Rupee Depreciation: Its Causes and Cure

Raj, Madhusudan

Department of Human Resource Development, VNSGU, Surat

1 July 2014

Rupee Depreciation: Its Causes and Cure

Madhusudan Raj[*]

Abstract

Indian currency rupee is depreciating rapidly against the US dollar and other foreign currencies. This paper analyses the major causes of this depreciation. It also discusses its cures.

Keywords: Rupee, RBI, Regime uncertainty, Inflation, Depreciation, Fractional reserve banking, Central bank.

JEL Classification: E41, E42, E51, E52, E58.

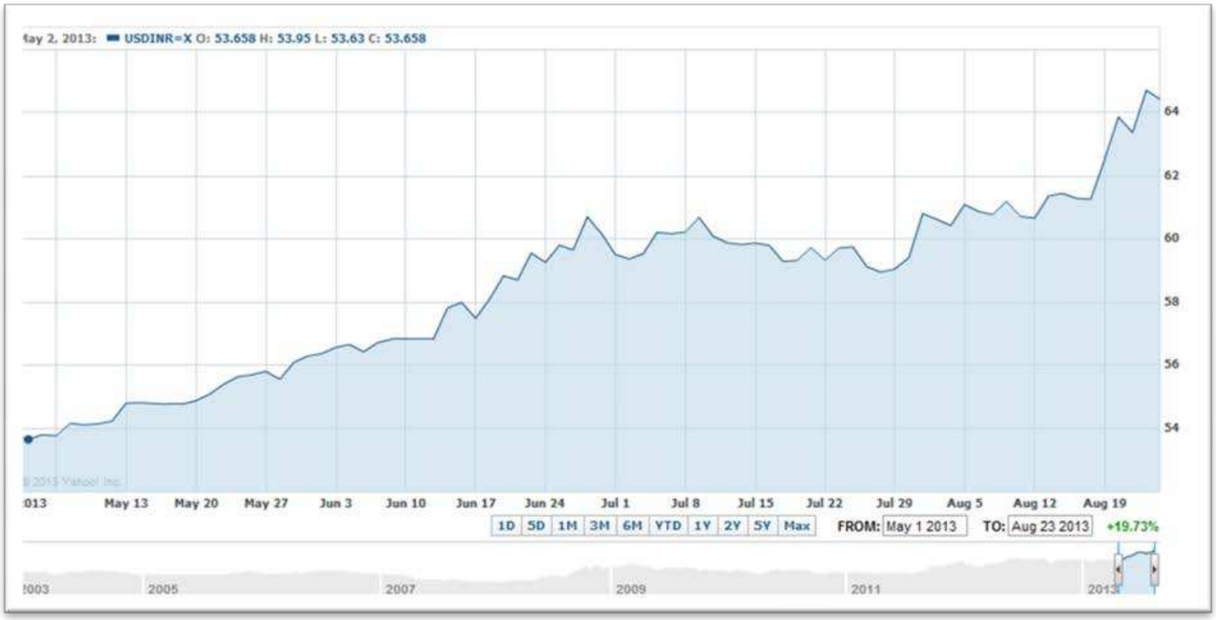
[*] Assistant Professor of Economics, Department of Human Resource Development, Veer Narmad South Gujarat University, Surat – 395007, Gujarat, India, Email: academia.raj@gmail.com.

Rupee depreciation: Its Causes and Cure

Introduction

The Indian currency rupee is under tremendous pressure recently in the Forex (Foreign Exchange) market. Since the beginning of the month of May, it has depreciated by more than 18% against the US dollar (see Figure 1 below). It crossed 100 rupee mark briefly against the British pound, and trading at 84.55 rupee against the Euro. It is one of the worst performing currencies in Asia so far. The Indian central bank RBI and the Indian government have tried various measures like trying to suck the liquidity out of the markets by raising various rates, selling dollar, and outright partial capital controls etc., so far to stop rupee's decline, but all in vain. The relentless dive continues with some pauses and retractions. This depreciation is threatening the Indian capital markets, and as a reaction to depreciating rupee the BSE Index as well as NIFTY has tumbled by hundreds of points recently. Many are even comparing this situation with 1990s 'balance of payment' crisis. Although no such similarities exist, the situation today, nevertheless, is very grave. The depreciating rupee means rising prices of many essential goods, especially food and energy products like petrol, diesel, cooking gas etc. If the rupee continues to slide against the dollar, then, sooner or later we will have a balance of payment crisis for sure.

Figure 1: Rupee’s Depreciation against the US Dollar (May 2013 to August 2013)



Source: Yahoo Finance.

In the wake of this precipitous fall in rupee’s value, people are asking questions about its cause and cure. The central bank and the government officials are, as usual, either clueless about the cause of this decline or they are fooling people by blaming various scapegoats like external foreign factors, supply side constraints e.g., low economic growth and export weakness etc. To understand rupee’s depreciation we need to understand the laws of human action first i.e., economics, which is nothing but *a science of human action*. Without a sound understanding of these laws, it is impossible to understand and cure the rupee crisis. In the second section of this paper, I will briefly discuss the theory of money. In particular, what money is and how its value is determined in the market first vis-à-vis other economic goods, and then its exchange value determination vis-à-vis other foreign currencies in the international Forex market. Once my readers are familiar with sound monetary theory, we are ready to tackle the issue of rupee’s fall. Understanding causes of this problem also gives us an insight into its cures. Third section will discuss the causes of rupee’s decline, and fourth section will discuss cures of this crisis.

Theory of Money

What is money?

Human beings are using money since the known human history of last 6000 years or so (Davies & Julian Hodge Bank., 2002). It is nothing but a common medium of exchange. Money evolved in the market process organically to solve the problem of the barter system. In barter system, which human beings were using before they invented money, there are two major problems impeding trading between human beings: 1) the double coincidence of want, and 2) the indivisibility of the products which are up for the trade. For example, suppose Robinson Crusoe wants to buy a coconut from Friday, and Friday wants to buy fish from Robinson, then, Robinson must have surplus fish in his warehouse and Friday surplus coconuts for this trade to happen. If Friday is having apples in his warehouse, then, this exchange cannot take place. Also, if Friday is having an Ox in his possession, then, he can’t trade it in pieces for the goods which he need for his consumption! Money solves both these problems because it is a common medium of exchange which all people readily accept against exchange for other economic goods. Any reading of human history will tell us, that the precious metals Gold and Silver are used as money by humans since last 6000 years or so. Humans have also used other economic goods like cowrie shells, grain, cattle, paper etc., as money, but in the market competition, over the long period of time, Gold and Silver has won over these other monies[1].

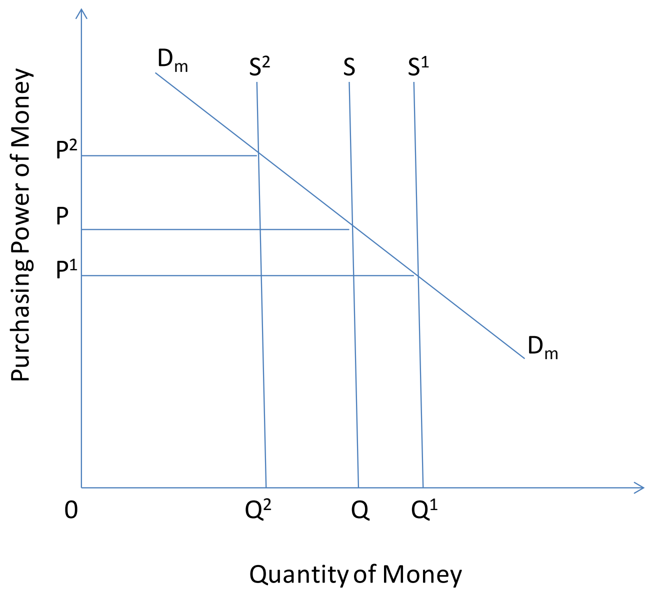
Because money is just another economic good in the market, its value, just like other economic goods, is determined by the market forces of demand and supply. The demand for and supply of money determines its purchasing power vis-à-vis other economic goods in the domestic market, and similarly its exchange value in the international Forex (Foreign Exchange) market. Let's see how this process works.

The Money Relation: The Demand for and Supply of Money

Figure 2 below presents the demand and supply analysis of money commodity. Y-axis represents money's purchasing power (its price), and X-axis represents its total money stock available in the economy. Ceteris paribus, initially when the total available stock was 0Q, money commodity's purchasing power was 0P. When the total available stock in the economy increased to $0Q^1$, its purchasing power declined to $0P^1$. That means, money commodity is now buying less goods than before, and increased supply of money is responsible for this reduced purchasing power of money. On the other hand, if the total quantity of money available in the economy decreased to $0Q^2$, then, it will raise money's purchasing power to $0P^2$ i.e., money will now buy more goods.

[1] Those readers who want to know about the organic evolution of money in the market process should read the groundbreaking analysis of Carl Menger (2009). For a solid grounding in the economic theory of money please refer to the very important works of Ludwig von Mises (2009) and Murray Rothbard (M. N. Rothbard, 1974; M. Rothbard, 2008a, 2008b; Murray Newton Rothbard, 2004).

Figure 2: The Money Relation: Money's Demand and Supply



If we obverse the same phenomena from the good's side, then, in the first case it will look as if the prices of various economic goods are rising. But, as we saw above, it is actually money that is losing its purchasing power and buying less. While in the second case, it will look as if the prices of various economic goods are falling, but as we again saw above, it is the purchasing power of money that is rising, and so it is now buying more economic goods. To understand why rupee is depreciating against the dollar we just have to substitute economic goods with the dollar (or any other foreign currency) in our on-going analysis.

Similarly, ceteris paribus, if the demand for money increases i.e., people increase their cash-balance, then, the rupee's purchasing power will increase, and vice versa. So, both demand and supply factors working dynamically together determine rupee's value not only against other economic goods, but also against other foreign currencies.

After understanding this crucial theory of money relation, now we are ready to analyze the recent fall in the exchange rate of rupee against the US dollar[2].

Causes of Rupee Depreciation

After having a sound understanding of monetary theory, it is easy to see what is ailing rupee in present time. There are two major factors which are responsible for rupee's decline against the US dollar:

1) Demand for rupee and supply of rupee on the one side; and
2) Demand for dollar and supply of dollar on the other side

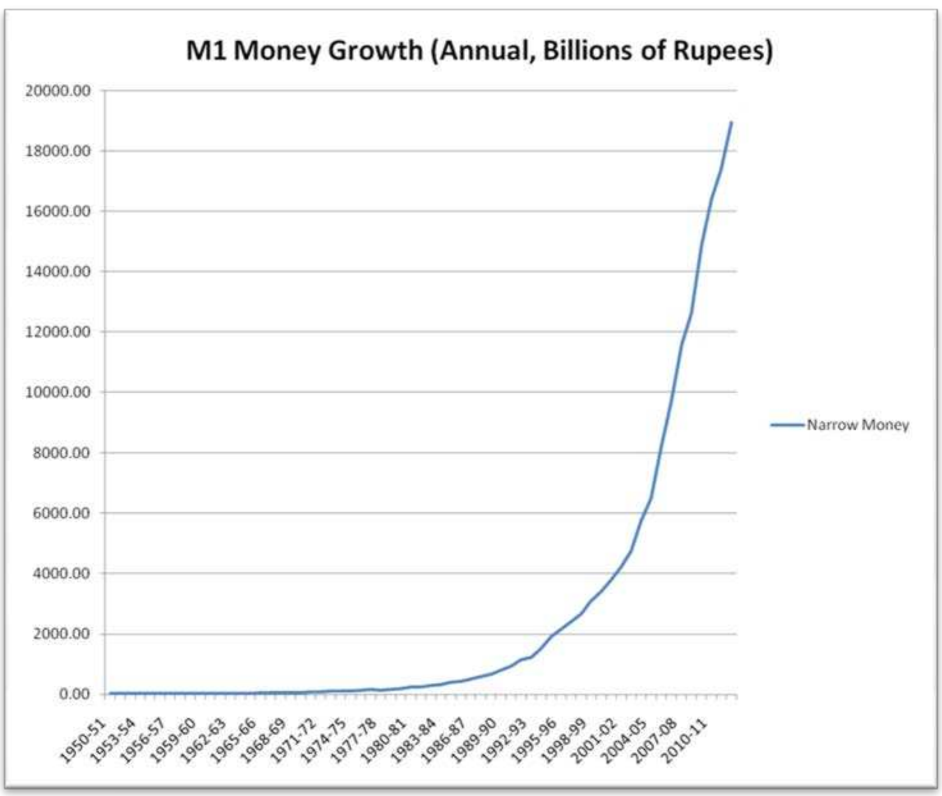
In the Forex market whenever the demand for rupee increases – under the ceteris paribus assumption – then rupee's value will increase against the dollar i.e., it will appreciate, and vice versa. Whenever its supply increases, its value falls against the dollar i.e., it will depreciate, and vice versa.

These factors in turn are determined by two major entities in this case: The Indian central bank RBI, and the US central bank US Fed. Both of these monetary central planning authorities are having a monopoly power of printing money in their respective countries. RBI is responsible for controlling rupee's supply in India and US Fed for dollar's in America. Now, since the beginning of the financial crisis in 2007, the Indian central bank RBI is printing and increasing the supply of rupee (M1[3]) at an average annual growth rate of 12%! This is a phenomenal growth in rupee's supply in last 6 years. Figure 3 below represents the M1 money supply growth in India. As can be seen

[2] I don't have to mention this, but this same analysis is also applicable to other foreign currency cases.
[3] In all given components of money stock measures in India, M1 correctly represents the stock of money available in the economy. M1 includes currency with the public + demand deposits with the banking system + other deposits with the RBI.

in the graph, the rise is relentless. Coupled with this steep rise in the supply of rupees, recently the demand for rupee amongst the international investors is also falling because the Indian economy is struggling. Indian government has created lot of 'regime uncertainty' (Higgs, Spring 1997) e.g., they have tried to retrospectively tax foreign companies, the GAAR issue, the on-going Vodafone and Nokia tax issues and myriad of other policy backtrackings etc., and because of that foreign institutional investors are reluctant in investing in India. On the other side, there was a talk of the US Fed starting to taper its money printing program called QE (Quantitative Easing), which increased the demand for dollars in the Forex market vis-à-vis Indian rupee. All these factors combined to depreciate the rupee sharply against the US dollar.

Figure 3: M1 Money Supply Growth in India (1950-51 to 2012-13)



Source: RBI Database.

The Cure

So, what should be done to halt the crisis of rupee depreciation? The answer lies in the monetary theory which we discussed above. If the increased supple of and decreased demand for rupee is the root cause of depreciation in rupee's value, then, we have to reverse both these causes. That means, first, the RBI must immediately stop creating any new money out of thin air. It must freeze the supply of rupee at its current level in the economy. This measure will halt any further depreciation in rupee's value against dollar, and other foreign currencies. In the longer run, we must, as a society, decide whether we need any monetary central planning or not. Theory and history both have shown that any kind of central planning will fail miserably (Hayek, 1948; Mises, 1975). Monetary central planning authority like RBI cannot fathom what the true market rate of interest rate should be. One RBI governor cannot substitute the market forces of demand and supply. Any fixation of interest rate by the RBI is and will be arbitrary, which will create problems of inflation, business cycles, unemployment and increasing income and wealth inequality in the Indian society. We must restore the control of money supply in the hands of market participants. This can be done by bringing back the market determined commodity monetary standard in the form of *pure gold standard*; this also means, dismantling the RBI. With RBI, other commercial banks are also responsible for the rise in the supply of money in the economy. Today's commercial banks, who work on the basis of the fraudulent practice of *fractional reserve banking*, also create money out of thin air (M. Rothbard, 2008a). This money creation also causes rupee's depreciation. This is the precise reason why we should declare this practice of fractional reserve banking (FRB) illegal, and bring back 100% reserve banking standard where all the deposit banks will legally have to keep all their deposits with them all the time instead of lending them to third parties. To do this we must separate the loan banks from the deposit banks. Loan banks will take care of savings and investment activities in the economy.

Secondly, we have to bring back investor's confidence in the Indian economy. That is only possible when we remove the problem of *regime uncertainty* which the Indian government has created. Only in a stable property rights environment, businesses can grow and profit. Only profit making opportunities will attract foreign investors to India. Once the government will stop meddling with the market economy, Indian economic growth will resume its higher trajectory. High economic growth rate will give incentive to foreign and local investors to invest in India, which in turn will increase the demand for rupee. Increased demand for rupee coupled with stable supply of rupee will result in a strong rupee. A strong rupee will benefit everyone.

In short, as long as the Indian government is meddling in the Indian economy, and as long as the RBI is meddling with the money supply, rupee cannot recover strongly. Only free market capitalist system is capable of solving our problems of inflation, business cycles, unemployment and inequality of income and wealth.

REFERENCES

Davies, Glyn, & Julian Hodge Bank. (2002). *A history of money : from ancient times to the present day* (3rd ed.). Cardiff: University of Wales Press.

Hayek, F A. (1948). *Individualism and Economic Order*. Chicago, IL: The University of Chicago Press.

Higgs, Robert. (Spring 1997). Regime Uncertainty: Why the Great Depression Lasted So Long and Why Prosperity Resumed after the War. *The Independent Review, I*(4), 561-590.

Menger, Carl. (2009). *The Origins of Money*. Auburn, Alabama: Ludwig von Mises Institute.

Mises, Ludwig von. (1975). *Economic Calculation In The Socialist Commonwealth*. Auburn, AL: Ludwig von Mises Institute.

Mises, Ludwig Von. (2009). *The theory of money and credit*. Orlando, FL: Signalman Pub.

Rothbard, M. N. (1974). *The case for a 100 percent gold dollar*: Libertarian Review Press.

Rothbard, Murray. (2008a). *The Mystery of Banking* (2nd ed.). Auburn: Ludwig von Mises Institute.

Rothbard, Murray. (2008b). *What has government done to our money?* Auburn: Ludwig von Mises Institute.

Rothbard, Murray Newton. (2004). *Man, economy, and state with Power and market (Scholars edition)* (2nd ed.). Auburn, Ala.: Ludwig von Mises Institute.