AN EMPIRICAL REEXAMINATION OF INDIA'S CURRENCY DEVALUATION AND TRADE BALANCE

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ABSTRACT

This paper examines the effect of India's currency devaluation on its trade balance using quarterly time-series data from 1997 to 2018. Based on elasticity, absorption and monetary approach, a trade balance model is developed. The model is estimated using the ARDL Bounds testing method. After establishing the long-run relationship among the variables, an error correction model is developed to find out the short-run dynamics. The estimated results from the error correction model suggest that foreign income, foreign money supply and exchange rate are significant in explaining India's trade balance in the short run. However, in the long run, only change in the exchange rate will have any effect on the trade balance.

***Keywords**: Devaluation, J-curve, ARDL, India*

1. INTRODUCTION

During its independence in 1947, the Indian rupee (INR) was on par with the US dollar (USD) (INR 1= USD 1) because there were no trades or borrowings from the US. However, the Indian rupee was pegged to the British pound at INR 13 to GBP 1, and since the British were already trading with the Americans, moving forward, 4 INR was worth approximately USD 1. Since then, the Indian rupee has gone through several episodes of devaluation, resulting in the current exchange rate of around INR 70 to USD 1.

The primary reason for the devaluation of India's domestic currency was to address its growing trade balance situation. In the process of devaluation, the internal value of domestic money has remained unchanged, but its external value has decreased.

This has helped to increase its exports because it makes goods and services cheaper for foreigners, and decrease its imports as foreign goods and services become more expensive for domestic residents, which results in improving the trade balance situation.

Certain terms and conditions follow this approach, as explained in the Marshall-Lerner condition and the J-curve effect. As per the Marshall-Lerner condition, an economy can expect to see a favourable impact on their balance of trade if the total of their long-term exports and imports elasticities is greater than unity.

The J-curve effect, on the other hand, explains the condition differently in the short- and long-run. As per the J-curve, the immediate impact of currency devaluation would be to worsen the balance of payment situation; over the long-run period, however, exports would rise while imports fall, making the balance of payment situation favourable for the economy.

Most of the studies done in the past were based on aggregate trade data, but more recently there have been a few studies done at the industry level, as well as for services and bilateral trade. Indian currency has seen a lot of fluctuations in the past decade, along with the US dollar (with the former experiencing mostly depreciations). This paper will re-examine whether the Marshall-Lerner condition and J-curve theories are still applicable for India's balance of trade situation.