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# VOLATILITY OF INDIAN RUPEE: CAUSES AND IMPACT ON INDIAN ECONOMY

**Dr. Manjinder Kaur*; Navpreet Kulaar****

*Assistant Professor,
Department of Commerce,
Guru Nanak Dev University College,
Chungh, Tarn Taran, Punjab, INDIA
Email id: manjindergndu@gmail.com

**Research Scholar,
University School of Financial Studies,
Guru Nanak Dev University,
Amritsar, Punjab, INDIA
Email id: navpreetkaur7005@gmail.com

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## ABSTRACT

*The volatility of the rupee has recently emerged as a contentious economic issue in India. The continued decline in rupee value in past few months has substantial impact on the Indian economy. A huge decline has been seen in the worth of rupee i.e., almost 10% depreciation this year. The rupee has plummeted multiple times over the past year and on 7 October 2022; it recorded its all-time low of 82.80 per dollar. The Indian economy has impacted both favourably and adversely as a consequence of rupee volatility, but the negative consequences are so tremendous that they overshadow all that are positive ones and leaving only the adverse aspects visible. Our economy that has been already facing a significant deficit of current and fiscal account was further negatively impacted by the frequent rupee volatility. The RBI and the Indian government should require to make numerous strict and critical actions in order to retrace it back on the correct path and to promote maximum stability. This study highlights several possible reasons behind this volatility as well as its potential solutions and impacts on economy.*

**KEYWORDS:** *Exchange Rate, Rupee Volatility, Current Account Deficit, Oil Prices.*
***Jel Classification Codes:*** *F3, F21, F32.*

## INTRODUCTION

Due to its significance in monetary and managerial decision-making, forecasting of financial data including interest rates, exchange rates as well as stock market has been recognized as a prospective and relevant field of research in few recent years (Majhi et al., 2009). The rate at which one country's currency can be convertible into another country's currency is known as the exchange rate. It is generally referred as the foreign exchange rate or forex rate. The volatility of the rupee has recently emerged as a contentious economic issue in India. A frequent variation in the value of one currency in relation to another foreign currency is generally described as the exchange rate volatility. In other words, all fluctuations or movements that drive a currency to appreciate or depreciate is referred as exchange rate volatility. Depreciation of currency refers to a fall in the value of the domestic currency which is caused by the demand for foreign currency exceeding its supply in the market

(Saravanan, 2015).

From 1950 until 1973, the Indian Rupee was tied to the British Pound. This connection with pound sterling was terminated in September 1975. The Indian foreign exchange market was controlled and regulated until 1991 and the country's economy was a closed economy then. The transactions that India may conduct with foreign countries were prohibited with certain restrictions. A fixed exchange rate system was present in India until 1991, was another prominent aspect. However, in 1991, the LPG program initiated by Dr. Manmohan Singh, the country's then-finance minister, allowed the Indian economy to integrate with the global economy. Since then, there has been significant fluctuations in the rupee due to the introduction of the Liberalized Exchange Rate Management System and later replacement of that system with the Unified Exchange Rate System in the year 1993 which led to a devaluation of the rupee.

The practical research studies on the structure of volatility spill overs throughout various sectors of the financial industry has been quickly advancing ever since the ARCH model was introduced by Engle in 1982. When ARCH model is applied in its generalised variant i.e., GARCH has been introduced by Bollerslev (1986). The work of Diebold and Nerlove (1989) can be credited with the original application of GARCH to the foreign currency market. However, in present study we focus only on the theoretical aspects of rupee volatility instead of practical one.

**Current Scenario**

The value of rupee dropped to its worst level in the recent month of September 2022 which is considered as the largest monthly decline as compared to previous 36 months. As a consequence of this recent rupee volatility, the average per day turnover of currency options jumped from 87,495 crore to 1.29 trillion(*₹)*i.e., 47% which is a new record of highest profit in the fiscal year 2022-23. In the current year, rupee has lost its value by 10% in comparison to US dollar so far. Different experts have given different views on the fall in the value of the Indian currency. Some believe it will have a good influence on the economy, while some others consider it will have an unfavourable impact. This paper aims to looked into the causes of the rupee depreciation as well as potential solutions and impacts.

RBI usually intervenes in the exchange rate market to defend the Indian currency during periods of significant volatility or whenever there are shortages of foreign currency, which cause the volume of foreign exchange reserves to decline. Owing to RBI selling of foreign currency, excessive imports and FIIs outflow, the country's foreign exchange reserves have plummeted to $545 billion from its peak of $641 billion in previous year 2020-21 which is a matter of concern. The Indian currency has been rapidly depreciated due to deepening current account and trade deficits, massive withdrawals of overseas investments and having a stronger US dollar day by day.

The economy has been stunned by the current decline in rupee value, which doubled the usual rate of 4 to 5 percent yearly and caused a 10 percent depreciation in a single year, creating big concerns regarding the health of our economy. The other wealthiest currencies in the world have also declined significantly vis-a-vis the US dollar. They exhibit considerably weirder cross-currency fluctuations as compared to the Indian rupee. For fact, the UK Pound has dropped by 21% over the previous year, Chinese Yuan by 10%, the Japanese Yen by 29% and the Euro by 20% approximately. The underlying volatility is anticipated to continue in the near future as the world economy shrinks in the upcoming year 2023. In light of potential cross-currency swings to the US dollar, the same is going to have an enormous impact on the exchange rate market.

**Causes of Rupee Volatility**

The possible reasons behind the frequent rupee volatility are discussed hereunder:

**1. Current account deficits (CAD):**

Increased current account deficit is another significant component in the rupee's volatility by causing a decrease in its value. It is the difference between exports and imports of commodities and services. India usually has a deficit in its current account since its imports is always greater than its exports. In March 2019, the current account deficit was 2.1% of GDP which has been increased from 1.8% in the preceding year. The data was at its peak with 2.2% of GDP which is in positive number in the year 2004 whereas it was at its lowest with 4.8% of GDP (negative) in 2012.

**2. Global Crisis**

The value of US dollar has enhanced in the midst of international crises such as the financial meltdown in Ireland, China's tightening of monetary policy and artillery assault of North Korea. Assuming that Indian economy is anticipated to expand rapidly over the upcoming years, a strong rupee might offset any strengthening of the dollar relative to other major foreign currencies.

**3. Crude Oil Prices**

Since India is among the largest importer of crude oil, the government carried the majority of the load through subsidization and the lessening of import tariffs on crude oil, creating uncertainty about the government's fiscal stability which in turn causes the fluctuation in rupee value. Approximately 80% of the petroleum consumed in the Indian economy is imported and the need is still escalating. In year 2020, there was a decline in oil import due to covid pandemic but after passing that phase, the oil import raises to 161810.5 US $ millions in 2021 which was around 130550.3 US $ millions in 2019. Following crude oil, gold is the second-largest commodity which is imported in bulk quantity by the Indian government. Additionally, to operate its thermal power plants, India has constantly imported a sizable amount of coal. All these significantly rises CAD and depreciate Indian rupee.

**4. Huge Imports of Gold**

Indians people adorn themselves with gold and diamond jewellery for their momentous events like weddings and other religious rituals as well as festivals. India is one of the biggest gold importers in the world. It is recognized as a "safe" asset in India. The demand for dollar is increased when gold is imported into the country since the payment must be made in dollars. Hence, Indian currency fluctuate in relation to dollar. Data from the Ministry of Commerce shows that during the first quarter of 2021–22, India's imports of gold is of $8.43 billion even after covid pandemic.

**5. Depleting foreign exchange reserves**

The Reserve bank of India has sold dollars to defend the rupee value by continuously depleting its foreign exchange reserves as the rupee has dropped approximately to 10% of its value in the current year. These reserves have been dropped by almost 67% during the current financial year that began on April 1st as a result of valuation adjustments driven on by the strengthening US dollar and increasing the US bond yields. This decline in forex reserves is about $4.85 billion, to $532.66 billion in September, 2022. However, over the first quarter of 2022-23, these forex reserves increased by US$ 4.6 billion on a basis of balance of payments

(BOP) metric.

**6. Intensifying of persistent Inflation**

If inflation persists for an extended period of time, it causes capital outflows and generalised deterioration in state of the economy, and eventually depreciate the currency. Evaluating the real effective exchange rate requires an understanding of inflation. The REER serves as a benchmark for determining whether a currency is overvalued or undervalued. The Indian rupee must decline by about 4% annually if India's inflation rate is 6% and the US rate is 2%. The value of rupee will be overvalued if it depreciates below that level and undervalued if it depreciates over that amount. For instance, if the rupee has a REER is 120, then it indicates 20% overvaluation of the Rupee in comparison to the US Dollar.

**7. Volatile Indian Share Market**

The share market of India has been inconsistent and erratic for quite some time. The FIIs are therefore lose their confidence and torn between investing in India or not. Although these FIIs contributed to the country's record-breaking inflows in the current year, it's still possible that they will withdraw their funds from the Indian share market, which might again lead to a decline in the amount of dollars inflows into India. This scenario again causes volatility by depreciating the rupee's value in relation to dollar in the international market.

**Impact of Rupee Volatility**

The Indian economy is impacted both favourably and adversely as a consequence of rupee volatility, but the negative consequences are so tremendous that they overshadow all that are positive ones and leaving only the adverse aspects visible. Some of these impacts are mentioned hereunder:

- Rupee volatility hinders our companies' capacity to compete internationally by escalating the burden of foreign currency loans and having a detrimental impact on their profitability and revenues.
- Because of the huge import bill, our current account deficit increased from $9.9 billion in July to September 2021 to $23 billion in October to December 2021. Analysts predicted that this margin would continue to rise in the current year.
- The already stressed bond and equity market may experience outflows if the currency starts to decline and volatile quickly. The RBI should try to step in and make assured that there would be lesser volatility in rupee's value.
- India's rating will be downgraded to "Junk" category by international rating agencies which in turn make it harder and more expensive to borrow funds from international institutions such as IMF.
- India has to pay in US dollars since our economy primarily depends on imported goods including crude oil, gadgets, metals etc. Therefore, if indeed the rupee is weak, there will be need to spend more to purchase the same amount of goods. In such circumstances, the cost of production increases, shifting those expenses on to general public.
- The volatility of the rupee will alter and thus impact the business models. Indian entrepreneurs will be urged to seek exports to countries with strong currencies and imports from nations with weakened currencies. Also, the Indian businesses now have to face higher costs while considering the foreign acquisitions.

- Input costs will rise in numerous sectors as a result of the volatility of the Rupee. It has a detrimental effect on almost all major industries such as automobiles, airlines, fertilisers, energy firms (oil companies), durables goods etc. Airlines with a higher percentage of domestic operations' income will also suffer because 70% of their overhead is paid for in dollars.
- The Rupee's depreciation will increase input costs across many sectors. Sectors that will be negatively impacted by the rupee's depreciation include automobiles sector, auto components, airlines, consumer durables, oil companies & fertilisers. Airlines with a higher percentage of their revenue coming from domestic operations will also suffer as they have to pay their major expenses in dollars.

**Steps needs to be taken by RBI:**

By enhancing market involvement to strengthen the Indian rupee, RBI should actively undertake essential measures to boost up the supply of international currency. The government should strictly enforce restrictions on the import of unnecessary and luxurious items such as gold, silver etc. Additionally, the government ought to think about levying the heavy customs charges on consumer electronics products. Further, RBI should remove the investment restrictions from FIIs in both commercial and public debt securities. Perhaps it would entice FDI to invest in our economy's infrastructure. In order to enable maximum external commercial borrowing, the limits of ECB borrowings should be raised beyond its present limits. In short, Indian economy's attractiveness to overseas investors may continue to boost systemic capital flows into the nation through these ECBs and FDI. Also, to prevent the rupee from experiencing a rapid decline in its value, the RBI should significantly enhance its foreign exchange reserves. The aggregate foreign exchange reserves have been dropped approximately $41 billion since february this year which is a good measure. Further liberalisation on the restrictions preventing the foreign acquisition of key industries especially healthcare, insurance and telecommunications should be implemented. Plans for issuing treasury securities should be introduced on a regular basis. By doing so, rupee's reputation in the overseas markets will be improve. Such policies should be implemented whose target is to maintain rupee volatility within a certain band limit. Despite of all the odds, although Nirmala Sitharaman, our union finance minister, has asserted recently that the Indian rupee is substantially better positioned than other foreign currencies against the dollar.

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