Rupee v/s Dollar- "The Double Edged Sword"

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Foreign exchange markets are the largest markets in the world and always remain volatile in nature. In such a market where cross currency buying and selling occurs and funds move from one option to another, one can face risk every time when one enters and trades in the market.

Indian forex market has undergone many changes before growing into one of the major foreign exchange markets in the world. However risk has been an inherent part of forex markets across globe and Indian forex market has been no exception. One of the important factors that have contributed towards this uncertainty is the prevailing exchange rate of Re. v/s $. The exchange rate has experienced several fluctuations and has been a major characteristic of Indian Forex market in recent times. Usually exchange rates are determined through the flow of capital between countries, rate of inflation, interest rates and confidence in the economy of respective country.

MEANING OF EXCHANGE RATES

Exchange rate is the price of one country's currency expressed in another country's currency. In other words, it is the rate at which one currency can be exchanged for another. The law of demand and supply determines the exchange rate of any currency. When the demand of a particular currency is more than its supply, the cost of currency in terms of other currencies will increase and vice-versa.

Reer is an index measure that reflects the degree of competitiveness of any country as compared to its trading partners. The index is created by taking weights of different currencies.

Appreciation- It means that the given currency has become stronger or more valuable with respect to another currency.

Devaluation/ Depreciation- Devaluation mean a deliberate reduction of the value of the national currency in terms of other currencies.

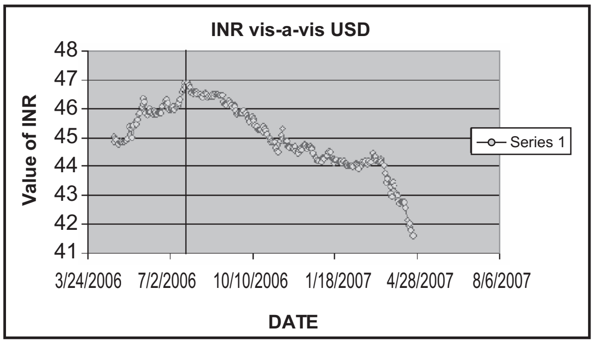
Indian Experience- Rupee Appreciation and Depreciation

Rupee has appreciated by many folds since last October. From lows of Rs. 49, it has reached up to around 39 Rs. in a time span of just 2 years.

The rupee continued to be volatile for the last few months especially between the periods of April to October 2007. The exchange rate of rupee which was 43.77 Rs per dollar at end of Dec 2004 depreciated by 3.33% to Rs 45.21 per dollar by end Dec 2005 but during the last years, Indian currency is strong against dollars.

Once the rupee was traded around 49 Rs per dollar. This nearly 20 % appreciation has seen the rupee break through its broad long period range of 43 to 48 Rs against Dollar as shown in **Exhibit-1**.

Exhibit 1- Rupee Depreciation & Appreciation



This is the fastest rise in last three decades. This genesis of this rally in the value of rupee started in second week of March 2006. Then the RBI was worried about rising inflation and began tightening money supply by raising the cash reserve ratio (CRR- i.e. the percentage of a bank's deposits the bank need to hold in cash).

It let the bank scramble for the liquidity and many began selling dollars in the market. Since RBI chooses not to buy back the dollars as they did in the past, US currency value fell against the rupee.

Currently the REER says that Rs. is overvalued by 5%-16%.

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FORCE BEHIND THE CURRENCY MOVEMENT:

The appreciation of Rs. against Dollar follows depreciation and vice versa. Forecasting the movement of any currency in the long run becomes more complicated. But still what is forecasted of exchange rate fluctuations for FY07-08 is shown in **Exhibit-3**. A lot of reasons can have their hands behind the fluctuating exchange rates, and not one or two can be blamed for any sort of rise or fall in them. Some of the factors that might be responsible for the movement of currency rates are discussed below:

Economic growth: Economic growth and reduction in unemployment rate strengthens the value of country's currency. Though Indian economy is growing at the rate of 9%, with the high of 9.2% recorded in 2006-07. According to RBI data, the trade deficit of payment basis expanded to 16.2 bn $ at huge trade deficit in Financial year 2005-06. The good news is India's balance of trade is developing a greater stock as the percentage of increase in trade deficit gradually reduces. The major cause of this trade deficit may be from increasing price of international crude oil, India needs more oil imports to meet its growth requirement. On the other hand, non- oil import also saw a tremendous growth during the last financial year.

FII Inflows: The FII inflows were very significant in recent past. In such a case such inflows and outflows put a tremendous pressure on Rupee. There is a great relationship between the Rupee and Dollar. Since Jan 2005, FII inflows to equity have grown. The month of Nov and Dec has seen a withdrawal of FII from equity market. That started putting pressure on rupee and gradually the value of rupee started falling from 44.79 in August 07 to 43.93.Whereas sudden FII outflows in October 07 put the net investment of FII in equity to negative.

Inflation and Interest Rates: People tend to take advantage of arbitrage when the interest rates are not uniform. Around the world, interest rates are always followed by money. If the interest rates of a particular country rise up, investors big and small from all over the world would want to invest their money with it in order to gain higher returns on their investments. Mostly it can be said that if you want to capitalize on higher investments, then you have to keep an eye on the rise and fall of the interest rates in a particular country. And the factors which will help you determine this rise and fall are mostly the financial rise indicators in addition to the speeches of the current leading, dominating and significant figures like big politicians, iron and steel magnets and businessmen.

The interest rate movements generally take place during the programmed meetings by the central banks like BOE, FED, ECB, and BOJ. An increase in the Interest Rates is always considered as a positive factor for a particular country as compared to the decrease in Interest Rates. Money flows follow this phenomenon comparatively in India. If interest rates go up, then money from all over the world tends to flow into that country. Generally interest rates depend on inflation and can be tracked by the investors in advance from the several sources. WPI based inflation rate increased from 4% at the end of March 06 to an intra year peak of 6.7% to end of Jan. '07 & in May '07, the rate was around 5%.

Oil prices had stopped rising: Owing to India's high dependence on oil imports, higher energy prices have been unfriendly towards the rupee. In the last FY2005/06 (Apr-Mar), India's oil deficit accounted for 81.8% of the country's total trade deficit. This, coupled with the return to a current account deficit position, is responsible for the rupee's lack of participation in the broad appreciation in Asian currencies over the past two years. The drop in oil prices provided scope for a relief rally in the rupee, similar to what occurred in the final months of 2005. As oil prices fell by USD13/bbl (about 25%) between Aug05-Dec05, the rupee found a path for the sharp appreciation.

The US dollar was weak again: The rupee shares one characteristic with the Japanese Yen. Both currencies have been trading counter to the broad trend of appreciating Asian currencies in the past couple of years. The times when they responded to their Asian counterparts tend to be the periods when currency markets turned their focus to the need for a weak dollar to address global imbalances. September 06 was packed with events (such as the IMF meetings in Singapore) setting the stage for a return to the issue of global imbalances. This had the potential to trigger a dollar sell-off.

THE INDIAN EXPERIENCE:

Why does the Indian government keeps the currency value low? What are the primary impacts of such a change?

The **first** is that exports are hurt. Most developing countries have economies based largely on exports that are competitive in global market because of low prices. When the currencies of these countries gains value, they are no longer able to offer exports to the global market at the same low prices that they planned to. This may cause exporters to look elsewhere to the countries with lower valued currency or to order less than they would have otherwise.

The **second** impact of rupee appreciation is that it hurts the value of repatriated profits from a country's international economic activity.
Third impact is if imports are cheaper, domestic players may loose out.
These are the 3 primary reasons that government & central banks are sometimes willing to put their own money into markets in order to stop appreciation of their currency.

THE RISING RUPEE BITES:

Whether it is WIPRO, INFOSYS OR TCS or a tiny exporter of knitwear, there is a deep concern in the world of Indian exporters. Profit rates too are now driving towards south. It has certainly wiped the smile off exporters' faces as shown in **Exhibit-2**. Consider an Indian company which exports only to the US market. This is quite a realistic scenario in Tirupur, for instance, where there are a number of mid-size exporters who sell almost entirely in dollars/ to the US market). Imagine a Tirupur garments exporter competing with a Chinese company for the American market share. This is a classic example of an Indian exporter running economic exposure on his business. The exporter has a basic transaction exposure against the US dollar. But he also runs an equally or even more significant economic exposure against the Chinese Yuan. If the Yuan does not appreciate or rises less than the rupee's gains against the dollar, the Indian exporter faces a serious threat to his share in the US market as there is an effective Chinese price cut in such a scenario. Any attempt to match the effective lower Chinese prices actually compounds the problem for the Indian exporter as his final rupee realizations are under greater pressure then. Even if exports grow 20% in the current year, the appreciation of the currency is expected to result in Rs 53,000 crore or $13 billion loss. For example, assuming per unit cost of production is Rs 100, an exchange rate of Rs 45 to the dollar and a price elasticity of 2, one can see that the unit dollar price for the exporter will be 100/45 (1-0.5) = 4.5.

Exhibit 2-Rupee Impact On Exports

ITEMS	FALL BY
Chemicals	11%-16%
Processed food & agro products	10%-17%
Readymade garments & textiles	20%-50%
Electronics & electrical items	Around 25%
Machinery	Around 15%

Now, if production costs rise and the local currency also appreciates (as has happened in the case of Indian exports), without any change in the price elasticity (elasticities are quite sticky in the short/medium term and also unlikely to change in the case of low value added items), the exporter will be literally priced out by his competitors who have not experienced such cost side pressures/local currency appreciation. Assuming that unit costs rise to Rs 120 and the rupee appreciates to 40 against the dollar, one can see that the equilibrium dollar price for the exporter should rise to at least $6 per unit. How many mid-sized Indian exporters have the pricing power to increase negotiated and agreed upon prices?
Compare the above workings with that of a Chinese exporter who has not experienced such cost side pressures and also importantly, benefits from a relatively much more stable currency. The Chinese Yuan, for instance, has been allowed to rise around 9% against the dollar in the two years since July 2005 from 8.28 to 7.51 now but the Indian currency is up 10 per cent in just the last 7 months
Now, Let us see how this appreciation had impacted various sectors:

Knowledge Industry: Rising rupee value will sharply affect the job of young professionals in the knowledge industry who are among the key drivers of demand in the rising growth story of India. The strengthening of rupee is bound to affect the job of blue collar workers also.

Textile Industry: The current impact of rupee appreciation is best demonstrated by what it has done to our textile exports A highly employment intensive sector, driven by small & medium enterprises (SMEs). From a healthy export of 21% in 2005-06, it has plummeted to a growth of mere 4.6% during the 11 months of 2006-07. More alarming is the fact that cotton & manmade apparel exports, which are particularly labour intensive have fallen from a growth of 33.9% to 2.9%. Our legitimate space in global market is now being occupied not only by china but by Pakistan, Bangladesh, Vietnam & Indonesia also. The export growth of these countries to US in 2006 has been 3 to 4 times that of India, while our textile exports to US in January-May 07 have actually shrunk by 2.3%. Rupee appreciation has costed 11,000 people employed in textiles and garment industry their jobs during March-June 2007.

Chemicals & Pharma Industry: An impact of rupee appreciation reveals that in Chemicals & Pharma, export realization fell by 3% in March, 8% in April & 12% in May 07 & reversal trend continuing. Export price was 7-8% higher vis-à-vis competitors as a result of rupee appreciation.

The export of **Steel products like utensils, kitchenware & tableware has fallen** by a whopping around 60%.

AVAILABLE OPTIONS:

So what can we do to reach an optimum level of the rupee, which reflect a vibrant economy & yet doesn't put an indirect tax on the exporters of goods & services? Can we discourage FDI Flows, which tend to strengthen the rupee? Obviously *NOT*. Infact the target of commerce minister ,Mr. Kamal Nath is to take the current amount to $30 billion a year. Should we therefore discourage foreign institutional investment which amounted to $7 billion in 2006-07 & $5.75 billion in the month of July alone? Again the answer is obviously, *NO*. Therefore can we turn to an embargo on private transfers from abroad amounting to $27.195 billion last financial year, much of which is sent by our NRI'S to their families? *NO*.

Exhibit 3-Estimated Exchange Rate Fluctuations For FY.- 2007-08

Quarter	High	Low	Mean
Q1(April-June07)	45.85	44.10	44.98
Q2(July-September07)	45.85	44.50	45.18
Q3(October-December07)	46.30	45.00	45.65
Q4(January-March08)	45	43.50	44.25

Source: Business World- Feb. '07

RBI has imposed stringent norms on who can borrow from abroad; who can lend to the Indian borrower & what will be the end use of ECB. Borrowing is not permitted for on lending or investment in capital market or acquiring a company in India. ECB'S can't be invested in real estate or working capital or any other general corporate purpose, including prepayment of existing rupee loans. Most importantly, "ECB proceeds shall be parked overseas until actual requirement in India" says RBI.

Within the strict guidelines, ECB'S in fact became an important engine of investment bringing in $16b in 06-07. With sky high domestic interest rates, what is wrong with foreigners funding our capital information? Infrastructure & Power Sector Companies too have raised ECB'S to fund vital projects. And now we know that big Indian companies have also found this instrument as an effective tool for lowering interest costs & making themselves globally competitive. Should we be tampering with this instrument for controlling the rupee? The answer is *NO*.

Then what are the remaining options? The first instrument can be borrowed from policymakers of Singapore. This instrument is now being followed by china. Let us use our massive Forex Reserves to buy equity in reserves of $1.3 trillion which is now embarking on this path. Let us raise this capital on Indian companies investing abroad from the current 300% of net worth to 500% immediately which will encourage outward flow & ease pressure on the rupee.

Oh! It's Good:-

The rupee appreciation had mixed reactions. Some will gain & others will loose as a result of this appreciation of the rupee. The key beneficiaries from the rupee appreciation are importers, as the dollar is now worth less for every rupee or to put it in different terms, fewer rupees can buy more dollar denominated assets/commodities/goods. The companies with major imports have benefited by reducing their import bill in rupee terms. Import bill has come down & it is far higher than our export earnings. When the rupee rises, the trade deficit comes down. Companies that source raw materials from the global markets and are largely domestic demand driven could potentially witness margin improvement as shown in Exhibit 4.

Among the importers, companies from energy dependent sectors are likely to benefit in a significant manner (energy, paints and few textile majors). Besides companies, rupee appreciation is also a positive for the government's financials and capital goods sector (most of the equipments are imported, as the country is technology deficient).

Secondly, INR appreciation is welcomed by those companies with overseas borrowings. Significant levels of foreign currency denominated, especially USD-denominated loans generate forex gains because of reduced interest payout occasioned by the rising INR. Companies like Ranbaxy and L&T have been able to generate forex gains in the last quarter because they have substantial exposure to ECBs.

Thirdly, the appreciation of the INR has helped in bringing down the country's import bill particularly that of oil imports which easily accounts for more than a third of all imports. According to an IOC official-

"For every 1 Rs. appreciation, the input cost of crude dips by 2%".
So this rising rupee has come to their rescue also.

The positive effect of Rising Rupee							
Company	Net Sales		Other income	Forex Gains		Profit Before Tax	
	Rs. Crore	% Chg	Rs Crore	% Chg	Rs Crore	Rs. Crore	% Chg
Reliance Energy	1624.01	40.63	359.92	110	359.92	270.09	37.3
Ranbaxy Labs	1014.63	-2.79	271.58	920	199.58	361.01	211.4
Mangalore Refinery	7439.14	14.98	208.27	2403	198.02	618.34	64.7
Larsen & Toubro	4505.21	29.60	211.47	221	133.45	576.39	135.4
Jubliant Organosys	454.90	26.82	90.50	940	87.90	165.50	168.7
Infosys Tech	3551.00	23.86	255	97.6	74.00	11.31	25.2
Orchid Chem	238.20	18.09	53.16	6715	52.86	75.91	335.3
Indo Rama Synth	679.68	45.11	49.36	889	26.46	4.41	28.2
Finolex Ind	328.37	23.07	35.08	407	25.77	34.72	166.0
Jain Irregation	327.40	42.38	10.26	683	15.06	32.33	2266

Source : Business Standard

Lastly, this Rupee appreciation has also helped some exporters using imported inputs to reduce the cost of the end products. This in turn helps the country in bringing down the trade deficit. Industry will be able to source its inputs from abroad at a cheaper price and hence can export more.

So exports that have an import component, borrowers in foreign currency & consumers of imported items have however gained & will further gain in the near future.

A RAY OF HOPE:

Following are some of the strategic choices that could help Indian companies meet the new economic environment caused by the appreciation of the RUPEE against the US DOLLAR:

Cost Reduction Policy: To succeed in the international market, future pricing strategies will require ensuring best quality, long credit periods & adherence to delivery schedule. Companies have to achieve cost reduction every year at least to meet the rupee appreciation rate against the US dollar in order to retain the profitability. TATA STEEL is a good example of a company that significantly focused on cost reduction to acquire the status of one of the lowest cost producers of steel in the world. Reduced costs & increasing quality production at international competitive rates will be the guiding strategy to do international business in near future under the rupee appreciation trend.

Change of Mindset: Companies have to plan by assuming that past experiences & approach could be of little use, even misleading under the rupee appreciation scenario. It is not strength or intelligence that will see a management survive in the future but quick response to change in the rupee exchange value against major currencies. Indian companies need well planned strategies to respond fast to these environmental changes which are beyond anybody's control. Demand & supply forces will decide the value of rupee against major currencies. Moreover economic development may lead to early capital account convertibility of rupee than expected.

World Class- A New Mantra for Growth: To meet world class standards & global economic competition, our manufacturing sector has to adopt large scale production capacities. Presently, foreign buyers with small orders are coming to India & for large quantity orders they fly to china. Companies have to develop world class price, quality, scale & competitiveness supported by R&D efforts. Otherwise our companies have to face the danger of being wiped out of business by cheaper imports. The logic of economies of scale will play an important role. Companies will use imports & exports transaction as a base to become M.N.C's. such approaches will help in reducing the cost of business transactions. The process of becoming an M.N.C has already started & companies like TATAMOTORS, MAHINDRA MOTORS, RANBAXY, DABUR etc. have already become M.N.C's by acquiring foreign companies abroad. With a strong rupee against a weak dollar, this process will be expedited in the near future.

Search for New International Markets: Increasing production capacities will get the demand exploding & finding new international markets. Big markets exist for India just next door- Pakistan, Bangladesh, Afghanistan etc. On the left of India are developing counties & on the right there is the underdeveloped

Africa, cash rich MIDDLE EAST, the very developed EUROPE, U.S.A. & CANADA. India should take advantage of this geographic location to develop international business. The threat should be to increase export to hard currency areas & import from soft currency areas.

To meet such challenges, new foreign markets will have to be explored & world class products would have to be developed eg is the '*MADE IN INDIA* brand as it was done in the IT & BPO sectors. Now, the industries have to achieve velocity in growth while managing change at every stage. To achieve high velocity in business growth, government support is essential. The government has to improve rigid rules, encourage growth & provide infrastructure support to corporate sectors.

The Right Time to Build an Industrial Base: The Indian industry will get cheaper technology, know-how & imported machinery to build up capacities in manufacturing sector. Imported raw material will also be cheaper because of the rupee appreciation & lower tariffs under the WTO regime. International communications will become cheaper as telecom companies pay their counterparts in US DOLLAR. Good industrial base will also help in solving unemployment & will get top priority in the government agenda.

Hedging Instruments- Meet Challenges: Exporters, importers, hedgers & speculators will use derivatives. Forwards, options & swaps along with future derivatives will be more popular. At present, forward contract is very popular with exporters & importers.

Attractive Foreign Acquisition Opportunities: This rupee appreciation rally is giving golden opportunities to leading Indian business houses for acquisition in American markets as appreciation has made it a good value proposition. Automaker Mahindra and Mahindra, consumer good major Godrej & biotechnology firm Biocon are all looking for acquisitions in overseas market as per the statements given by them. An acquisition of range $500 million would now cost today less than Rs.2000 crore in the Indian currency but would have been higher by 10-15% as of last year.

SIGNIFICANCE OF RUPEE APPRECIATION TO COMMON MAN

Rupee appreciation has lead to falling bottom lines of IT/ITES companies. But how has the rupee appreciation affected the layman?

If you are an NRI visiting home & decide to swipe your international credit card here, you will have to pay more.

If you are sending money home you have to send more.

Students who took study loans from India a year back to go abroad will loose out dollar rates which were higher then.

CONCLUSION:

So at last we can say that the currency appreciation is mainly as a result of capital inflow from FIIs, FDIs and ECBs. To counter that, RBI was mopping money and injecting liquidity. But, this causes inflation. The best way to fight currency appreciation is to do the reverse of FDIs and FIIs - encourage more Indian companies to buy overseas assets & companies.

So, the big problem now is how to deal with billions of dollars that come every week, while already holding a $200b worth reserve. Why not encourage more companies like Tata that bought Corus thereby causing an outflow of dollars? India should encourage its PSUs to buy more oil fields, mines and other assets abroad along with guided value purchases that will bring India better practices and more potential for intra-company exports. This will bring as much benefit as incoming-FDI, while keeping rupee lower.

For this to happen, we need to evolve a national policy and bring low-interest dollar loans for the companies to make valuable purchases abroad that will benefit everybody.

The Government of India will gain tremendously as the rupee value of its external debts will drastically reduce in the near future. It is the right time to mobilize dollar funds to create world class roads, communication channels, ports, bridges, energy alternatives, health care & education in India.

The rupee appreciation trend against the dollar will provide opportunities to Indian companies to grow fast in international business, provided corporates are prepared to meet the challenges of cost reduction, quality production at low price, meeting international standards & hedging techniques. Corporates should treat international business as an opportunity to grow & the rupee appreciation trend against the dollar as challenge for wealth creation. Professionals have to develop expertise in currencies risk management to help Indian companies face the challenges & opportunities due to the rupee against the US DOLLAR.

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2. According to Naik`s analysis as the conclusions of a study by IIM Bangalore Professor Gopal Naik (posted online on Aug 11th 2007. After the ban, the facts: Futures didn`t spike wheat, pulses prices by Ravish Tiwari) “the jump in prices , isn't because of futures trading but because of lower production, lower stocks and soaring international prices of certain commodities”, the reason being if futures trading help farmers to decide which crop to grow, it leads to imbalance in production. It makes the farmer grow the crop that is profitable rather than the crop that is desirable for the nation. It leads to low production and high prices.
3. Another observation is, it takes time to sell the produce since farmer waits till he gets a better price for his crop which in turn creates artificial demand with low supplies due to hoarding, hence the rise in prices.
4. In case the farmer gets a better price after 3 to 4 months also, he cannot wait to take advantage of this price as he has to meet many financial obligations post harvest of the crop.
5. Apart from all these, India being basically an agrarian economy should see to that the country is self sufficient, mainly in food grains. Pulses “the common man's meat” cannot be put to future trading. The country should first have sufficient to meet the internal demand for consumption at fair prices. That is what is needed for the country. One can carry out futures trading on metals, energy, etc., which are not basic necessities to live with. But as far as food grains are concerned, the government should help the farmers to get a better price and facilitate the consumers to get it at an affordable price.

It is appreciated that the government banned futures trading on some pulses protecting the farmers and the consumers and not leaving the market open to speculative trade like futures trading. It is still beneficial if the trading on pulses as such is banned which will benefit the farmers to grow crops according to the nature of the soil and the seasons and not as per futures trading demand.

Hence a total ban on futures trading on pulses is advisable.

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