Fall & Rise of the Rupee

A dollar in the 1970’s cost Rs. 7.50 and for the next three decades the rupee continued to decline. The rupee climaxed to touch Rs. 49.00 to a dollar in mid 2002, and then slid downwards till it breached the 40s’ mark in September ‘07 and still is at that level. Recently, Mr. P. Chidambaram, Hon’ble Finance Minister of India, speaking at the Peterson Institute of International Economics in the USA said, “The depreciation in the value of the dollar versus the rupee has thrown up unexpected downside risks and (although) the level of appreciation of the rupee was “well beyond comfort levels…that is something we have to live with and our exporters will have to learn to live with it”.

In a relatively free market economy, a currency reflects the inherent strength of the economy and the stronger rupee in many ways reflects this aspect. An exchange rate depends on a number of complex factors – from trade deficits to inward flow of foreign exchange, interest rates, reserves of currency etc. Reserve Bank of India would need to balance between restraining any rise in inflation and foreign investments flowing in including those from FIIs, i.e., match inflow with outflow of dollars.

The government had announced in July this year, export relief packages for a number of industries amounting to Rs. 14 billion but trade bodies are asking for more. They are asking for RBI’s intervention to stabilize the exchange rate, at least for the short term. In one of the world’s fastest growing economies, one can do this only to an extent.

Various interest groups want the government to act in a certain way – but the government should act in the best interest of the nation – but then again, we live in a political democracy!

Where do we go from here? Where do we stand?
But are we better off with a weaker rupee?

Rising currency has both pros and con – some enterprises gain and others do not. Companies with revenue models that have earnings in dollars but costs are incurred in rupees are worst hit. The IT and BPO industry is clearly hit as profits are falling due to lower realisation in rupee term of the billable hours denominated in dollars and salary costs in rupees show no trend of buckling down. Other export industries face similar challenges, especially the SME segment which operates at low margins and employs nearly 20 million people. As the rupee keeps rising, profits of such enterprises evaporate and the prospect of loss of jobs looms large. Outsourcing is based on complex geopolitical reasons of the country that is exporting jobs. Every outsourcing or import is potentially a loss of job in the country that imports. Global trade will never happen if countries only protected jobs of people who support export related activities.

It is now accepted knowledge that for every job in IT and ITES sector, four new jobs are created in the economy, like recruitment agents, airline and other service providers, hospitality sector, etc which are also called “dollar dependent businesses”. As the margins of the principal fall, the service providers get squeezed harder. The pain of loss of margins gets passed down the line in a chain reaction.

Countries make the decision to import or outsource from another country mostly for reasons of lower price. However, often a job goes to a place simply because of an unbeatable combination of price and quality. A pure cost advantage is not everlasting—someone else will just as easily come along and beat the price. The loss of profits is not solely of the rupee rising, which is a macroeconomic factor but costs of inputs like increasing salaries etc., which take away the cost arbitrage on a more permanent basis.

Future benefits to Indian companies will come from creation of freight corridors, electricity reforms and creation of new generation capacity (which should reduce losses and bring down the real cost of power) and structural
improvements in infrastructure would go about reducing the overall cost of inputs to make Indian businesses more competitive, but currently a number of businesses in export are looking at the government for help through a relief mechanism.

Rupee is rising against the US dollar and US economy is currently not riding its best phase; the rupee has not risen significantly against other major currencies of Europe and Asia. In fact, Euro and the British Pound have appreciated against the rupee in recent times. Risk concentration with the US markets and US dollar, though the US happens to be the biggest market, is detrimental for Indian businesses in the long run and like other Asian economies, Indian businesses need to diversify risks around the world.

Is a rising rupee really bad?

It depends on where you sit. Imports of crude (at 30% of total imports, the biggest item on the import bill), machinery (17.2% of total), electronic goods (8.4%), gold and silver (7.7%), etc., become cheaper.

These are big ticket expenditure for the country and capable of generating huge savings but do not stir up emotions like potential job and revenue loss of the export sector and hence does not capture popular imagination. Outward travel and investments by Indian residents in dollars become more attractive.

IT companies and other companies in a globally competitive scenario have been able to make large acquisitions of US companies and at the current exchange rates, any drop would entail substantial savings. Tata’s 8 billion dollar acquisition of Corus or Hindalco’s recent 6 billion dollar acquisition of Novellis would have a lower cost of acquisition from an Indian shareholders’ side due to the current exchange rates.

Montek Singh Ahluwalia, deputy chairman of India’s Planning Commission believes that the Reserve Bank and Finance ministry face a difficult set of
choices. In a recent interview, he said, “This is a balancing act that the Reserve Bank and the Finance ministry have to play. It is a reflection mainly of the trilemma that economists face; you can only have two out of three things. If you want to have a stable currency, an independent monetary policy and capital account convertibility, you can’t have all three. You have to give up one”. This is the classical trilemma and the multiplicity of choices!

As Indian economy continues to mature and as Indian businesses gain confidence to do business globally, nuances of risks associated with a fluctuating currency have to be better understood and tackled in a holistic way and factored in as only another business risk. In other words, core strength of businesses has to be expanded from just cost-competitiveness.

Meanwhile, let us toast the rising rupee as a symbol of resurgent India.

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