

CRISIL YOUNG THOUGHT LEADER 2007

Dissertation on
WRESTLING WITH THE RUPEE

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Submitted by

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EXECUTIVE SUMMARY

As the Indian economy finds itself increasingly integrated with the rest of the world, it is becoming clear that it will have to accept a stronger currency as the inevitable fallout of its economic development process.

Global diversification of investments away from the USA is causing most non-US assets, including crude, gold and emerging markets to go up. Due to rapid and sustainable growth envisaged over the next decade, India is being increasingly viewed as a lucrative destination by global investors and can expect its currency to firm up against the Dollar over the next couple of years.

Against this backdrop, Indian businesses, especially exporters, will have to stop depending on a weak Rupee as a sop bestowed on them by the RBI/MOF for so long and start looking at ways to counter the effect of this external business phenomenon.

In fact, it can be used by them as an opportunity to build competitiveness in manners such that the advantage does not get diluted easily.

This paper discusses the role that the Dollar-Rupee exchange rate has played so far and also what changes a stronger Rupee necessitates for India Inc and its regulators.

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WHERE WE WERE AND WHERE WE ARE

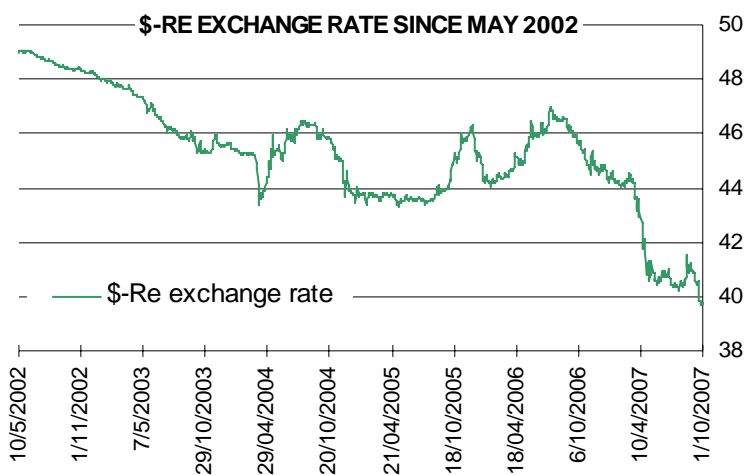
Journey of the Rupee

The devaluation of the Rupee in 1991 in two quick steps by almost 19% was the result of a severe Balance of Payment crisis when the government was forced to mortgage its gold reserves to stave off bankruptcy and usher in major economic reforms in the country.

In 1992-93, the Liberalized Exchange Rate Management System (LERMS) prevailed, under which 40% of the export receipts were to be surrendered to the RBI at the official rate so that it could be used for the import of necessary items like petrol, fertilizers, etc, and 60% could be traded in the free market. Till 1993, the Rupee was a “controlled” currency and everyday the RBI would peg it vis-à-vis the currencies of its major trading partners and change the reference rates when the market seemed to break out of the controlled range the apex bank had decided for it.

In 1993, at the exchange rate of 31.37 Rupees to the Dollar, the Rupee moved from a controlled regime to a “**managed or dirty float**” regime where the exchange rate was determined by the market forces of demand and supply, but active intervention by the RBI through purchase/sale of Dollars in the open market partially controlled the movement of the Rupee.

For a long time, the Rupee weakened and was deliberately kept weak and the Dollar-Rupee exchange rate touched 49 against the Dollar in May 2002 before a trend reversal was seen.



Around this time, the US economy slowed down and the Indian economy started showing promise- through political stability, better investment climate, a sound equity market regulator (SEBI) with statutory powers, a large and young talent pool, labor-cost arbitrage possibilities, robust domestic demand, etc.

Foreign investments began to flow into the Indian capital markets and corporate firms, chasing high interest rates and growth potential. As a result, the Rupee began to appreciate steeply. It touched a high of 43.50 in April 2004. Thereafter it moved more or less sideways between 43-47 till July 2006. From then began a strong uptrend for the Rupee, which recently touched a 9 year high of 39.63 in September 2007. During this period, the central bank kept mopping up Dollars to shield the exporter community which contributes about 20-21% to the GDP, from the ravages of a strong domestic currency on their competitiveness and operating margins. But this brought another significant macro-economic variable under siege-domestic inflation rocketed to a record high of 6.73% in early 2007 on account of increased liquidity sloshing around in our financial system resulting in a demand-supply gap. This has now reduced to a respectable 3.5-4% in the recent weeks.

WHAT BENEFIT DID AN EARLIER WEAK RUPEE AND LOW VOLATILITY BRING TO INDIAN CORPORATES?

Safe Haven!

Earlier, in the 1992-2002 period, a **weak Rupee** provided a much needed boost to our exports. Goods like textiles, handicrafts, leather products, agricultural products, drugs, jewellery, etc and services like software exports and BPO earn their export revenue in Dollars. A weak Rupee made imports from India more attractive for global buyers.

More recently, however, with appreciation in the valuation of Rupee, the export competitiveness of low margin and low end products of India have taken a severe beating, leading to expectations of a likely shortfall in meeting the government's export target of \$160 billion for the current fiscal year (2007-08) by about \$20 billion.

Low currency volatility, accompanied by thin trade volumes and restricted capital account convertibility, had, so far, allowed Indian exporters to leave their positions uncovered in the forex market. The blanket cover provided by RBI's unwavering stance on the exchange rate enveloped exporters in a sense of safety. Exporters saw little need to employ hedging techniques or undertake steps to base their competitiveness on factors other than the sop provided by a falling currency.

WHY IS THE RUPEE APPRECIATING SO QUICKLY AND WHY IS THE RBI ALLOWING THIS TO HAPPEN?

The Tides Have Turned

A currency appreciates because of increase in its demand and increased demand for the Rupee can be attributed mainly to the following factors:

1. INVESTMENT INFLOWS FROM ABROAD:

Foreign direct investment into India Inc rose from \$5,035 million in 2002-03 to \$17,745 (provisional) in 2006-07. Likewise **portfolio investments** grew from \$979 in 2002-03 to \$7,003 in the last financial year.

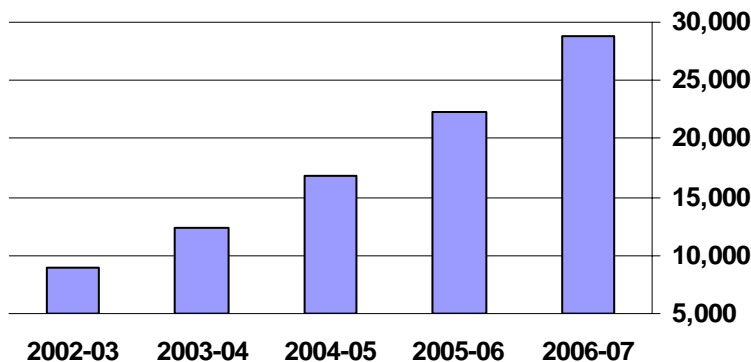
A heavy dollar deluge triggered the climb of the Rupee.

External Commercial Borrowings of Indian corporates on account of cheaper Dollar-denominated loans also supported Rupee’s appreciation against the Dollar.

2. INVISIBLES INFLOW , ESPECIALLY SOFTWARE EXPORTS AND REMITTANCES BY INDIANS LIVING ABROAD:

Software exports and private transfers by Indians living abroad have risen substantially over the last five years to contribute to rise of the Rupee.

RISE IN INDIA'S NET SOFTWARE EXPORTS
(in \$ mln)



NET PVT TRANSFERS	
Year	Amt (in \$ m)
2002-03	16,387
2003-04	21,608
2004-05	20,525
2005-06	24,102
2006-07	27,195

Data source: RBI Database on Indian economy

RBI has allowed the Rupee to appreciate by almost 12% over the last 12 months as shown in the table below. A significant point here is that the Rupee has seen far more appreciation against the Dollar than the currencies of most other emerging markets, because of higher **interest rates** and stellar **stock market returns**.

	<i>Absolute movements against US Dollar</i>												22nd Aug 2007
	Aug-06	Sep-06	Oct-06	Nov-06	Dec-06	Jan-07	Feb-07	Mar-07	Apr-07	May-07	Jun-07	Jul-07	Current
Jap Yen	117.40	118.18	117.00	115.81	119.11	120.10	118.57	117.83	119.54	121.73	123.17	118.61	114.82
Indo Rupiah	0.9120	0.9198	0.9088	0.9166	0.8992	0.9098	0.9130	0.9129	0.9093	0.8803	0.9040	0.9215	0.9445
Thai Baht	37.58	37.54	36.69	35.81	35.45	34.68	33.87	32.28	32.78	32.83	32.45	33.78	34.56
SG Dollar	1.5732	1.5876	1.5561	1.5402	1.5346	1.5365	1.5285	1.5165	1.5198	1.5286	1.5304	1.5167	1.5281
HK Dollar	7.7773	7.7919	7.7773	7.7779	7.7780	7.8085	7.8134	7.8137	7.8229	7.8080	7.8145	7.8216	7.8095
Indian Rupee	46.5345	46.1138	45.4539	44.8386	44.6394	44.3128	44.1541	43.9944	42.3853	40.8257	40.7839	40.4115	40.9475
Taiwan Dollar	32.88	33.11	33.30	32.40	32.59	32.97	32.99	33.13	33.40	33.13	32.84	32.91	33.05
SK Won	961.85	947.00	943.20	929.85	929.00	942.70	941.75	940.95	930.85	928.85	923.90	919.25	944.40
SA Rand	7.1993	7.7838	7.3710	7.1532	7.0025	7.2152	7.2325	7.2550	7.0801	7.1175	7.0430	7.1388	7.3431
Russian Rouble	26.749	26.780	26.704	26.240	26.325	26.489	26.137	25.970	25.680	25.889	25.753	25.539	25.810
Brazilian Real	2.1440	2.1695	2.1410	2.1650	2.1360	2.1230	2.1195	2.0570	2.0360	1.9180	1.9289	1.8822	2.0285
	<i>Percentage movements vis-à-vis 31st Aug 2006</i>												Gain Y/Y
	Aug-06	Sep-06	Oct-06	Nov-06	Dec-06	Jan-07	Feb-07	Mar-07	Apr-07	May-07	Jun-07	Jun-07	Gain Y/Y
Jap Yen	117.4	-0.66%	0.34%	1.35%	-1.46%	-2.30%	-1.00%	-0.37%	-1.82%	-3.69%	-4.91%	-1.03%	2.20%
Indo Rupiah	0.912	-0.86%	0.35%	-0.50%	1.40%	0.24%	-0.11%	-0.10%	0.30%	3.48%	0.88%	-1.04%	-3.56%
Thai Baht	37.575	0.11%	2.37%	4.71%	5.66%	7.72%	9.87%	14.11%	12.77%	12.64%	13.65%	10.11%	8.02%
SG Dollar	1.5732	-0.92%	1.09%	2.10%	2.45%	2.33%	2.84%	3.60%	3.39%	2.83%	2.72%	3.59%	2.87%
HK Dollar	7.7773	-0.19%	0.00%	-0.01%	-0.01%	-0.40%	-0.46%	-0.47%	-0.59%	-0.39%	-0.48%	-0.57%	-0.41%
Indian Rupee	46.5345	0.90%	2.32%	3.64%	4.07%	4.77%	5.12%	5.46%	8.92%	12.27%	12.36%	13.16%	12.01%
Taiwan Dollar	32.883	-0.68%	-1.27%	1.48%	0.91%	-0.25%	-0.31%	-0.75%	-1.57%	-0.75%	0.13%	-0.08%	-0.51%
SK Won	961.85	1.54%	1.94%	3.33%	3.42%	1.99%	2.09%	2.17%	3.22%	3.43%	3.95%	4.43%	1.81%
SA Rand	7.1993	-8.12%	-2.38%	0.64%	2.73%	-0.22%	-0.46%	-0.77%	1.66%	1.14%	2.17%	0.84%	-2.00%
Russian Rouble	26.749	-0.12%	0.17%	1.90%	1.59%	0.97%	2.29%	2.91%	4.00%	3.22%	3.72%	4.52%	3.51%
Brazilian Real	2.144	-1.19%	0.14%	-0.98%	0.37%	0.98%	1.14%	4.06%	5.04%	10.54%	10.03%	12.21%	5.39%

Source: kshitij.com

The Balancing Act

Rupee appreciation has been allowed by the RBI as there is a limit to the extent to which it can intervene in the currency market, as every time the central bank mops up Dollars to keep the Rupee from escalating sharply, it has to release an equivalent amount of Rupees into the financial system, leading to increased money supply which can, potentially, lead to inflation. This has forced the government to release MSS (Market Stabilization Scheme) bonds to suck out excessive liquidity and ease inflationary pressures. But MSS incurs interest payments that result in fiscal loss that could run up to Rs 25,000 crore per year, putting the government in another tight spot.

WHO IS LOSING OUT AND BY HOW MUCH?***Sunshine Sectors and Traditional Strongholds...***

A strong Rupee shows confidence in India's growth potential. It benefits consumers as India is a net importer and a weak Dollar reduces our overall cost of imports, translating into lower prices for consumers. It also benefits companies that are repaying foreign currency debts taken at a time when they borrowed 45/46 Rupees to a Dollar because they now have to pay back at the rate of 40/41.

The main losers are the companies earning their revenue in Dollar terms. The sectors of the economy which have been hardest hit by Rupee appreciation are textiles, handicrafts, agriculture, pharmaceuticals, gems and jewellery, airlines, IT and BPO industry, etc.

- **PHARMACEUTICAL INDUSTRY**: Nearly 4/5 of the pharmaceutical export revenue of Rs 25,000 crore is dollar denominated which, in turn, contributes 5% to India's total forex earnings. Due to controlled prices in India and lean margins in the US, India's pharma industry has taken a 10-15% hit on their top line.
- **IT/BPO INDUSTRY**: Almost 2/3 of the IT industry revenue is in Dollar terms and for every 1% appreciation in Rupee, operating margins of the IT/BPO segment declines by 40-50 basis points. In the first quarter of 2007-08, IT majors saw their operating margins shrink considerably. Wipro's margins have come down by 3.4%, that of Infosys Technologies by 3.5% and TCS's reduced by 2.5%.
- **TOURISM INDUSTRY**: Inbound tourism is also feeling the heat as most tourist operators had contracted group tours at 44/ Dollar but at the time of execution, the realization will be around 10% lower.
- **GEMS AND JEWELLERY INDUSTRY** is taking a hit even though this sector is a raw material importer because of costlier import invoices a quarter ago and cheaper export billing today. This gap has eliminated their opportunity to offset the effect of the rising Rupee on their revenue with cheaper input costs.
- **AVIATION INDUSTRY**: In the airline industry, while companies like Jet Airways may lose revenue earnings but there will be huge savings for them on imported aviation turbine fuel, lease rentals of aircrafts, interest, etc.

WHAT CAN COMPANIES DO TO DEAL WITH THIS SITUATION?***Way Up Is The Way Out!***

Strategies available to organizations to tackle this menace have been dealt with across three time-frames:

1. **Near term**, which perceives exchange rate as an external and uncontrollable factor and suggests what companies must do at once to protect their margins from falling further;
2. **Medium term**- in which companies can take steps to build competencies in areas they can influence (internal factors) and move away from dependency on the exchange rate.
3. **Long term**, which discusses the way out for companies to minimize the impact of Rupee, which can only be expected to turn stronger in future, on their order book, revenue and profits.

In the near term, that is, a timeframe of about 12-18 months, exporters can only play defensive and try to minimize plausible losses by **hedging** their positions in the forward market. IT giant TCS used derivatives to hedge its currency exposures to mitigate the effect of the falling Dollar on its bottomline. HCL Technologies is known to have taken a forward cover of \$1.7 billion to cover its exposure.

Hedging is akin to buying insurance: Just like organizations insure their offices and equipment and pay premium to transfer risk to the insurer, they will have to eliminate exchange rate risk by taking adequate forward cover on their exposures.

The dampener here is the added cost of derivatives which makes this a viable option only for large exporters, leaving the smaller ones without any defense.

- A majority of Indian exporters earn Dollar revenues and thus their earnings depend a lot on the \$-Re exchange rate alone. \$-Re risk can be ***diversified by holding exposures in currencies other than the US Dollar***:

Say an exporter was to receive \$100 in September 2007. At Rs 40/ Dollar, he receives Rs 4000. Had he diversified a part of his exposure (say \$10) by synthetically converting it into Euros through a Forward Contract at the time of invoicing, say 3 months ago, he would have held 90 Dollars and 7.69 Euros (in July 2007, EUR-USD=1.3. Therefore, \$10=7.69 Euros) and at the time of realization in September 2007, he would have received Rs 4034.5 ($\$90 \times 40 = \text{Rs } 3600 + 7.69 \times 56.5 = 434.5$).

Diversification brings better realization because all major currencies are not likely to move in the same direction at the same time, against the Rupee.

In the medium term, that is, given a time horizon of about 12-36 months, a slew of solutions surface that can apply differently to the different sectors affected by a costly Rupee:

1. ***Diversifying geographically*** so that the bulk of export revenue of firms is not dependent on the Dollar-Rupee exchange rate. Euro and Pound denominated earnings will correct the current imbalance where the health of foreign trade is too dependent on the US economy.

Countries of the Euro zone and Asia Pacific region also present huge untapped opportunities for Indian exporters.

2. ***Invoicing*** in Rupee terms is a way out for exporters if it is acceptable to their customers. The hitch is that the exporter's clients will accept this only if **they** can hedge **their** position in the currency market, which is currently possible only in the illiquid offshore Dollar-Rupee market.

3. ***Increasing cost efficiency*** by utilizing material and human resources better. One way of doing this, especially for BPOs is employing wage arbitrage by tapping talent from Tier II and III cities and moving to low- cost regions.

Companies can try to change or rationalize cost structures by arranging for the import of fixed and variable inputs that can be procured at relatively cheap prices abroad.

4. ***Establishing operations abroad*** for low-margin and low-end services so that costs are denominated in the local currency, thereby removing the exchange rate risk that depresses the already thin margins. This would be welcomed by the host countries due to local employment generation.

5. ***Innovating products and services*** constantly and moving up the value chain so as to stay competitive in the overseas markets and capture hitherto untapped market segments to maintain and enhance export base. Traditional merchandise industries like textiles and handicrafts need to revamp their offerings to ensure that demand for their products is not cannibalized by competitors offering the same product at a cheaper price.

China, which is being touted as the prime beneficiary of the lost share of Indian exporters on account of the Yuan being deliberately kept weak against the Dollar, will only be able to grab the low-margin, basic and low-end products because of lack of the need to innovate and create unique product offerings.

6. **Catering to domestic demand** arising out of India's economic growth and finding fortune at the bottom of the pyramid to create fresh demand rather than focusing solely on overseas clients presents challenges to several corporate big wigs to spend on R& D to develop products that cater to new demands. For instance, the boom in telecom, banking and financial services, medicine, infrastructure sectors are developing possibilities for the IT sector to provide software and technology solutions to new projects.

7. Software exporters need to target a bigger revenue pie through **new areas** like animation, gaming, engineering, accounting and legal outsourcing apart from the areas of work that they are currently engaged in.

In the long term, that is, a time frame beyond 36 months, Indian corporates have no choice but to **move up the value chain** and deliver high-end, value added products whose demand is not dependent on a favorable exchange rate. This will entail long- term planning and a major overhaul of products, changes in organizational systems and structures, technology and manpower planning, etc.

Being on guard through **hedging** exposures will remain pivotal for firms on account of expected volatility in the exchange rate.

WHAT CAN THE REGULATORS DO TO FACILITATE THEIR STRATEGIES?

Make Your Presence Felt, But In The Right Places!

There is consensus among economists and business intellectuals that a strong currency reflects confidence in the economic prospects of a country and that a weak currency is counterproductive as it nips entrepreneurship in the bud, diverting investors away and allows the government to be complacent and lax in pushing reforms and modernization of the economy.

The regulators need to identify currency risk as external and non-diversifiable and let the market take its own course which will also allow the Indian corporates to discover their own ground and enable them to really compete, without a weak Rupee acting as a sop. **The recent comment by Finance Minister P Chidambaram that there is very little he can do about the rising Rupee and that exporters have to learn to live with it, needs to be seen in this light.**

The capital absorption capacity of the economy needs to be improved and the government must act swiftly to remove the constraints in the way. The hurdles discussed below are **external to business firms and come under the realm of the government's influence.**

Infrastructure remains a major bottleneck as roads, airports, seaports, warehouses, power, etc are still hugely inadequate and add enormously to the costs of companies. The revised draft of the Eleventh Plan Approach Paper states that investment in physical infrastructure will have to be stepped up from 4.6% of the GDP to 8% to enable GDP to grow at 9%.

Policy and legal bottlenecks, especially with respect to FDI, labor laws, conflicting rulings by regulatory bodies etc, continue to hamper productivity and impede growth of organizations and sectors in India. Also, the *investment climate in India needs to be made more predictable* by the government through well thought-out policies and speedy procedures eliminating bureaucratic delays that erode efficiency.

Both opportunity and challenge are knocking at India's door and the way to transformation lies in **not** shying away from a stronger Rupee, as it looks like the uptrend is here to stay!

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EDUCATIONAL QUALIFICATIONS AND ACCOMPLISHMENTS

➤ Awarded the **PIMR Chairman's Gold Medal** of the year 2005 for being the **overall topper of BBA**.

2006-2008 Pursuing MBA (Full Time) from I.M.S. DAVV, Indore -77%

Major specialization **Finance**

Minor specialization **Marketing**

2002-2005 BACHELOR OF BUSINESS ADMINISTRATION (BBA) -76%

Prestige Institute of Management and Research (PIMR), DAVV, Indore.

2001-2002 CLASS XII (CBSE) - 80.6%

The Emerald Heights International School, Indore

1999-2000 CLASS X (CBSE) -74.2%

The Emerald Heights International School, Indore

SUMMER INTERNSHIP (June 09- July 15, 2007)

Company: Kshitij Consultancy Services, Kolkata. It is an independent forex consultancy firm that owns and manages kshitij.com, which is ranked the most popular forex advisory website worldwide.

Key Learning	<p>Currency forecasts:</p> <ul style="list-style-type: none"> ▪ Fundamental Analysis- economic indicators that impact currency exchange rate movements. ▪ Technical Analysis-reading of price charts and identification of trends. <p>Negotiation:</p> <ul style="list-style-type: none"> ▪ Successfully negotiated and reduced the fees for a forex workshop the firm sponsored at the Corporate Treasury Forum held in Mumbai on 27-28 Sept 2007- a high level business conference targeted at over 55 senior management (finance and forex) professionals.
Impact on the company	<p>Projects assigned were used by the company to enrich the website and as inputs for report writing. Successful negotiation resulted in direct monetary saving for the firm.</p>

AREAS OF INTEREST

Language and communication skills development related.

➤ 14 months work experience at **THE GENIUS**- the leading I.Q. and communication skills development institution for school children in Indore.

Mentor to age-wise groups of 8-16 year olds (2005-07)

