

Collapse of Dollar Value – Its Impact in India

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INTRODUCTION

The recent depreciation of US dollar has created quite a stir in the countries throughout the world. All the economies trading largely in US dollar have had some impact on their present working. But what is more of an alarming question is that - is the US Dollar depreciation a well planned initiative by the world wide central bankers or are we going to witness an uncontrolled collapse of US Dollar ?

Understanding the exchange rates, there are primarily two main types of determining exchange rates- Fixed and floating. A fixed exchange rate is one where the government of a country decides the official exchange rate for the country and all exchange related transactions take place at this fixed rate. The floating exchange rate on the other hand means that the market driven forces of demand and supply for a particular currency determines the exchange rate. In such a case, the rate keeps on fluctuating every minute.

However, most countries like India have adopted a system of exchange rate whereby the rate is determined by demand and supply of currency but the central bank or the government intervenes from time to time and regulates the exchange rates to control its movement in any particular direction. With Project India – a profitable venture with forex reserves of about US\$ 214.835 billion, India is emerging as one of the fastest developing nations on the globe. Even its GDP has crossed the US\$ 1 trillion mark.

With the growth of the economy, India is heading towards a developed nation from its earlier status of developing nation. The stock exchanges throughout the country have had a pleasant flight upwards, of course with a few turbulences, attracting investments in huge quantum. The country's stock market capitalization has risen to \$944 billion, which is also closing fast on the trillion-dollar level. All these signs represent India as an attractive investment option for the international investors to park their funds in anticipation of a reasonably high ROI.

THE RUPEE

It was only 39.12 leaps behind the dollar! A great achievement indeed! The rupee had appreciated to a new high few months ago. Decades back, the Indian rupee was regarded as being much inferior to the dollar. People strove hard those days to stash away the hard-earned dollars for their next foreign visit or for their children abroad. The rupee, which ruled at an all-time low of 49.06 against the dollar, was expected to further depreciate. That is the reason why people regarded stashing away dollars as a smart idea. It is not the dollar's value which is decreasing but the strengthening of the Indian rupee that has brought about the present state of affairs.

Anyway, after a long time some great news come our way which was particularly welcomed by those who want to travel abroad. Now their rupee will buy more goods and services - they will be able to visit more places and do more shopping. For students who want to study abroad, it is a great boon. They will have to pay fewer Indian rupees to buy dollars. And studying in the best of universities would be cheaper.

On the other hand, with the shrinking of the dollar, the exporters are getting worried. Even the NRI's and families who depend on the money sent by their kith and kin abroad are not happy with the appreciating rupee, because now a dollar translates into fewer rupees. However, it would be very advantageous if the rupee further rises. It would be very lucrative to those foreign institutions and companies who have invested in India, since, along with the increasing dollar returns, they can hope for steady rupee returns.

Oil companies and gold importers who were facing tough competition in the global market can breathe easy. All their imports will cost less in terms dollars. Internationally, a few days back, the oil companies were faced with soaring crude prices—a barrel costing as high as \$ 127. On the flip side they were unable to increase the oil price in the domestic market, because the government would not support such increase. However, given the stability of domestic prices and increase in the value of rupee, gold importers are likely to benefit more, especially at a time when the global price of this precious metal is constantly increasing.

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The other side of the coin implies that software companies, textiles, leather product and apparel manufacturers would be the major losers. The dollars earned by software exporters (already operating on thin margins) will translate into fewer rupees. In case of textiles and leather products too, the exporters cannot increase their dollar price in the global market because of the fierce competition.

The rupee did not surge all of a sudden. The increasing software exports, more and more FII's investing in the Indian market led to the inflow of more dollars into the Indian market, thereby making the rupee scarce compared to the dollar. Keeping in view the threat of inflation, the Reserve bank of India has allowed appreciation of the rupee, which resulted in (20 September 2007) historic news—rupee is now just 39.90 leaps behind the dollar!

INDIAN RUPEE AND ITS SCENARIO

TEN per cent appreciation alone in 2007 made the Indian rupee Asia's best-performing currency this year. It strengthened 10 per cent to 40.20 to a dollar from end-2006 on top of a 15 per cent gain in BSE Sensitive Index over the same period. It oscillated between 40.20 to 41.64 during this time. The Indian rupee edged higher at 41.05 against dollar as firmer Asian stock markets raised hopes for renewed fund flows into local shares. Dollar buying by oil importers to meet month-end payments limited the rupee's rise. It hit a nine-year high of 40.20 on 29 May 2007 with foreign buying of local stocks providing support and FDI inflow surges in April-June 2007.

Rupee appreciation is the net effect of embarrassment of riches! There is a problem of plenty as FIIs started pumping money in Indian stock market, obviously smelling gains in an economy growing at 8.5 per cent per annum. These are the terms with which finance ministry officials are coming to grip with due to the ever-increasing foreign exchange reserves which have already crossed \$229 billion as on August 10, 2007 as against China having \$1,333 billion and Japan having \$924 billion. Mind it; the reserves were less than \$1 billion in 1991.

Recent Decline

The Indian rupee fell to 41.64, its lowest level in about four months since April 2007, as investors cut exposure to risky assets amid lingering fears of a global credit squeeze. There was a speculation that the rupee will fall to 42 by end of the year. RBI is estimated to have bought \$15 billion in intervention between May and June. This was being done to maintain the competitiveness of the Indian exporters. The rupee had touched 48.88 to a dollar on February 25, 2002.

Appreciation: Reasons

One striking feature of economic strength is that its reach in terms of global presence. The total value of the takeover deals by Indian companies was less than \$1 billion in 2006. January 2007 alone saw two mega deals; Hindalco / Novelis and Tata Steel/Corus. There have been 72 foreign takeovers by Indian companies worth \$24.4 billion in the first four months of this year.

Investment highlights

Positive tidings about the Indian economy combined with a fast-growing market have made India an attractive destination for foreign institutional investors (FIIs). The number of foreign institutional investors (FIIs) registered with the Securities and Exchange Board of India (SEBI) has now increased to 1,042 in June 2007. In the beginning of calendar year 2006, the figure was 813. Till May 2007, FIIs had pumped in a hefty \$6 billion in equities. Last year, during the same period, the FIIs' exposure to Indian equities was 25 per cent lower at \$ 4.5 billion. FIIs have raised their holding in 540 companies out of top 1,000 companies on the Bombay Stock Exchange (BSE) during September-March (2006-07) period.

CLSA, HSBC, Citigroup and Merrill Lynch have been the most active foreign investors during January 2006 to April 2007. Together they were involved in \$4.73 billion worth of trading in shares. Apart from the four FIIs, many others, including Crown Capital, Fidelity, Goldman Sachs, Morgan Stanley, UBS, T Rowe Price International, Capital International and ABN Amro, have taken a significant exposure to Indian equities.

Inflow of dollars

Foreign direct investment (FDI) in India almost tripled to \$4.9 billion during the June 2007 quarter from a year earlier on the back of large deals by Vodafone and Matsushita Electric. During January-June 2007, FDI inflows were \$11.4 billion, more than three times the \$3.6 billion received a year earlier. FDI inflows were \$15.7 billion for the fiscal year that ended in March 2007, almost three times the level in 2005/06. The gross FII investments in the country till June from the time they were allowed to invest in the India equity markets stands at \$53.06 billion.

NRI deposits

NRI deposits have increased from \$17,156 million in 1995 to \$39,624 million in 2007.

Balance of payments

N. R. Narayanamurthy of Infosys recently mentioned in an interview that though there is an impact of rupee appreciation on exports, yet in a growing economy the country's strength is reflected by the strength of currency and the respect and acceptance it commands.

Narayanamurthy went on to state that India is a gainer as its imports are larger at \$190 billion than exports of \$126

billion in 2007. Ramadurai of Tata Consultancy Services (TCS) went on to state that rise of rupee is inevitable in coming period. Earlier there was a case for increasing exports which has now reached \$126 billion as on March 2007. However the balance of payments is still tilted towards imports. India imported goods and services worth \$190 billion leaving a gap of \$64 billion.

Foreign Trade

After the liberalisation programme was launched, the exports did leap at 20 per cent per annum for many years from \$45 billion at March 2002 to the current level of \$126 Billion as of March 2007.

Effect on Employment

Already various export promotion councils and business federations have drawn up plans to counter the effect on competitiveness of Indian products.

It is already reported by the Confederation of Indian Textile industry that 579,000 jobs could be lost in 2007-2008. This could include the direct loss as well loss in dependent ancillaries.

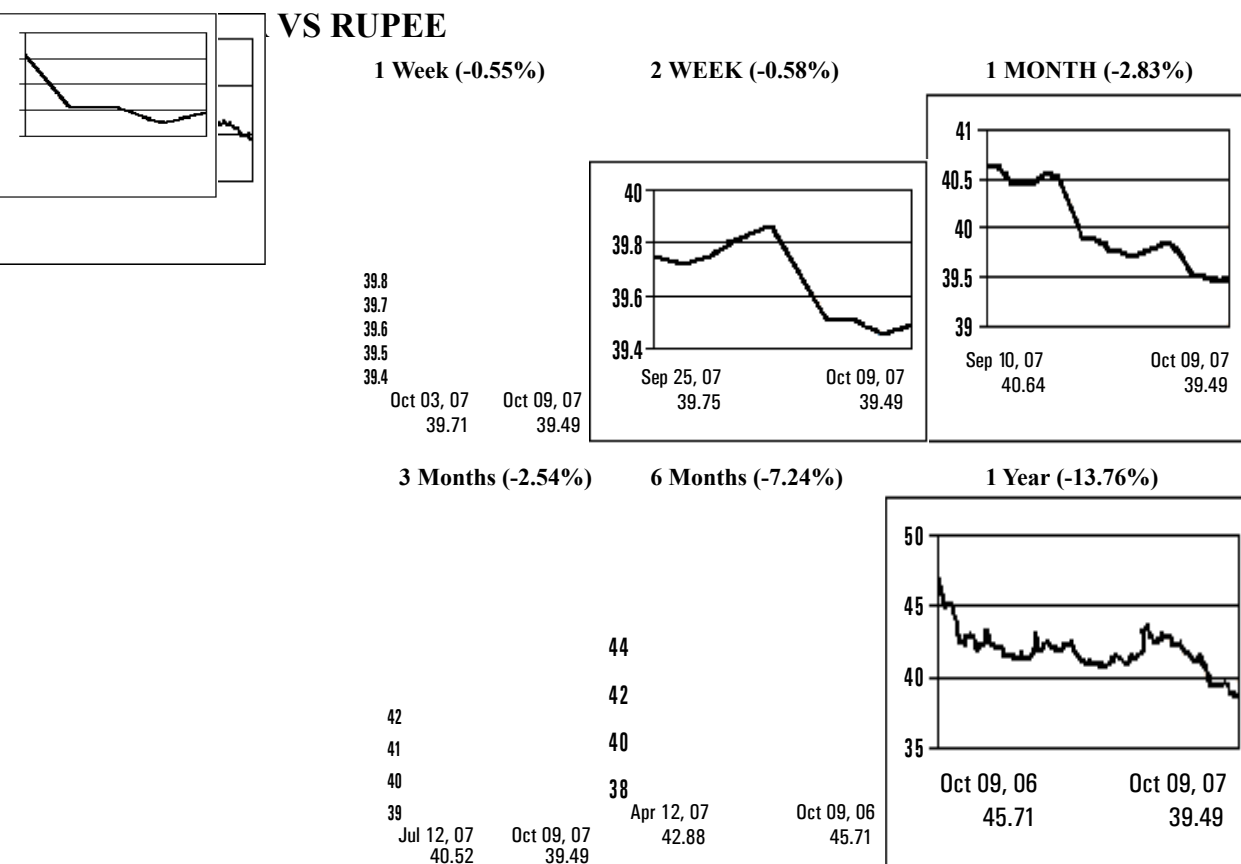
What is the right level?

From time to time senior officials of RBI, Finance Ministry, Commerce Ministry are issuing statements about the relative fundamental strengths of the economy, decline in inflation and a level at which rupee/dollar can operate. Although they are not targeting any specific level, the rupee appreciation further is a possibility as the flow to India increases unless the sub-prime problem continues resulting in massive withdrawals by the FII's.

INDUSTRY IMPACT EXAMPLE

Over last couple of months;

1. Infosys has increased its billing rate by 3-4 percent on new contracts and 2-3 percent on old contracts.
2. It is trying to broaden its base while diverting dependency from US. US revenue share has come down to 50% from 60%. Europe's share increased from 26 to 30 percent. Rest of the world rose to 205 from 14%.
3. Earnings forecasts remain unchanged.
4. Infosys' exposure to the subprime (and volatile) and mortgage industry is about 0.5 per cent.
5. Shares have fallen 5 per cent in the past three months against a 2.8 per cent gain for the Sensitive Index of the Bombay Stock Exchange.



INDIA: TEXTILE INDUSTRY MUST COPE WITH RUPEE APPRECIATION

Indian textile exports may fail to reach the set target of \$25 billion as rupee appreciation and lower investments are taking its toll. It is expected to face a shortage of 16 percent in the current financial year. Experts estimate that exports value this year will touch around \$20 - \$21 billion, up four percent compared to last year's revenue of \$19.7 billion. Industry players are concerned with this negative growth especially in the garment sector, which has happened for the first time in several years.

Fibre2fashion contacted Mr. D K Nair, Secretary General, Confederation of Indian Textile Industry (CITI), in an attempt to find the justifications behind this negative growth in exports for the garment sector. He said, "The major reasons are the fast and steep rise in the value of rupee and the increase in interest rates on loans. The appreciation of rupee is especially high with reference to US dollar and our exports have shown negative growth particularly in USA and in other countries where our contracts are in terms of US dollar."

Talking about lesser amount of foreign investments in the textile sector, Mr. Nair said, "Until recently, our textile and clothing industry was not attracting much investment even from Indian companies, especially the larger ones. The reason was the perception that this industry had limited growth prospects. This opinion has now changed substantially and domestic investments are now pouring in. However, FDI continues to be low because the improvement in the investment climate has not percolated well to overseas investors. The image of the country as a potential destination for overseas investment in labour intensive manufacturing industries is still not very positive. Our infrastructure also needs considerable improvement before significant FDIs can be expected in industries like textiles." Discussing about insignificant implementation of facilities like Technology Upgradation Funds Scheme (TUFS), the Secretary General reveals that there is a tremendous backlog in disbursement of TUFS assistance. Initially, the major problem was of funding. Now, the Ministry of Finance has provided funds but disbursement is still getting delayed because of the complicated procedures involved. One major issue to be sorted out is the delay on the part of FIIs and banks to supply proper and complete information stipulated by the Ministry of Textiles, while claiming funds for disbursement to borrowers.

"It is evident that the textile industry has to cope up with the rupee appreciation and for that defocusing of the US market and currency is one strategy that the industry will have to adopt. Few industry players are already looking for other markets and trying to do business in other currencies. Measures for cost cutting, innovations and branding are among other steps being attempted. Given the resilience of our dynamic entrepreneurs, export deceleration is quite likely to be a short term problem", said the CITI official.

While updating about raised Duty drawback and DEPB rates and its advantages to exporters, the Secretary General informed, "Increase in Draw Back and DEPB rates announced by Government are being implemented and will benefit exports to a limited extent. However, these rates do not take into account the duties and levies charged by State Governments and local bodies such as Municipalities. The burden of unrebated State level duties has been eroding the competitiveness of our exports and adding to the problems that exporters are currently facing."

On a happier note, Mr Nair considered that in the cotton textiles segment, exports are showing a positive growth. Cotton production has been scaling new heights consistently for the last few years. In cotton year 2007-08, production is expected to cross 310 lakh bales. The quality of our cotton has also increased substantially in recent years. The improvements in the cotton economy are bound to have a positive impact on the cotton textile sector, including its exports.

Looking Forward

The deal in a forward contract is that the exporter (with a receivables exposure) sells to a counter-party (importer) who is keen to buy a cover in the forward market. On the maturity date, the dollars are sold at the contracted rate. Since the dollar weakened faster in March (as the Reserve Bank stayed away from the market), IT companies with forward contracts maturing in this month were able to mitigate losses. For earlier months in 2003-04 too, there were gains in the forward segment for exporters, but not to the extent seen in March. "Our forward contracts and other proactive measures have enabled us to realise better rates than the prevailing spot rates," says Laxminarayana. They may not reduce losses significantly, but they do soften the impact.

THE PSYCHOLOGICAL DIMENSION

But as the imbalance shows no sign of correcting, players seek to shift to commodities and assets across continents to hedge against the impending fall in the US dollar. Thus, it is a fight between central banks and the psychology of market players across continents.

As a corrective measure, economists are coming to the conclusion that most of the currencies across the globe are highly undervalued vis-à-vis the dollar, which, in turn, requires a significant dose of devaluation. For instance, a consensus exists amongst economists and currency traders that the Yen is one of the most highly undervalued currencies (estimated at around 60%) along with the Chinese Yuan (estimated at 50%) followed by other countries in Asia. This artificial under valuation of currencies is another fundamental cause for increasing global liquidity.

To get an idea of the enormity of the aggregation of these two factors on the world's supply of dollars, Jephraim P. Gundzik calculates the dollar value of rising prices of just one commodity — crude oil.

In 2004, global demand for crude oil grew by a mere four percent. Nevertheless higher oil prices advanced by as much as 34 per cent. Consequently, it is this factor that significantly contributed to increase the world's dollar supply by about \$330 billion.

In 2005, international crude oil prices gained another 35 per cent and global demand for oil grew by only 1.6 per cent. Nonetheless, the world's supply of dollars increased by a further \$460 billion.

Naturally, with all currencies refusing to be revalued, this leads to increased global liquidity. While one is not sure as to whether the increase in the prices of crude led to the increase of other commodities or vice versa, the fact of the matter is that, in the aggregate, increased liquidity has led to the increase in commodity prices as a whole.

Although some of this increase in the world's supply of dollars has been reabsorbed into US economy by the twin American deficits — current as well as budgetary — it is estimated that as much as \$600 billion remains outside the US. What has further compounded the problem is the near-zero interest rate regime in Japan. With almost \$905 billion forex reserves, it makes sense to borrow in Japan at such low rates and invest elsewhere for higher returns. Obviously, some of this money — estimated by experts to be approximately \$200 billion — has undoubtedly found its way into the asset markets of other countries.

Most of it has been parked in alternative investments such as commodities, stocks, real estates and other markets across continents, leveraged many times over. Needless to reiterate, the excessive dollar supply too has fuelled the property and commodity boom across markets and continents.

The twin causes — excessive liquidity due to under valuation of various currencies (technical) and fear of the US dollar collapse leading to increased purchase of various commodities to hedge against a fall in US dollar (psychological) — needs to be tackled upfront if inflation has to be confronted globally.

Impact of weak US Dollar, oil price and World Trade Organization agreement on outsourcing

As US dollar comes down crashing on euro and yen, Indian Rupees moved little as compared to US Dollar and keeps falling compared to UK pound and Euro. The way India's central bank has handled the currency volatility is interesting. The main source of outsourcing contracts is America. European and Japanese companies literally survive by selling to America. Seventy percent of outsourcing contract originate from US demands.

Consequently, as US Dollar declines compared to Indian Rupees, India will lose the edge of lower cost compared to US Labor force. But that is not happening. Like China, India has pegged its currency to US Dollar. As a result, Indian currency floats on the basis of US Dollar values and hence there is no question of reduction in the number of outsourcing contracts.

Three factors may however change that scenario.

- ❖ First is that the US Administration will require India and China to revalue their currency and allow free floating instead of pegging to US Dollar.
- ❖ Second, the higher oil price will provide an added incentive for India and China to revalue their currency. Higher value of Rupees compared to Dollar or Euro effectively lowers the domestic Petroleum prices since 70% of the same is imported.
- ❖ Third, the World Trade Organization requirements of Process Patent Law implementation will also provide added incentive for India to revalue the currency.

Outsourcing IT, Telecom and other services to India was supposed to be a temporary transition process. As the Western economies automate through use of Robotics and automated code generation techniques, the repetitive tasks that are outsourced from India will reduce in volume over time. However, Indian Rupees revalued to even a marginal extent may kill outsourcing even within a few years.

CONCLUSION

To conclude, all these are pointers needed for a different strategy. The current bout of inflation is caused by a multiplicity of factors, mostly global and structural. Monetary as well as trade policy responses, as has been attempted till date, would be inadequate to deal with the extant issue effectively. Crucially, a stock market boom, a real estate boom and a benign inflation in the food grains market is an economic impossibility.

It has to be noted that the Indian market is structurally suited for leveraging shortages rather effectively. Added to this is the information asymmetry among various class of consumers as well as between consumers, on the one hand, and producers and consumers, on the other.

Most of all, countries have experienced significant real exchange rate appreciation over the last year or two. India has been managing this complexity relatively successfully within the context of high economic growth, high credit growth, a reasonable degree of price stability and most importantly maintenance of financial stability.

A higher Rupee value vis-à-vis the dollar would mean lower purchase price of commodities in Rupee terms. The Indian economy has undergone significant changes in the past decade and a half. With increased linkages to the global economy, it cannot duck the negatives of globalization.

Quite the contrary, it needs to come with appropriate policy responses for the same, which cannot be of the 1960s vintage. Allowing Rupee to appreciate is surely one of them. The time for a rethink on our exchange rate policy to tackle inflation is now.

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SUGGESTIONS

Commercial banks in India are considered to be one of the instruments for achieving the twin goals of higher growth rate and distributive justice. To achieve these national objectives, provision of adequate institutional credit to the weakest of the weaker sections of the society is an important input. Even the banking policy of the government has placed thrust on diverting the flow of credit to the weaker sections of the population under various poverty alleviation programmes such as Differential Rate of Interest Scheme (DRI), Integrated Rural Development Programme (IRDP), Self-Employment Scheme for Educated Unemployed Youth (SEEUY) and Self Employment Programme for Urban Poor (SEPUP) etc.

After nationalization, public sector banks have increased their lending to priority sector to achieve the various targets and sub-targets laid down for the purpose. With an objective of reaching the larger sections of the population. Commercial banks in India have followed an avowed policy of massive branch expansion. More particularly with the advent of the social control measures and the subsequent nationalisation of major commercial banks, our public sector banks started opening their branches in rural areas located in relatively less developed regions of the country on a massive scale.

CONCLUSION

The empirical analysis of this study discloses the relationship among the earning factors and expense factors which are controllable and non-controllable by the bank itself, enriches the scope of the study. This study is especially useful for policymakers, bankers, researchers as it provides adequate information about the determinants of the bank earnings and profit. The banking sector as well as the Reserve Bank of India and the Government of India in future can use the findings of the study for better financial management of the banking sector.

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