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Dr. Bhanupong Nidhiprabha

An Essay on
THE FALL OF THE ₹UPEE

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Joan Jose [6104930125]

A Brief History

Ancient India was one the earliest issuers of coins in the world with the usage of rupee tracing back to the 6th century BC. During the 19th century, the value of the rupee was based on silver while most of strong economies' currencies were based on the gold standard. Hence, the word rupee comes from the Sanskrit word *rupiya* meaning silver coin.

After India gained independence in 1947, the rupee was pegged to the British pound at a rate of 1 pound = 13.33 rupees. Around that time, the pound was worth around 4 USD, making rupee around 3.33 per dollar. During the 1960s, the currency was fixed to the dollar at the rate of 7.50 rupee per dollar. After the liberalization of the Indian economy starting from 1991, the rupee was devalued against the dollar to eradicate the problems of fiscal deficit and to accelerate the intended reforms.

Nonetheless, the Indian economy has evolved over the recent years to currently reach the feat of one of the fastest growing economies in the world. However, the rupee is one of the most volatile currencies in the world. This short essay aims to explain the reasons surrounding the rupees recent sharp depreciation as well as some other reforms occurring within this economy.

Recent Crippling Structural Reforms

To further modernize the Indian economy and to make it ready and prepared to take on an advanced role in the world, the government introduced major economic reforms recently. The first one has been the anticipated tax reform, *i.e.* GST (Goods and Services Tax). This was a necessary introduction to eliminate all the other indirect taxes and to fully formalize the Indian economy. However, this was not the only major operation introduced by the current government.

On the 8 November 2016, PM of India - Narendra Modi - made an unprecedented live televised address to the nation, declaring the circulation of all ₹500 and ₹1,000 banknotes as invalid effective from the midnight of the same day. Citizens were given until 30 December 2016 to exchange the demonetized notes to the newly printed ₹500 and ₹2,000 banknotes. Nevertheless, the new notes could not be printed fast enough so that it could be exchanged and the nation was left in a currency crunch leaving millions of people cashless in a cash driven economy.

India's massive informal economy reeled and the small & medium sized businesses faced severe turmoil due to this large scale financial experiment witnessed recently. In total 14 trillion rupees, *i.e.* 86% of the currency in circulation, were withdrawn from the economy.

The government facilitated the demonetization program with the promise to fight *'black money'* - funds earned without paying the necessary tax or gained through bribes and corruption. Furthermore, the objectives of expanding the tax base and increasing the number of taxpayers, promoting a cashless digital payments system were all advocated by the government.

On the contrary, the outcome of the demonetization process halted the growth of the Indian economy. It is fair to conclude that Narendra Modi wildy miscalculated the outcome of curbing the high value currencies.

Firstly, the Reserve Bank of India (RBI) was ill equipped and slow to issue the quantum of new currency required. Citizens had to wait in queues under the hot sun for hours hoping to receive the new currency, but only to find out that banks or ATMs had run out of it. Secondly, months after the data on the demonetization process was made available, the nation realized that the promise to eradicate *'black money'* was fundamentally flawed. Data released by the RBI showed that 99% of the invalidated currency was returned. The report concludes that either the amount of black money in the economy was grossly overestimated or those who held such wealth successfully evaded the consequences of demonetization by outwitting the government's simplistic plan.

Considering the GST, no one argues that a unified tax system was indeed necessary to solidify the formalization of the Indian economy. Prior to this tax regime, several different taxes were levied at different stages of production. Moreover, different states in India had implemented various taxes to one another for the inter-state trade. However, GST was implemented as the economy was still recovering from the aftermath of demonetization. Since its inception, the GST system has come into an inordinate number of operational glitches due to improper planning and faulty administration. These problems together with curbing of the currency caused large disruptions to businesses, especially in the informal sector, as well as small and medium sized enterprises.

Due to these large miscalculated and wrongly implemented policies, the GDP growth in India took a big hit during the 2017/18 period (since then until now the economy has picked up pace again). During this period, the economy grew at a 4 year low of 6.5% while in the previous period it grew at a rate above 7%. While we are still witnessing the negative impacts of demonetization, the implementation of GST will benefit the Indian economy in the long-run once policy makers finally polish out the system.

What is happening to the rupee?

The recent steep depreciation of the Indian rupee caused widespread concerns amongst commentators. It is one of the world's worst performing currencies of 2018, depreciating more than 13% against the dollar. Nevertheless, considering other emerging nations' currencies, such as Turkey lira and Argentinian peso, the rupee has performed better.

Several factors contribute to the depreciating currency. Emerging markets have been hard hit by the global trade war and rising US interest rate making the dollar more attractive. Due to rising rate in the US, investors favour purchasing US bonds rather than buying overseas. More importantly, India is an oil-importing nation with 81% of its energy needs imported and is the third largest importer of oil after USA and China. Currently, crude oil price is at a record high of $85 per barrel. The problem emerges from the fact that the payment of crude oil is conducted in dollars and the high price together with high demand, leading more rupee to be converted to dollars, strengthening the US currency. Furthermore, the rupee is a free floating currency, *i.e.* exchange rate is determined by market forces (supply & demand). Thus, due to the high demand for the dollar, the rupee naturally becomes weak.

Additionally, the Indian current account deficit have been rapidly increasing, meaning that more rupee is needed to pay for the higher imports. This leads to the forces contributing to the depreciation of the currency. Even overseas investors are pulling investment out of the Indian capital markets, increasing the rate of the capital outflows. These factors eventually lead to the further widening of the current account deficit and fall of the rupee.

As countering mechanism to the 'Trump-sanctions', China has used the yuan devaluation as a tool to try to keep its exports competitive. However, this weakness in yuan has spilled over to other emerging economies' currencies.

Nonetheless, the Indian Central Bank (RBI) has already taken up certain policy measures to prevent further depreciation of the currency. The RBI has been buying rupee from the market and foreign currency reserves have dipped below $400 billion. Furthermore, the interest rates have been steadily increasing over the period. Raising the rates is a justified move given the extent of the weakness in the currency, high oil prices and above target inflation rate. Alternatively, the RBI could raise dollars by borrowing from non-resident Indians.

However, RBI has been cautious about intervening to support the currency given that in previous years the result was not very successful. During the depreciation period in 2013, the central bank's intervention caused the rupee to be the worst performing currency out of the emerging economies.

The very recent news

Over the last two weeks an unprecedented standoff has been taking place between the Indian government and the RBI. The administration of Prime Minister Modi is attempting to encroach on the central bank's independence. It becomes problematic when the democratically elected official's goal is to revive irresponsible bank lending, please crony businessmen and win votes for the upcoming general elections rather than protecting the public interest.

Government of India wants the RBI to reverse its policy of gradually hiking rates and rather lower interest rates to inject liquidity into the economy. Furthermore, the government wants the regulator to lift restrictions imposed on ailing state-owned banks that are already struggling with faulty loans, so that they can resume lending again.

More worrying reports suggest that the government is attempting to raid the RBI reserves. This is not a step the government should be following given the history of Argentina in 2010 when its central bank governor was fired following his refusal to pay the country's foreign debt using its reserves.

Given that it is the general election year, the cash-strapped government is trying all it can even beyond its jurisdiction to stimulate the economy. Government revenues from tax have not been substantial, as mentioned previously by the problems of the implementation of the GST. It needs to be seen whether the current RBI governor will give in to the government's pressure or simply resign. Both scenarios will for certain bring about another uproar and crisis to the fragile Indian economy.

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