

Appreciation of Indian Rupee against US Dollar: A Challenge for Indian Corporate Sector

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Abstract : Foreign exchange rate plays a very important role in the International trade scenario. Appreciation of Indian Rupee against US dollar is the trend that is noticed in the Indian Economy from year 2002. This trend is of much concern for Indian Corporate sector as a big share of International trade is with US and apart from it US dollar carries a global reputation as of an important foreign currency. This paper aims to study the effects of this phenomenon on the Indian Economy and especially on the corporate sector. The paper further attempts to come up with certain Business policy solutions for the Indian Corporate sector in lieu of this present going situation.

INTRODUCTION- FOREIGN EXCHANGE RATE

Foreign Exchange rate plays an important role in determining the health of an economy. The exchange rate influences the prices of tradable vis-à-vis non-tradable and thereby induces shifts in consumption and production patterns and also the profitability of the export industry. Thus the exchange rate adjustment in conjunction with other macro-economic policies is a necessary part of the balance of payments strategy of the less developed countries as it directly or indirectly affects the economy of a country. Further exchange rate by linking together the currencies of different countries determines the volume, composition and direction of the flow of international trade. There are host of factors which influence the supply of and demand for foreign exchange and thus are responsible for the fluctuations in the rate of exchange. Appreciation or depreciation of the domestic currency depends on the supply, central bank's policy intentions and differences in the interest yield on dated securities of the concerned economy.

Foreign exchange rate is the price of a unit of foreign currency in terms of the domestic currency. In floating exchange rate mechanism followed in India and USA, foreign exchange rate is determined much in the same way as the price of any commodity in a free market economy.

Thus foreign exchange rate is a price which is determined by the demand for and supply of foreign exchange. The equilibrium in the foreign exchange market gets disturbed if some changes occur in the

factors that determine the demand for and supply of foreign exchange

RECENT PHENOMENON IN INDIAN ECONOMY

The problematic aspect of the exchange rate till year 2002 was the declining value of Indian rupee vis-à-vis major currencies of the world. The trend shows that US dollar appreciated continuously against Indian Rupee with marginal fluctuations till year 2002. But the order changed from July 2002 as the rupee started to appreciate against US dollar. A trend in the monthly average exchange rate of the Indian Rupee against the US dollar in the year 2002-03 and 2003-04 indicates that the Rupee dropped to a low of Rs. 48.50 against the US dollar in May 2002. The cause for it was the border tensions of the country. The Rupee has almost consistently gained against the US Dollar since May 2002. In 2002, the Rupee started with a bearish trend and slowly breached Rs.49 per dollar mark which was very much on the cards. It was expected that the level should be reached by November, 2002. Then came the reverse trend as the Rupee started reched strength and gained steadily to touch a hight of Rs.47.97 per dollar at pre-Christmas and closed the year 2002 at 47.92. The sharpest month-over-month appreciation in the value of the Rupee vis-à-vis US dollar was observed in the months of July and October 2003. The Rupee appreciated by almost 6.7 percent in 2003. It began strengthening thereafter to reach a monthly average of Rs. 45.02 against the US dollar in March 2004. Between 2 July 2002 and April 2004, the Rupee rose by 10.7 percent against the

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US Dollar, with the steepest increase occurring during 23-31 March of 2004, when the currency moved from Rs. 45.09 to Rs. 42.35 per dollar. In the first three months of 2004 it appreciated by 4.7 percent. Most of the increase was in the month of March 2004. Vis-à-vis the US Dollar, the Indian Rupee, which started strengthening from June 2002 onwards, steadily appreciated (except during May to August 2004) by about 12 percent over the past 32 months (January 2005 over May 2002). On an annual basis, against the US Dollar, the Rupee appreciated by 5.3 percent in 2003-2004 and further by 2.1 percent in April-January 2004-05. During early 2004-05, the rupee ended a continuous twenty four months (May 2002-April 2004) run of appreciation against the US dollar and started weakening from May 2004 onwards. The new phase however, turned out to be relatively short-lived as the rupee started to gain against the US dollar from September 2004. The third quarter of 2004-05 (October-December) saw a sharp forming up of the Rupee against the US dollar with the nominal monthly appreciation a high of 2.6 percent in December 2004. The Rupee appreciated by around 2.2 percent against the US dollar in 2004-05 and recorded an annual average value of Rs 44.95.

At the end of the first ten months of 2005-06, *i.e.* from 2005 April-January 2006, the Rupee appreciated by around 2.1 percent against the US Dollar compared to the corresponding period of the previous year. While such appreciation maintained the progressively strengthening trend displayed by the Rupee against the US Dollar in recent years. Month-wise analysis reveals that after July 2005, the Rupee had depreciated against the Dollar in all months up to November 2005. During this period, the sharpest monthly depreciations (around 2.1 percent) were observed in October and November 2005. Since December 2005, the Rupee started strengthening again. The Rupee further showed fluctuations in year 2006 with appreciation against US Dollar of around 2 percent in the month of October.

CONCERN FOR INDIAN ECONOMY

This recent observed phenomenon of Rupee appreciation against US dollar is of much concern for Indian Economy as the direction of India's foreign trade indicated the major share of USA in India's

total export and imports. This study has a larger significance in present scenario since the openness of the Indian economy has increased continuously since the launching of economic reforms in 1991.

Under the economic reforms in India, not only have we opened up the economy but have also liberalized the industrial sector, made our currency convertible and allowed exchange rate to adjust freely. Further as India has adopted flexible exchange rate system, the critics of this system say that flexible exchange rate creates a situation of instability and uncertainty. It is further argued that to frequent fluctuations in exchange rate under it creates uncertainty about the amount of receipts and payments in foreign exchange transactions. This instability hampers foreign trade and capital movements between the countries. Along with reduction in tariff, India has also reduced non-tariff restrictions. Even the new WTO regime has helped in decreasing the international trade barriers between the countries. In India imports have also galloped because of increasing requirements of capital goods, defense equipments, petroleum products and raw materials. Exports have remained relatively sluggish owing to lack of exportable surplus, competition in the international market, inflation at home and increasing protectionist policies of the developed countries. In the light of such recent foreign trading environments the appreciation of Indian Rupee against Dollars becomes more important as International trade is largely influenced by this recent phenomenon and in the process it has affected the profit margins of corporate sector.

Effects of Appreciating Rupee against US Dollars

A rising Rupee does effect the economy of a country. We will analyze such effects in perspective of Indian economy. Let us first look at the benefits that follow a rising Rupee:

BENEFIT FOR IMPORTERS:

A rising Rupee helps importers to buy goods and services at a cheaper rate than earlier. This is vital for a developing economy that relies heavily on imports. So those who import from dollar linked countries and foreigner who invest dollars in India will be the beneficiaries of appreciation. Also during last few years a tendency among Indian corporate to expand their industrial capacities has been noticed.

So with this phenomenon persisting in future a significant proportion of new plant and machinery will be imported and that too at low cost. If, say, 50 percent of the capital cost of a new project is spent on imports from countries transacting in Dollars, a 10 percent appreciation of the Rupee will mean an effective discount on capital costs of 5 percent. This is beneficial for developing country like India which needs infrastructure and new investments for stepping up its economic status. With the country's imports being higher than its exports, it may prove to be a blessing in disguise. Besides, a stronger Rupee may also induce higher foreign direct investments in the country. Import intensive sectors, particularly infrastructure, in which a lot of capital investment are, or will be, taking place, will clearly benefit from Rupee appreciation. The quantum of benefit depends on how long the scenario persists.

IMPORT-INTENSIVE SECTORS

Any appreciation in rupee against the Dollar would be beneficial for the import-intensive sectors. A number of sectors depend on overseas markets for their energy needs, capital goods and raw materials. India is a major importer of oil and gas, engineering and capital goods, edible oils and fertilizers. Those using these products would benefit if the Dollar depreciates. Being the largest importer, oil and gas sector may be a beneficiary due to the lower cost of crude purchases. The benefit is, however, neutralized as the selling price is linked to the international prices. As the product selling price and the raw material price are both linked to international prices, depreciation in US Dollar will result in decline in sales realization as well as purchase costs. Analysis point out that infrastructure and other capital intensive sectors may prove to be the beneficiaries. Power sector would benefit because of reduction in project costs leading to better tariff setting, while the telecom industry should gain from reduced cost of equipment in rupee terms as most of is imported.

EXPORTER'S DISADVANTAGE

The exporters are at a disadvantage due to currency appreciation making their produce expensive in the international market compared to other competing nations whose currencies haven't appreciated on a similar scale. This take away a part of the advantage from Indian companies, enjoyed

due to their cost competitiveness. However, it must be noted that despite the sharp currency appreciation in recent times Indian exports have continued to grow.

The rising raw material and energy prices have resulted in slower growth in revenues for corporate India. Sharp surge in exports from sectors like technology, steel, cement, automobiles and ancillaries, pharmaceuticals and textiles has helped India post a higher growth in turnover. Pharma companies have a significant dependence on exports. Dollar depreciation may have a constraining impact, although limited, on the overall sales value and profits of companies. However, the extent of impact may vary from company to company depending upon the amount of exports which is US dollar denominated. In case of textiles, the impact of dollar depreciation may not be helpful for the sector especially in light of the fact that the Chinese currency is relatively fixed vis-à-vis dollar. In case of automobile and cement companies, where the domestic market is large and exports have picked up recently, the impact of Dollar depreciation would not be significant.

DOLLAR DENOMINATED EARNINGS HURT:

The strengthening Rupee has an adverse impact on various companies/sectors, which derive a substantial portion of their revenue from the US markets (or in Dollar denominations). To combat this, Indian software need to hedge their Dollar earnings, which involve a cost. Further, their earnings tend to face pressure because of the fact that while a major part of their revenue is in US Dollar terms (as exports form a major source of their revenues), the costs incurred are in Rupee terms. Other sectors hit by this phenomenon include the domestic pharmaceuticals and textiles industries, which have a similar revenue model.

A small case which was recently observed in Indian market will help us to understand this. A record appreciation of the Indian Rupee in the forex market by 3.8 percent affected the operating margins of Infosys Technologies Ltd by two percent during the third quarter of the financial year 2007. In spite of taking forward cover and hedging \$373 million during the third quarter the Rupee appreciated to Rs. 44.53 from Rs. 46.29 and affected the operating margins of Infosys by 200 base points (two percent)

which led to a revenue loss of Rs. 1.45 billion. Further this Rupee appreciation phenomenon influenced the stock market. Information Technology stock fell on funds due to the appreciation of the Rupee against the US Dollar hurting earnings, dragging the IT sector index by over 138 points.

OTHER DISADVANTAGES:

Appreciation of Indian Rupee against US Dollar is harmful for Indian International competitiveness against countries like China. China who has kept their currency pegged to the US Dollar has been able to prevent any movement against the Dollar. Indian products will have to face greater competition from Chinese goods, both at home and abroad. If Rupee appreciates our imports will be affected very much by Chinese competition as the markets for current and prospective Chinese imports in India are price-sensitive. We should see in future our consumer markets flooded with Chinese products. Government adopted different measures to check this phenomenon of Rupee appreciation against US dollar. In the process government sucked the excess dollars from the market which did push the excess of money supply in the economy resulted in inflation in the country. Often government absorbs back this excess supply of money by selling bonds in the market but any delay or reluctance in doing this will certainly push up the inflation rate in the economy.

ADVERSE EFFECT OF FOREIGN PORTFOLIO INVESTMENT

India has noticed a huge influx of capital inflow mainly in the form of Foreign Portfolio Investment (FPI) which has resulted in the appreciation of Indian Rupee against US Dollar. This type of investment is not preferred by most countries. Generally FDI is preferred to FPI as it is linked to the performance of the real economy and secondly it is less volatile than FPI. FDI directly helps in stimulating investment activity in the country. The FDI can have the effect of not only bringing in additional resources, but also leading to better absorption of domestic savings. The most important disadvantage of FPI flows is that it tends to be pro-cyclical, in the sense that it comes in when the Balance of Payment situation is seen to be strong and the interest rate structure in the country are favorable and goes out when the BOP position is

expected to weaken and when the interest rates are unfavorable. In case of countries like India, where the foreign exchange markets are very thin as compared to the international market, a free FPI regime carries the danger of speculative movements, which may lead to serious disruptions in the economy as noticed among the countries that went through East-Asian crisis.

RUPEE APPRECIATION AND ITS DEGREE OF IMPACT OVER FOREIGN TRADE

It is difficult to quantify the impact of a rising Rupee on individual sector. However the impact will certainly differ due to different individual price elasticities of imports and exports. Further the impact will also depend on the import intensity of exports of different goods. The export of goods with low import content will suffer the most and vice versa as due to Rupee appreciation the cost of imports will decrease. The import component in diamond exports is about 75 percent thus it will be benefited in the international trade market. Oil is important as an input for all sectors of economy. Its imports meet more than 60 percent of the energy needs of the economy. On the other side products like naphtha, diesel oil, fuel oil and aviation turbine fuel are emerging as important export items. The increase in the price of oil in the international market, partly neutralized by the appreciation of the Rupee may not be worth from the point of view of imports but it is good from the side of exports. Future is uncertain but for the present, Indian companies seem to suffer heavily from Rupee appreciation as import intensity of exports has steadily declined in recent years. The import intensity of exports measured as number of times imports as percentage of sales over exports as percentage of sales, has declined from 2.2 in 1995-96 to 1.61 in 2002-2003.

BUSINESS STRATEGIES:

Indian companies have to face this phenomenon of appreciation of Indian Rupee against US Dollar but they can adopt few business strategies to minimise the adverse consequences of this phenomenon and to maximize the benefits coming out of it:

1. To safe guard against themselves from the adverse effect of Rupee appreciation against

US dollar, Indian companies can take the benefit of forward exchange transaction facilities provided by foreign exchange market. The forward transaction is an agreement between two parties, requiring the delivery at some specified future date of a specified amount of foreign currency by one of the parties, against payment in domestic currency by the other party, at the price agreed upon in the contract. The rate of exchange applicable to the forward contract is called the forward exchange rate and the market for forward transaction is known as the forward market. So Business firms may enter into forward transaction contract to protect themselves against the risk of present and future exchange rate changes. This process is called "Hedging".

2. Further Indian exporters can shift the export invoices to other strong currency like Euro. With the Rupee appreciation expected to continue, billing in Euro is a much better step to diversify their currency risk. This trend is presently noticed in Indian economy. According to the Federation of Indian Export Organization (FIEO) in mid of this decade the Euro accounts has increased to about 30 percent of the trading volumes in the domestic foreign exchange markets or about \$300 million per day. So it seems better that Indian companies should fix the prices of their export products in Euro rather than in Dollar. If the Rupee continues to depreciate against the Euro but appreciate against the Dollar, Indian exporters will gain in Dollars.
3. Even companies can choose to shift their factories to countries like China if they can get better exchange rate from there. China has kept its currency pegged to the US Dollar and not allowing the currency to appreciate. So by virtue of their fixed currency peg they have been able to prevent movements against the Dollar.
4. The impact will certainly differ from product to product due to their different individual price elasticities of imports and exports. Further the impact will also depend on the

import intensity of exports of different goods. As export of goods with low import content will suffer the most due to Rupee appreciation the cost of imports will decrease Indian companies should focus more on producing and exporting goods with higher import content.

5. Further some short-term actions which the Indian companies may follow to minimize the impact of a strong Rupee are to rely on cost cutting in selling/marketing and general/administrative expenses etc.

Indian companies should rely on such steps but the question still arises how long this Rupee appreciation will continue and how it will effect Indian economy. Though Government is taking measures to prevent its adverse effect but the question still remains that how long these measures will be effective keeping off the bad effect of it on the Indian economy, inflation the foremost of them

CONCLUSION

Whether Indian Rupee will continues to appreciate in future is a big dilemma. The future movements of the Rupee against the US dollar would depend on many imponderables such as timing of US recovery, the interest rate policy of Fed, the future investment climate in Europe, Japan and China relative to the US, the inflation rate in India vis-à-vis the US, the exchange rate policy of China, the political and economic developments in the Arab world. Take for example if OPEC countries take a decision to fix oil prices in Euro instead of US dollar, it may signal a shift of global economic power centre from the US to Europe with far-reaching implications for the exchange rate of the US dollar against other currencies, including the Indian rupee. While there are advantages as well as disadvantages of a rising Rupee, one needs to understand whether the rise in the Rupee is sustainable to derive any reasonable conclusion at this stage. The weakness of the US Dollar is largely due to the relative unattractiveness of US assets. This is in part due to a very low interest rate regime prevalent in the US currently. Already there are indications that those lower interest rate may not be sustainable for long. This means that US interest rates may go up and likely to strengthen the US Dollar. But it is important to note that favorable

interest rate structure in India in as compared to US is not the sole cause of rupee appreciation. Though it is believed that the rise of Rupee may not be sustainable for a long but for the time being Indian government and companies have to adopt suitable policies to reduce the adverse affects and maximize the profits arising out of the Rupee appreciation.

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