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CURRENCY DEPRECIATION AND ITS BENEFITS

SAMIYA BHATIA

Delhi Public School, R.K. Puram, New Delhi

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ABSTRACT

This project studies currency depreciation in depth and correlates the advantages of depreciation and devaluation due to the similarity in both phenomena. It also studies why currencies depreciated in a few case studies, and how the economies suffered and recovered.

INTRODUCTION

CURRENCY DEPRECIATION and its FACTORS:

A. DEFINITION:

Currency depreciation is broadly defined as a fall in the value of a currency in terms of its exchange rate versus other currencies.

Different countries have different methods of determining their currency's exchange rate. It can be determined through Flexible Exchange Rate, Fixed Exchange Rate or Managed Floating Exchange Rate.

1. Flexible or Floating Exchange Rate:

It is determined by the market forces of demand and supply. The exchange rate is determined where the demand curve intersects with the supply curve, i.e., at point e on the Y – axis. Pointq on the x – axis determines the quantity of US Dollars that have been demanded and suppliedon e exchange rate.

Suppose the demand for foreign goods and services increases, then the demand curve shifts upward and to the right of the original demand curve. The increase in demand for foreign goods and services result in a change in the exchange rate. At the new equilibrium, the exchange rate means that we need to pay more rupees for a dollar now. It indicates that the value of rupees in terms of dollars has fallen and value of dollars in terms of rupees has risen.Increase in exchange

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rate implies that the price of foreign currency (dollar) in terms of domestic currency (rupees) has increased. This is called **Depreciation** of domestic currency (rupees) in terms of foreign currency (dollars).

Similarly, when the price of domestic currency (rupees) in terms of foreign currency (dollars) increases, it is called **Appreciation** of domestic currency (rupees) in terms of foreign currency (dollars).

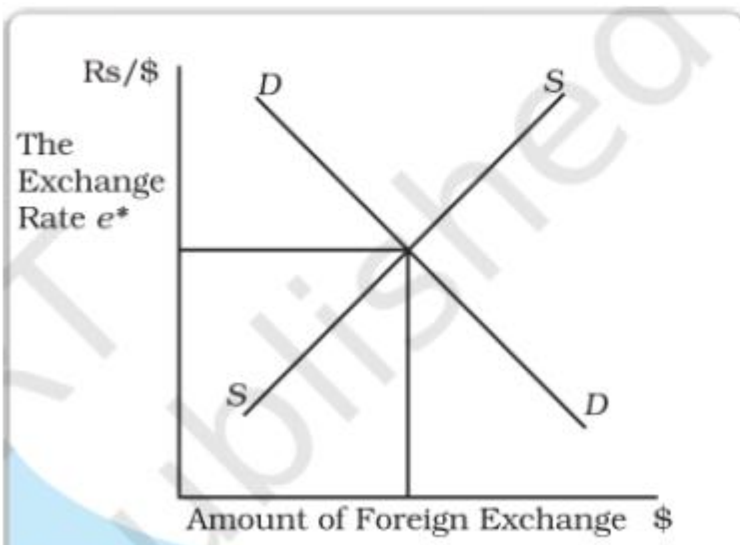

Fig. 6.1

Equilibrium under Flexible Exchange Rates

2. Fixed Exchange Rates:

In this exchange rate system, the Government fixes the exchange rate at a particular level. Let the exchange rate determined by the market be e. However, let us suppose that for some reason the Indian Government wants to encourage exports for which it needs to make rupee cheaper for foreigners. It would do so by fixing a higher exchange rate, say Rs 70 per dollar from the current exchange rate of Rs 50 per dollar. Thus, the new exchange rate set by the Government is e1, where e1 >e. At this exchange rate, the supply of dollars exceeds the demand for dollars. The RBI intervenes to purchase the dollars for rupees in the foreign exchange market in order to absorb this excess supply which has been marked as AB in the figure. Thus, through intervention, the Government can maintain any exchange rate in the economy. But it will be accumulating more and more foreign exchange so long as this intervention goes on. On the other hand if the government was to set an exchange rate at a level such as e2, there would be an excess demand for dollars in the foreign exchange market. To meet this excess demand for

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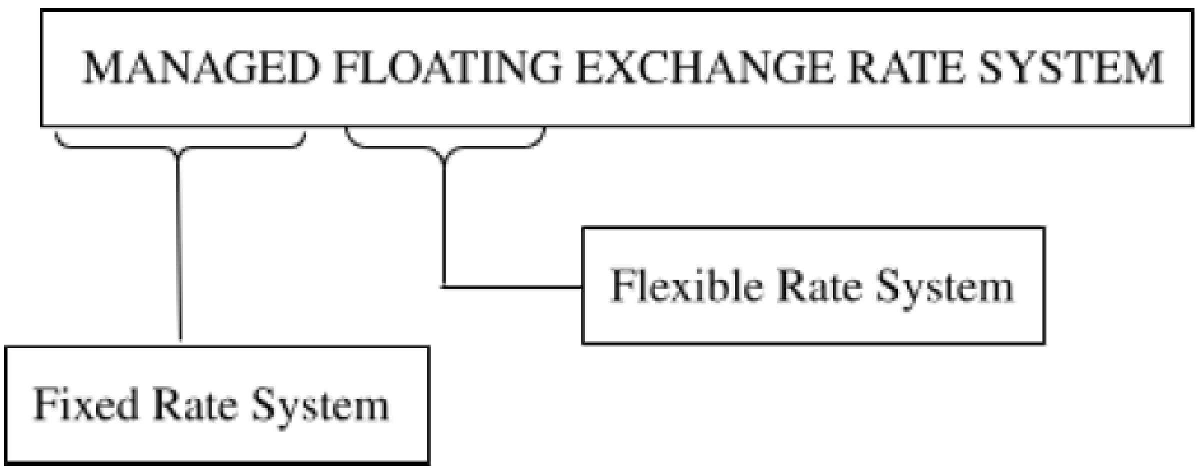
dollars, the government would have to withdraw dollars from its past holdings of dollars. Failure to meet this demand for dollars leads to a black market for dollars. In a fixed exchange rate system, when some government action increases the exchange rate to make domestic currency cheaper is called **Devaluation**. On the other hand, a **Revaluation** is said to occur, when the Government decreases the exchange rate thus making domestic currency costlier in a fixed exchange rate system.

3. Managed Floating Exchange Rate



It is a mixture of a flexible exchange rate system and a fixed rate system. Under this system, also called dirty floating, central banks intervene to buy and sell foreign currencies in an attempt to moderate exchange rate movements whenever they feel that such actions are appropriate. This is the most commonly adopted exchange rate, although there is no formal international agreement regarding the same.

B. FACTORS:

Currency depreciation can occur due to factors such as economic fundamentals, interest rate differentials, political instability, or risk aversion among investors.

1. Economic Fundamentals:

The cause of currency depreciation is due to economic factors like the productive capacity of an economy and the size of its money supply (total money - cash, coins, and balances in bank accounts - in circulation in an economy). The complex process of the interplay of productive ability of an economy and money in circulation is what determines the demand and supply of a

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currency and thus also plays a huge role in deciding the amount of depreciation or appreciation in a nation's currency.

ECONOMIC FACTORS LEADING TO CURRENCY DEPRECIATION		
Aspect	Productive Capacity	Size of Money Supply
Defined:	"Productive capacities are the productive resources, entrepreneurial capabilities and production linkages that together determine a country's ability to produce goods and services that will help it grow and develop." - UNCTAD	Total money - cash, coins, and balances in bank accounts - in circulation in an economy
Effect:	When the supply of money grows faster than productivity, there are more units of currency to absorb productivity, so each one ends up representing less exchange value in the market. Thus leading to depreciation of currency which in turn leads to inflation.	

2. Interest Rate Differentials:

Interest rates determine the value of a country's currency by influencing foreign investment, demand for and value of a currency.

Higher interest rates attract more foreign investment, increasing the demand for and value of the home country's currency. On the other hand, lower interest rates have the opposite effect as they tend to be unattractive for foreign investment and decrease the relative value of a nation's currency.

Although the phenomenon is deceivingly simple, it is an intricate play of a variety of factors which end up impacting currency value and exchange rates. One such major complicating factor is the correlation present between higher interest rates and inflation. To manage inflation when it reaches the point of an overheating economy, central banks often raise interest rates. However, in case the rise in inflation is too rapid, the value of the currency will plunge quicker than the But, if inflation rises too quickly, a nation's money will quickly lose its worth and the currency's demand will dive. This will cause the currency to lose value, or depreciate, quicker than the interest rates can compensate households which are saving and depositing currency in these banks.

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INTEREST RATES' EFFECT ON CURRENCY DEPRECIATION

FACTORS AFFECTING INTEREST RATES

Many factors - majorly macroeconomic - affect the interest rates of a country. These factors, by impacting interest rates also indirectly influence the depreciation or appreciation of a country. These factors include:

1. **Politics:**

Table 1
A Rudimentary Typology of Political Factors of Interest to Students of Macroeconomic Policy

	Governmental	Nongovernmental
Variable	Type I Election Contests Dynamics of Public Opinion Legislative Politics Bureaucratic Politics Interest Group Politics	Type II Wage Bargaining Strike Behavior Business Confidence
Structural	Type IV Division of Power between Executive and Legislature Structure and Control of Public Bureaucracy Central Bank Independence	Type III Degree of Unionization Links of Parties and Unions Organization of Business Sector Financial Structure National Preferences for Inflation/Unemployment

2. **Economics:**

a. Demand and Supply for money	**b. Government Borrowing**	**c. Inflation**	**d. Central Bank's Monetary Policy**
- Increase in the demand for money, ceteris paribus, leads to increase in price of money and therefore, rise of the interest rates	- Fiscal deficit is the amount by which government expenditure exceeds government revenue. To fund this deficit in	- Prices of all goods and commodities are determined by taking into account the general price increase in the economy due to	- The Central Bank may increase interest rates to restrict inflation during a phase of strong economic expansion - or a
	revenue, the government may resort to borrowing. As the largest borrower in the economy, government borrowing influences the demand for money and thus influences interest rates.	inflation. This is not only true for goods and services but also for interest rates.	boom phase. This curbs borrowing and thus curtails consumption and investments.

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- If the supply of money increases, ceteris paribus, the price of money reduces leading to reductions in interest rates	- There is a positive correlation between the fiscal deficit and interest rates: higher the fiscal deficit, more the government borrowing and in turn higher the interest rates	- During high inflation, savers have to be compensated through higher interest rates to incentivise sacrificing their consumption motive. The idea is to keep the real rate of return positive so that after inflation the saver saves some amount. That means in a high inflation era, the interest rates tend to stay up and vice versa.	- To induce economic growth during a recessionary period, the Central Bank may want to incentivise consumption and investments by reducing the interest rates.

3. **Global Trade:**

A nation's balance of trade and its currency's value and demand show a high positive correlation to the extent that they are often used interchangeably when estimating a currency's strength. This is due to the fact that greater demand for a nation's commodities correlates to greater demand for its currency which means higher the balance of trade, higher the value of a currency. A country with a high demand for its goods tends to export more than it imports which means that there exists an increasing demand for its currency. A country that imports more than it exports will have less demand for its currency. This influences the currency exchange rates by swaying the currency values.

4. **Financial Stability:**

An example of how financial stability is important is the case of the U.S. Dollar. The USD is still perceived as a safe haven in an economically uncertain world. This is the major reason - more so than interest rates, inflation, or other factors - that has played a pivotal role in maintaining the relative value of the U.S. Dollar.

One opposing force regarding financial stability is a country's level of debt. In the short term, high levels of debt are manageable. However they eventually always lead to higher inflation rates and may ultimately offset an official devaluation of a country's currency.

CURRENCY DEVALUATION in context of Currency Depreciation:

1. Currency Depreciation vs. Currency Devaluation

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Currency Depreciation	Currency Devaluation
1. Not intentional.	1. Intentional.
2. Depreciation refers to a decline in a currency's value due to adverse economic developments, which can usually be observed by tracking economic indicators.	2. On the other hand, devaluation is a monetary policy tool deliberately used in fixed or semi-fixed exchange rate systems. The exchange rate is pegged to a reference or pivot of some kind, usually made up of a currency, a basket of currencies or a commodity like gold.
3. Beyond control of the government or monetary authority concerned.	3. In control of the government or monetary authority concerned.

2. Can effects of devaluation be relevant to depreciation?

Although depreciation and devaluation are separate phenomena, the core impact of both on a currency remains the same. They both essentially lead to the decrease in price of domestic currency in terms of foreign currency. Therefore, the benefits of both will be broadly similar.

3. What are the advantages of currency devaluation?

As a monetary instrument, its main objective is to reduce a trade deficit by promoting exports. Another direct effect of currency devaluation is that it sometimes leads to higher wages.

1. ***More competitive exports:***

A weaker currency leads to less value of the home currency with respect to foreign currency. Due to the drop in the price of exported products, the demand increases. Thus, the quantity of products sold abroad increases as these products become more affordable to a greater number of consumers overseas.

2. ***Lower Trade Deficit:***

As exported products become cheaper, foreign demand for these products increases. However, foreign goods experience a steep hike in cost, and thus products imported from outside reduce in volume. This also affects the country's trade deficit for the better by reducing it.

3. ***Increased wages:***

Since devaluation causes an increase in the price of imported products, wages are often increased by manipulating Dearness Allowance, for example, in order to compensate the employees and workforce and manage inflation scenarios to improve the purchasing power of consumers.

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LITERATURE REVIEW

CASE STUDY:

India:

Recently the Indian currency has hit an all time low after depreciating 7% against the US Dollar. This has happened due to various factors, crossing INR 80 to every 1 USD for the first time in a decade in July 2022.

According to Finance minister Nirmala Sitharaman, factors are mostly global:

1. Volatile diplomatic conditions globally, i.e., various conflicts among countries
2. the Russia-Ukraine war
3. The rising price of crude oil
4. Tightening international financial conditions

She also pointed out that although the Indian Rupee has hit a historical low, other currencies such as the British pound, the Japanese yen, and the Euro have weakened more than the Indian rupee indicating that the Indian rupee strengthened against these currencies in 2022.

In India, this is mostly being combated by monetary policy tools such as bank interest rates. Due to a complicated medley of many volatile factors all working simultaneously against and with each other, it is very difficult for the country to control inflation without hurting India's economic growth.

"Global crude oil prices are above $100 per barrel and remain volatile. Global food prices touched a new record in March and have firmed up further since then. Inflation-sensitive itemsrelevant to India such as edible oils are in short supply due to conflict in Europe and export ban by key producers. Jump in fertiliser and other (agriculture) input costs has a direct impacton food prices in India," RBI Governor Shaktikanta Das said while giving the rationale for the decision by the monetary policy committee (MPC), which also announced ₹87,000 crore liquidity withdrawal via 50 basis points increase in cash reserve ratio. Market players anticipate that RBI will restore repo rate back to the pre-pandemic level of 5.15% by the end of the year or even before. Rattled by the April numbers, the government announced measuresto control inflation on May 21. Finance minister Nirmala Sitharaman announced excise duty cut of ₹8 per litre on petrol and ₹6 per litre on diesel along with LPG subsidy of ₹200 per cylinder. This will cost government ₹1 lakh crore.

- (Kumar 2022)

War On Inflation - Fortune India

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Germany:

Germany's Papiermark, adopted 1914, is a perfect example of political interference with an economy affecting the nation's currency.

A condition of the Treaty of Versailles required Germany to pay war reparations to the Allied Nations. When Germany failed to honour the repayments, France and Belgium occupied parts of the German industrialised areas and thus cut off important earning sources of the economy. This pressured the German government to print money rapidly to pay salaries and the war debt, and hyperinflation set in. When the Rentenmark was introduced in 1923 to replace the existing currency, the exchange rate was 1 for 1 trillion.

Thus the political scenario after the World War ultimately led to the collapse of Germany's currency whose cause and effects are broadly explained by three theories:

1. The Theory of the Balance of Payments
2. The Theory of Inflation
3. The Theory of Purchasing Power Parity

Chile:

'Thirty years ago, when referring to the study of the economic history of Chile, Edwards (1985) asserted that: "the study of Chile's modern economic history usually generates a sense of excitement and sadness. Excitement, because from 1945 to 1983 Chile has been a social laboratory of sorts, where almost every possible type of economic policy has been experimented. Sadness, because to a large extent all these experiments have ended up in failure and frustration."'

- (Caputo and Saravia 2018)

Salvador Allende, elected president of Chile in 1970, an ardent follower of the Marxist ideology and member of the Socialist Party, he focused government spending according to the welfare motive and introduced left-wing oriented structural reforms. He nationalised banks and industries and drastically hiked social spending to redirect the flow of resources, especially money, to the poor.

In 1970, there was substantial unutilized capital capacity in the manufacturing sector. In this context, it was expected that an increase in aggregate demand could be accommodated without generating inflationary pressures in the short run. As a result, in 1971 an aggressive expansionary fiscal policy was implemented. Thus initially all was well, and in Allende's first year, prices did

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not increase substantially, primarily due to the existence of price controls, and commodity and factor market rationing.

Although it initially produced economic growth, this fiscal policy approach also paved the way for a steep subsequent rise in inflation. The output expansion of 1971 was not to be sustained in the following years. The rate of growth of high-powered money could not be contained even by the government controls in place. In particular, government interventions were usually preceded by long labour strikes and seizures of the firms' installations by their workers that generated significant output losses. In October 1972, a national strike generated a further decline in activity.

Amid the widespread turmoil due to chaotic labour strikes caused severe production drops and falling exports, and price-fixing led to a rise in black markets for critical commodities and thus the shadow economy.

The expansionary policies caused a progressive deterioration of the current account deficit and the government used the large foreign reserves it had inherited from the previous administration to finance those deficits. As a consequence, foreign reserves declined dramatically during Allende's administration.

Three elements characterised the crucial period between 1971 and 1973:

1. A sequence of increasing fiscal deficits
2. An important expansion of the high-powered money
3. An inflationary process that became a hyperinflation

The evidence presented thus far indicates that fiscal deficits, which increased substantially between 1971 and 1973, could not be completely financed by additional public debt (domestic and foreign). As a consequence, seigniorage became the most important source of funds for the fiscal authority. The implication of this strategy was that inflation became, in the end, a fiscal phenomenon. As shown in Figure 15, the fiscal deficit was, by far, the most important component of obligations in the 1971-1973 period; whereas, the sources of funds were seigniorage and, to a smaller degree, an increase in domestic public debt.

By the end of 1972, inflation had reached 600%. The rate had doubled to 1200% within one year and the government defaulted on debts owed to other countries and international banks. To add to this, political discord also became prevalent as the famous 1973 Chilean military coup d'etat came about in which the Allende government was overthrown as Salvador committed suicide

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and Augusto Pinochet came to power with US support. In 1985 the Escudo was replaced by the new peso at a 1,000 to 1 rate.

CONCLUSIONS

ADVANTAGES OF CURRENCY DEPRECIATION

As explained in previous sections, advantages of currency devaluation also broadly apply to currency depreciation. Respecting that hypothesis, the advantages of currency depreciation are as follows :

1. More competitive exports:

A weaker currency leads to less value of the home currency with respect to foreign currency. Due to the drop in the price of exported products, the demand increases. Thus, the quantity of products sold abroad increases as these products become more affordable to a greater number of consumers overseas.

2. Lower Trade Deficit:

As exported products become cheaper, foreign demand for these products increases. However, foreign goods experience a steep hike in cost, and thus products imported from outside reduce in volume. This also affects the country's trade deficit for the better by reducing it.

3. Increased wages:

Since depreciation causes an increase in the price of imported products, wages are often increased by manipulating Dearness Allowance, for example, in order to compensate the employees and workforce and manage inflation scenarios to improve the purchasing power of consumers.

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