

FALL OF THE INDIAN RUPEE



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**Understanding the fall in the
value of the Indian Rupee**



FALL OF THE INDIAN RUPEE



Everyone is asking that if Euro-zone is the cause of economic problems then why is Indian Rupee rapidly losing value?

FALL OF THE INDIAN RUPEE

Our “Current Account Deficit” is the main reason for this. In other words we have been spending more than we have been earning and that is causing stress to our economy and also the currency



FALL OF THE INDIAN RUPEE

Current Account Deficit is the difference between our income from exports of goods & services and imports. When we import and spend abroad more than we export and earn from abroad causes Current Account Deficit



FALL OF THE INDIAN RUPEE

The Value of any currency is a function of its demand and supply i.e. if people demand more Rupees then Rupee appreciates in value while if there is more demand for US dollars then Rupee depreciates vis-à-vis dollar (i.e. Dollar appreciates)



FALL OF THE INDIAN RUPEE

Let's understand the background.

In the wake of the financial crisis the government in order to stimulate the economy enhanced its spends and reduced interest rates.

This added liquidity into the economy.

Had the additional liquidity got sufficiently deployed in investments such as infrastructure projects and other capital intensive projects, it would have resulted in genuine capital formation



FALL OF THE INDIAN RUPEE

However, the investments that took place was not sufficient. Instead the additional liquidity or money moved into the hands of consumers leading to consumption demand. Consumer good companies benefited from this.

But this also meant that for the same amount of goods the amount of money increased.

This naturally led to inflation or in other words the value of the money reduced.



FALL OF THE INDIAN RUPEE

To understand this a little better let's look at an analogy. Imagine there is dam which is storing a lot of water. Now imagine we add more water to the current stock of water. So in a sense we can say that the liquidity in the dam has increased.

In such a case what options do the dam authorities have?



FALL OF THE INDIAN RUPEE

Ideally they should release water into the agricultural fields so that it could result in a better crop output. But for that to happen it is mandatory that the channels carry water to the fields.

However if the water intended for the fields does not get there and instead is used up for domestic purposes then this adversely affects the crop output.



FALL OF THE INDIAN RUPEE

In this example the water is like the money that was released in to the economy. The channels are like the policy execution mechanisms that help to deploy capital and the crop produce is like the economic growth that takes place in the economy



FALL OF THE INDIAN RUPEE

Now, since the policies meant to support investments did not get executed on time the stimulus capital could not get deployed as intended and hence the capital formation for the needed economic growth that was expected did not take place.



FALL OF THE INDIAN RUPEE

So as the channels taking water to the fields were blocked, the released water by dam authorities ended up being used for domestic consumption purpose by the villagers.

When there was excess water available, the villagers used more water for the same work than they used earlier.

Thus just like the currency that loses value due to inflation the excess water released into the village too lost value from the villager's perspective



FALL OF THE INDIAN RUPEE

Thus, as in the case of the dam, the liquidity in our economic system increased but instead of being deployed by way of investments that would have created commensurate economic growth instead got into the system as additional consumption leading to inflation.



FALL OF THE INDIAN RUPEE

As a consequence of additional money in the system without commensurate increase in country's economic growth, the value of Rupee has depreciated as we pay more for the same quantity of goods and services.



FALL OF THE INDIAN RUPEE

Our current account deficit has also increased in recent periods due to increase in oil prices internationally which increases our dollar payments. Increase in dollar payment leads to increase in its demand.



FALL OF THE INDIAN RUPEE

An example of how depreciation of Indian Rupee leads to losses to foreign investors can be given as:

Assume a foreign investor invests \$1million in Indian market as on 01st Jan 2010. The rate of 1\$ was Rs.45 so he invested Rs.4.5 crore. He earns a returns of 10% in the first year.

On 01st Jan 2011, he decides to sell his investments and take back money. With 10% return his investment value was Rs.4.95crore, however, due to Rupee depreciating to Rs.50 he actually takes U.S \$ 9,90,000 back which means he not only lost the returns he earned, he also lost his capital to the tune of U.S \$ 10,000



FALL OF THE INDIAN RUPEE

When FII's start pulling out they sell rupees which again adds to fall in its value.

Thus increase in current account deficit, weakening risk appetite of FII's, their pulling out investments have all lead to the fall of the Indian Rupee vis-à-vis U.S dollar.



FALL OF THE INDIAN RUPEE

However, we must also remember that the weakening of the Indian Rupee will help make the country's exports more competitive which will help exporters.

Secondly, any correction in global commodity prices will also help the Indian Rupee



FALL OF THE INDIAN RUPEE



Hope this story has clarified the loss
in the value of the Indian Rupee

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