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DEVALUATION OF THE INDIAN CURRENCY (RUPEE): IMPLICATIONS FOR THE INDIAN ECONOMY

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ABSTRACT

Since its independence in 1947, India has faced four major financial crisis and consequent four devaluation of its currency. These crises were in 1966, 1991, 2008 and 2011. This paper is an attempt to find out the causes of these four crises and to see whether they were of similar nature and were caused by similar reasons.

KEYWORDS :*Devaluation, financial crisis, depreciation of currency.*

INTRODUCTION

Foreign Exchange reserves are an extremely critical aspect of any country's ability to engage in commerce with other countries. A large stock of foreign currency is necessary to facilitate trade with other countries. If a nation depletes its foreign currency reserves and finds that its own currency is not accepted abroad, the only option left to the country is to borrow from abroad. But, the borrowing nation has to pay back the loan in the lender's own currency and if the nation is not credit worthy enough to borrow from private bank, it has no other option of paying for imports and a financial crisis results. The Indian Currency has gone through drastic changes in the recent past. In 2006-07, there was a sudden upsurge in the value of the rupee which surprised most market players and made it one of the best performing Asian units. But in 2011, it lost ground and the rupee suffered one of its steepest slides which this time shocked the market players.

The obvious consequences of devaluation in the short run would be to worsen the balance of payment position and raise the burden of India's foreign debt and debt service liability and foreign loan repayment would break the back of the budget, which in turn, would increase the trade gap. It will upset all the cost price relation in the economy, leading to galloping inflation and will stall many ongoing projects due to rising costs.

WHAT IS DEVALUATION?

Devaluation means a fall in the value of domestic currency relative to gold or the currencies of other nations. It is usually used to denote the unofficial increase of the exchange rate due to market forces. Some analysts are of the view that weakening the value of currency could actually have some positive outcomes for the economy since a weaker currency will boost exports, will lead to higher cost of imported goods and make some capital extensive projects more expensive to execute. But the fall in rupee too quickly would pose a danger that the foreigners will stop investing in the country, will increase the cost of dollar loans taken by companies and increase foreign debt. It will slow down the overall economic growth by increasing the interest rates.

HISTORY OF RUPEE MOVEMENT:

After independence, in the initial years from 1950 to 1973, Indian rupee was linked to British Pound. In 1966 the devaluation was the first major financial crisis the government faced. In 1975, the connection between Indian rupee and pound was broken. After that, rate of Indian rupee was linked to a "basket of currencies" of India's major trading partners.

Again in 1991 Union Budget, Indian rupee was devalued and the government also opened up the economy. This was then followed by several reforms liberalising the economy and exchange rate regime shifted from fixed to floating one. Indian rupee and its exchange rate historically were as follows:

Table No.1
Exchange Rate of Indian Rupee as against US $ 1

Year	Rate of Exchange
1950	Rs. 4.79
1955	Rs. 4.79
1960	Rs. 4.77
1965	Rs. 4.78
1970	Rs. 7.56
1975	Rs. 8.39
1980	Rs. 7.86
1985	Rs. 12.36
1990	Rs. 17.50
1995	Rs. 32.42
2000	Rs. 44.94
2005	Rs. 44.09
2010	Rs. 50
2016	Rs. 67.04

Before 2011 India had faced two major devaluations that is in the year 1966 and 1991.

Devaluation of India Rupee – 1966:

India being a developing economy, it is expected that its imports must be more than its export. Despite of government's attempt to obtain a positive trade balance, India has had consistent balance of payment deficits since 1950s. The following factors have been responsible for the 1966 devaluation:

1. India was continuously experiencing deficits in trade and the government budget, and the country was significantly aided by international community. During the time frame of 1950 to 1966, foreign aid to India was never greater than the total trade deficit of India except for 1958. Infact in 1966, foreign aid was finally cut off and India was told it had to liberalise its restrictions on trsde before foreign aid would again materialise. The response was the step of devaluation.
2. India's war with Pakistan in late 1965. The US and other countries friendly with Pakistan, withdrew foreign aid to India, which further necessitated devaluation.
3. The large amount of deficit spending required by any war effort also accelerated inflation and led to a further disparity between Indian and International prices.
4. Another factor responsible for devaluation was drought of 1965/66. The sharp rise in prices in this period led to devaluation.
5. Indian system of severe restrictions on international trade began in 1957 when the government

experienced a balance of payments crisis. This crisis was caused by a current account deficit of over Rs 290 crore which necessitated India lowering its foreign exchange reserves.

Devaluation of India Rupee – 1991:

As in 1966, there was foreign pressure on India to reform its economy, but in 1991 Indian policies were changed voluntarily by the government of P V Narsimha Rao. The following causes, as cited by Miss Bhawna Kalra, in her research paper on "Devaluation of Indian Rupee against US $" were as follows:

1. The trade deficit in 1991 was US $ 9.44 billion
2. The current account deficit was US $ 9.7 billion
3. The gulf war led to much higher imports due to rise in oil prices
4. Cost pull inflation
5. Political and economical instability
6. Depleting foreign exchange reserve

Devaluation of India Rupee – 2008:

In 2008, rupee not only was devalued against the dollar but it also depreciated against other strong currencies like the euro and the yen. On January 1, 2008 exchange rate of Indian rupee was Rs. 57.51 against the euro and Rs. 35.29 against 100 nyens. While in a span of 8 months on September 1, 2008 exchange rate of Indian rupee was Rs. 67.95 against the euro and Rs. 43.85 against 100 yens which means almost 15% decrease within 8 months.

Table No. 2
Select Asian Currencies against the Dollar

Select Asian Countries	Value of Currency		
	Jan 2008	Sep 2008	% change
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

(Source: Singh S., 2009, Depreciation of the Indian Currency, World Affairs. Vol 13, No.2)

The above table shows that there has been a steep fall in Indian currencies against the dollar. Main factors responsible for devaluation:

1. During Lehman Crisis capital flows shrunk sharply from a high of $ 107 bn in 2007-08 to just $ 7.8 bn in 2008-09 and led to sharp devaluation of the currency. Rupee plunged from around Rs 39 per $ to Rs 50 per $.
2. The fiscal deficitcontinues to remain high. Persistent fiscal deficits affect the currency rate.
3. Flight of foreign funds from the Indian market
4. Slowdown in the capital inflows, which decreases the supply of dollar

5. Higher global crude oil prices leading to widening of current account deficit
6. Recovery of US dollar

Devaluation of India Rupee – 2011:

The 2011 devaluation is the highest devaluation in the Indian history which is having and will continue to have much greater impact on the economy. In July 2011, rupee was Rs 43.96 against US dollar while in Jan 2012 it was Rs. 54.30 and at present it has crossed Rs 60

The major reason of this devaluation is the persistent fiscal deficits continue to remain high. Persistent fiscal deficits play a role in shaping expectations over the currency rate as well.

Another reason is populist policies of Indian government. The government wanted to break a trend of these populist policies and announced FDI in retail but due to opposition and allies, it had to hold back this policy. This has further made investors negative over the Indian economy. To attract FII, FDI is must.

The Euro –Zone crisis has weakened the Euro significantly against the US Dollar. In other words dollar is getting stronger in the world markets. Obviously the investors are considering US a safe place to invest in.

Number of Indian scams distracted government’s concentration away from economy. All these scams make the bad image of India in the global market.

CONCLUSION:

These two financial episodes in India’s modern history show that engaging in inflationary economic policies in conjunction with a fixed exchange rate regime is a destructive policy. If India had followed a floating exchange rate system instead, the rupee would have been automatically devalued by the market and India would not have faced such financial crises. A fixed exchange rate system can only be viable in the long run when there is no significant long-run inflation.

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