P: ISSN NO.: 2394-0344 RNI No.UPBIL/2016/67980 VOL-4* ISSUE-2* (Part-1) May- 2019
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Impact of Exchange Rate Fluctuations on Macroeconomics Variables in Indian Economy

Abstract

Throughout in the twentieth century, government have pursued a fixed exchange rate system. However, after the collapse of Bretton Woods most of the countries adopted flexible exchange rate system where exchange rate determine by market forces .The exchange rate is a rate at which one currency will be exchanged with another currency . Exchange rate is influenced by several internal & external factors. Fluctuation in exchange rate is a common characteristics of flexible exchange rate system .A common fallacy that most people is that strong domestic currency is a good thing but this is not true fluctuations in exchange rate create several adverse impact on different sectors in the economy.

Keywords: Exchange Rate, Fixed Exchange Rate, Floating Exchange Rate, Currency Appreciation, Currency Depreciation.

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Introduction

The exchange rate between two currencies is that rate at which one currency will be exchanged with another currency. It is also known as a foreign exchange rate, forex rate. Exchange rate of a currency influenced by numerous fundamental & technical factors. These includes capital mobility, interest rate differentials, credit & debit items in BOP, supply & demand of two currencies and economic performance. Exchange rate system may be fixed or flexible. Most of the analyst economist and policy makers have favoured floating exchange rate system over fixed exchange rate system.

It is important that even India adopt flexible exchange rate system since 1994 but there is a managed float system because RBI intervene in foreign exchange market to influence the exchange rate of rupee. RBI always try to maintain exchange rate of rupee within a rational and reasonable limit. Because when the exchange rate vary beyond the limit, several adverse impacts reflect on different segment in the economy. Thus, when rupee in the free market depriciated much RBI want to maintain exchange rate and sell foreign exchange ($,£,¥) from its reserves in the foreign exchange market to prevent it from depreciating. On the other hand, when rupee appreciated much against international accepted currency like dollar, euro etc. RBI intervenes and buys foreign exchange. In this way, RBI maintains exchange rate within rational and reasonable limit.

Problem

A poorly managed exchanged rate can be disastrous to economic growth. To understand exchange rate and the factors affecting its movement is very important, since transactions outside or inside of the country are affected by the exchange rate. Exchange rate fluctuations affect various macroeconomic variable like export, import, employment, income etc. The impact of exchange rate to the macroeconomic variable is an essential factor that policy makers should consider. Can central banking set a rational limit of exchange rate, which maintain economic stability in the economy.

Review of Literature

Impact of exchange rate fluctuations on macroeconomic variable has been widely discussed in the literature. Earlier empirical work based on cross section data and time series data. For example, Hooper and Koh Lhagen (1978), focussed time series data to study the impact of exchange rate fluctuation on exports of dominants industrialised countries and conclude no negative correlation between two. Like that Arize (2000, 2008) and Dognalar (2002) examine the correlation between export and exchange rate fluctuation in emerging and developing countries like India, South Africa, Brazil. However, these studies conclude the impact of real effective exchange rate fluctuation on the total exports of the economy not on bilateral international trade.

Some important panel data conclude the negative impact of exchange rate fluctuation on bilateral international trade. Rose (2000), Clark (2004) deputed panel data and cover more than 100 economies using a random-effect model, Rose (2000) conclude that the impact of exchange rate fluctuation on international trade is significantly negative. Clark (2004) concludes negative and significant effect of exchange rate fluctuation on trade. Recently, Tenregro (2007) examine a small negative correlation and conclude that reducing exchange rate fluctuation to zero induced trade by two percent. A general characteristic of the majority of literature is that they focus on direct effect of exchange rate fluctuation on international trade.

While the debate on impact of exchange rate volatility on different major sector of economy till ongoing. Here, is a still research gap that what is positive or negative impact of exchange rate volatility.

Objective of the Study

1. To understand the concept of exchange rate and currency fluctuations.
2. To understand the causes for decline of the ruler against dollar.
3. To study the real implications of the depreciation of the rupee on the Indian economy.
4. Different stringent measured by RBI & government to make rupee stronger.
5. To propose potential suggestions to overcome the problem.

Impact of Exchange Rate Fluctuations

Merchandise trade

Exchange rate plays a vital role in a country's level of merchandise trade. A higher valued currency (it means currency appreciation) makes a country's imports more expensive and its exports less expensive in foreign market. A higher exchange rate can be expected to worsen a countries balance of trade. While a lower valued currency (it mean currency depreciation) makes export cheaper in the rest of the world and makes import expensive in domestic economy. It makes balance of trade better. Actually it is a policy of export promotion and import reduction. In general terms, a weaker currency will stimulates export and make import more expensive. Thereby decreasing a Nation trade deficit. While a stronger currency stimulates import and make export more expensive.

Economic Growth

The basic formula for an economy GDP is C+I+G+(X-M).A strong exchange rate is offer considered to be a sign of economic growth. Often politicians and policy makers are worried if they see a weakening in the exchange rate .They will point to a strong exchange rate as a symbol of economic growth.In long term, a strong exchange rate tends to occur in countries with low inflation enhancing competitiveness and string economic performance. For example, Japan and Germany saw a sustained rise in their exchange rates in the post war period because they had a good economic performance. In the short run, a appreciate exchange rate could be due to a variety of other factors Short run movements in the exchange rate can be misleading to the overall economic situation because it might be driven by speculation rather than long run economic improvement.

Exchange Rate and Inflation

Volatility in exchange rate also affect inflation rate. The depreciation of currency (Rupee) tends to raise the price level in the economy and thus enhance the rate of inflation. There is two important reason behind it:-

Firstly, as a result of depreciation, prices of imported goods enhance. If country import related with consumer goods, rise in their prices directly induce the rate of inflation, and if country import related with capital good and raw materials, the rise in their import prices will not only directly raise the price level but as they are used as raw materials in the production of other goods, rise in the import prices will also induced cost of production and thus bring out cost push inflation.

Second, depreciation of home currency makes export cheaper and therefore more compatative in the rest of the world. This causes the exports of goods to increase and reduce the supply and availability of goods in the domestic economy which enhance domestic price level.

Conclusion

In this paper, we argue that instead of looking at exchange rate volatility in isolation, it is important to look at the interaction between the exchange rate volatility and nature of macroeconomic shocks. We develop a theoretical model in which higher levels of exchange rate volatility can stunt growth especially in countries with thin capital markets and where financial sector are main components of macroeconomic fluctuations. The classical literature holds that the greater the volatility of real shocks relative to financial shocks a country faces, the more flexability it should allow in its exchange rate. Our analysis shows that this prescription has to be modified to allow for the fact that exchange rate should be in a rational limit.

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