US dollars have also become costlier thus increasing the import bill causing Current Account Deficit (CAD). The decision of the Federal Reserve is the single most factor influencing dramatic changes in the exchange rates of major currencies including Indian Rupee.

6.3 Current Account Deficit (CAD)

India has been struggling to control its Current Account Deficit which is the difference between the inflows and outflows of foreign exchange in the country. The target is to contain it at 3.7 per cent of the GDP in the current financial year i.e. at -$70 Billion. The CAD has been registering an increasing trend. The impact of CAD on exchange rate is negative because imports are more than exports. A country has to buy foreign currency in exchange for its currency in order to make payment leading to fall in its currency's value.

6.4 High Inflation Rate

The high inflation rate puts tremendous amount of pressure on the exchange rate of a currency. In India, the inflation rate has been hovering around at a very high level. This has resulted in increase in cost of exportable and importable goods - exports fall while imports rise due to depreciation in exchange rate.

6.5 Other Reasons

There are a host of other reasons responsible for downfall of Rupee e.g. Slowdown in FDI, FII Outflows, Fall in Foreign Exchange Reserves, Low Growth Rate etc. Falling value of the Rupee could be attributed to these factors as well. India does not enjoy the same level of confidence in the eyes of the foreign investors as it used to be.

7. Steps

In order to arrest the falling Rupee, the Reserve Bank of India and Government of India have initiated a number of steps.

7.1 Under the Liberalized Remittance Scheme (LRS), the Reserve Bank of India has introduced some restrictions on acquisition of immovable property outside directly or indirectly. All resident individuals were earlier allowed to remit up to $200,000 per financial year for any permissible current or capital account transaction or a combination of both. But now the outflow has been restricted to $75,000.

7.2 The deposit rates on FCNR (B) deposits have been increased by the Reserve Bank of India. RBI has also deregulated the interest rates on NRE deposits.

7.3 The Government has decided to increase import taxes on gold and limiting how much money Indians can send abroad.

7.4 The Government has approved infrastructure projects worth $28.4 billion aimed at reviving the economic growth and shoring up investor confidence.

7.5 On the basis of assessment of current market conditions, Reserve Bank of India has decided to open a forex swap window to meet the entire daily dollar requirements of three public sector oil marketing companies (IOC, HPCL and BPCL). Under the swap facility, Reserve Bank will undertake sell/buy USD-INR forex swaps for fixed tenor with the oil marketing companies through a designated bank.