

A



STRONG

RUPEE

BANE OR BLESSING?

by
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What is currency appreciation?

The appreciation of any country's domestic currency is defined as a decline in the exchange rate of its own currency vis-à-vis a foreign currency. The exchange rate here refers to the number of units of domestic currency required to purchase one unit of the foreign currency in question. Alternatively, it is the price (in terms of the domestic currency) of one unit of the foreign currency. Hence, we can also define appreciation as a decline in the domestic price of a foreign currency.

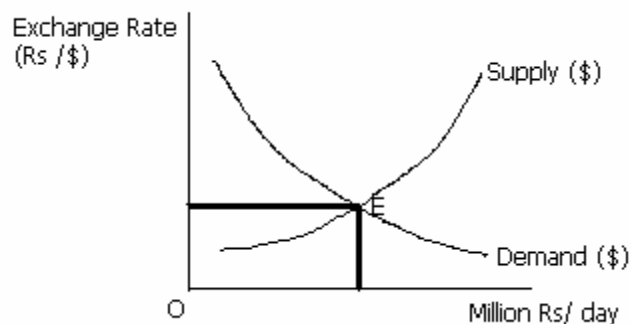
For instance, if it takes 46 rupees, for an Indian couple planning to holiday in Las Vegas, to buy 1 dollar; the (nominal) exchange rate (INR/US\$) is 46. Now assume that this couple comes back from their holiday with a few unspent dollars. When they go to redeem these dollars against their domestic currency, the exchange bureau gives them 40 rupees against each dollar that they exchange. Hence the exchange rate (INR/US\$) has declined to 40. What has happened in effect, while they were holidaying, is that the Indian Rupee has appreciated against the US Dollar.

What causes currency appreciation?

Under a flexible exchange rate system, the value of the domestic currency of the country following such a system, is left to be determined by the market forces of demand and supply.

For instance —hypothesizing that India follows a fully flexible exchange rate system with no state intervention— the exchange rate of the Indian Rupee against the US Dollar is decided by the demand and supply of dollars in India's foreign exchange market. This, in turn, is affected by a host of factors —India's imports, its exports, foreign investment in India, Indian investment abroad, borrowings from and loans to RoW, et cetera— all those transactions that lead to an inflow or outflow of dollars.

In fact, the demand and supply curves of say, US Dollars, that we obtain while taking the nominal exchange rate as its price (in Indian Rupees) are identical to those for any normal commodity. The demand curve is downward sloping indicating that the lower the exchange rate, the greater the quantity of US Dollars demanded in the forex market. The underlying reason is that a lower exchange rate causes imports to be cheaper and hence increases in import demand. Consequently, a greater quantity of US Dollars is demanded to pay for the increased imports. On the other hand, the supply curve is upward sloping indicating that the higher the exchange rate, the greater is the quantity of US Dollars supplied in the forex market. The reason is that at higher exchange rates Indian exports are more competitive and investments cheaper, creating a huge inflow of US Dollars in the form of export earnings and foreign investment.



The nominal exchange rate is therefore determined by the intersection of these curves, at a level where demand matches supply.

Consequently, any increase in supply or shortfall in the level of demand for the foreign currency in question causes an appreciation of the domestic currency vis-à-vis this foreign currency. This is reflected in a declining nominal exchange rate.

In general, any of the following six factors can cause an appreciation of domestic currency:

1. Large increase in exports
2. Upsurge in foreign investment
3. Increase in foreign aid, external borrowings or interest payments from RoW
4. Significant decline in imports
5. Decreased investment abroad
6. Decline in aid, loans and interest payments to RoW

The Indian experience

The exchange rate of the Indian Rupee is broadly market-based. The exchange rate management policy continues its focus on smoothening excessive volatilities in the exchange rate with no fixed target, while **allowing the underlying demand and supply conditions to determine the exchange rate movements over a period in an orderly way.** The RBI closely monitors India's exchange rate to ensure that all is well.¹

Over the past few months, there has been much ado about a constantly strengthening Rupee, reflected also in India's bulging forex reserves, which have now touched an all-time high of 85 billion US Dollars. This steep rise has been largely due to a major change in India's current account structure. From a perennial average annual deficit of around \$4.2 billion over the last 10 years, the current account moved into a surplus in

¹ As stated in the Economic Survey for 2002-2003 under section 6.66: "Exchange Rate Developments."

2001-02. More importantly, it is likely to remain in positive territory in the years to come.

This is not a usual trend witnessed by India, fiscal 2002-03 being the first time in over 17 years, when rupee ended higher against the dollar. For the fiscal 2001-02, India's exchange rate depreciated on average by about 4% every month. However, after reaching a high of Rs 49.06 per US\$ in May 2002, the Rupee took a sharp turn and has been constantly strengthening. It stood at Rs 47.80 in January 2003, indicating an appreciation of roughly 2.1% over the period Mar 02 – Jan 03.

In fact, this upsurge of the Rupee did not end here. By August 2003, the Rupee had gained by another 227 paise, reflecting an appreciation of about 5% over the Jan 2003 level. Going by the current trend, earlier forecasts that India's exchange rate would nudge 46 by December 2003 may have to be revised as well, given that the rupee has already crossed the 46 level.

Let us look at some reasons for this continuous appreciation of the Rupee:

1. Huge rise in the export of invisibles, primarily IT and software exports

For the fiscal year 2002-03, India achieved a **\$16.18 billion surplus of exports over imports on invisibles**. Of this, over **\$9 billion came from IT and software exports**. If NASSCOM estimates that IT and software exports will rise by 25-30% per annum by 2005 are to be believed, we anticipate a surplus of over \$20 billion on this account only. The sudden **BPO boom** over the past year has also led to a significant inflow of forex. In fact, NASSCOM expects the **Indian software and business process outsourcing sectors to achieve exports of over \$55 billion by 2008**.

2. Upsurge in overall exports, causing surplus on current account

A favourable balance of trade position over the past year is reflected in India's **current account surplus of over \$3.71 billion for 2002-03**. One of the prime reasons for this was the unprecedented rise in our exports. **India witnessed an export growth of roughly 20% last year**. This export growth has been fuelled by many factors, global economic recovery being one. Economists expect that this trend will only continue in the near future. India has, in fact, **targeted an export growth of about 12% for the year 2003-04**.

3. Huge inflow of foreign investment

The domestic currency's gains over the last few months have also been driven by foreign funds, which have pumped huge sums into Indian equities. **These investments have been undertaken with the hope that a good monsoon will aid economic recovery**. In the first week of July 2003 itself, foreign funds had invested a huge \$300m in the Indian markets. This was preceded by an inflow of about \$554m for the month of June 2003. Another factor that has contributed to increased foreign investment is **interest rate differentials** and arbitrage possibilities. **Declining interest rates globally** have made India a favourable destination for investment, with the interest rate **differential**

between US and Indian markets being around 3-4%. Remittances from NRIs have also increased by huge amounts due to this reason.

Thus, the Indian Rupee has continually been strengthening as a fallout of the above phenomena. Economists admit that they anticipate no change in trend in the near future, with the stage set for continued appreciation, unless the Reserve Bank intervenes to devalue the Indian Rupee.

According to Omkar Goswami, chief economist, CII: "The trend is likely to continue because there's least possibility of either a rise in the interest rates in the United States or a fall in the rates in India, particularly since this is an election year. So, this factor will serve as an additional funnel sucking in dollars into India."

At current levels of forex inflow, it is anticipated that India's forex reserves would bulge to \$92-93 billion by December 2003 and by March 31, 2004, it'll be close to \$100 billion! So, this makes India the third largest depository of forex in Asia, after China, Taiwan and Hong Kong, apart from Japan.

The case *for* a strong and rising rupee

Strong currencies are not accidents of nature or freaks of fate – behind a strong currency is a certain national sentiment and a certain administrative outlook. Let us ask ourselves: **Why should India not have a strong currency? What will happen if the Indian rupee is equivalent to the dollar? What if the Indian rupee is equivalent to 10 US dollars? What will be the consequence of the Indian rupee becoming the world's currency of choice for trade and commerce?**

The ramifications boggle the mind. The exporters are feeling their hearts sink and indeed, the chief argument against a strong rupee is that India will price itself out of some extremely competitive markets. However, the arguments for a strong rupee are many and varied and generally good for India in the long term for a variety of reasons.

Let us look at some arguments in favour of a strong Rupee:

1. Cheaper and increased imports

With a consumer base of more than a billion, a decline in the effective prices of imported items due to appreciation will benefit India in a big way. The prices of many imported commodities, most importantly oil and gold, for which India has a voracious appetite, will either level off, or actually fall leading to an increase in import demand; and a possible reduction in India's import bill.

For instance, most of the petrol that we use in India is imported. **India's petroleum products import bill is huge, at about \$17.5 billion in 2002-03**, which is as much as 30 per cent of the total import value. The rupee's steep appreciation has had a clear benefit here. First, Indian oil companies pay less for imported oil, since the dollar is now cheaper. This benefit is passed on to petrol and diesel consumers since petroleum products' prices are revised every

fortnight. In recent months, despite international oil prices moving up steeply, a rising rupee has helped mitigate the adverse effect on your bills.

2. **Reduction in prices of commodities requiring imported components or imported raw materials**

An appreciating Rupee that leads to a substantial decline in the price of imports, triggers a significant drop in the domestic prices of commodities with heavy import components. For instance, **the import cost of a chip from Intel, the world's largest chipmaker, is down by over 7 per cent** thanks to the rising rupee. Also, the probability of such benefit being passed on to consumers is very high in this era of fierce competition.

Also, given that most large export sectors such as textiles, gems and jewellery have large import constituents, this will help reduce the cost of their final products thereby making them more competitive in the international market.

3. **Reduction in interest payments on foreign borrowing and increased profitability of Indian companies**

For companies that have borrowed huge sums from overseas markets, the rising rupee translates into substantial cuts in interest outgo. This also means increase in profits without much sweat. For instance, **a rising rupee is said to have benefited Reliance Industries by a neat Rs 125 crore** so far. For stockholders of such companies, this amounts to increased dividend payments.

4. **Foreign Leverage**

With a strong currency comes the **ability to negotiate stronger deals in international diplomacy and commerce**. A strong rupee allows India to not only bid for larger and larger percentages of high value products of other countries (generally weapons, industrial machinery and technology), but allows it to leverage these deals into foreign policy advantages. Also, a strong rupee, which as stated above leads to a rise in domestic demand, **allows India to negotiate favorable trade equations** in return for access to the Indian market and the Indian consumer.

The case *against* a strong and rising rupee

So then, if a rising rupee is indeed of great benefit to you and me like we saw in the earlier section, what is all the hue and cry about? In the words of Omkar Goswami "India now stands at the point where the exchange rate un-competitiveness will start hurting us. It has not happened so far, but can now. We have till now been masters of scarcity management. But how to manage plenty, without being market unfriendly? This is a new phenomenon confronting us."

Let us understand, in detail, the negative ramifications of a strong and rising rupee:

Non-competitive and declining exports

The appreciation of the rupee makes our goods more expensive to foreign buyers, adversely affecting our trade pattern. It has a catastrophic effect on India's exports, leading to a multitude of outcomes:

1. Decline in production levels due to reduction in exports

A rising rupee translates into costlier Indian exports in international markets. This increase in the effective price of Indian goods and services pulls down their demand, directly affecting India's production levels and economic growth, especially since India's exports form a large proportion of its GDP. For instance, **export growth dropped from 18% in April 2002-July 2002 to 9% in the same months this year. This translates to a Rs 25,000 crore loss in additional production.**

This setback may not be felt so much by the manufacturer exporter, who can set off the declining export proceeds of finished goods against cheaper imports of raw materials. But other exporters such as IT, healthcare services etc. would be the main losers. **A 1% appreciation in rupee results in 0.5% reduction in revenue, which could run into millions.** It is quite ironic that the success of IT companies in exporting services across the globe that has resulted in this rise of the rupee, which will now play devil for them.

Adding further to the un-competitiveness is the fact **that India's competitors' currencies such as that of China, Malaysia, Thailand, Taiwan and the Philippines have either not appreciated or appreciated slightly less than India or simply depreciated** and this has will impact Indian exporters adversely, blunting their competitive edge even further.

The Indian industry's fear is evident in the fact that India has set a modest 12% annual export growth target for the year 2003-2004, despite roughly 20% export growth in the previous year and a bullish global economy, because of worries about the strengthening of the Indian Rupee against the US dollar.

2. Disincentive to exporters causes further decline in exports

Apart from the usual decline in export demand caused by appreciation, a rising rupee also **reduces sharply the incentive for an exporter** to export higher volumes. Exporters have, in fact, been the worst affected by the rising rupee. **For every 10 paise that the rupee gains, an exporter stands to lose Rs 1 lakh for every \$1m of exports.** A company with, say, \$30m of exports, stands to lose as much as Rs 30 lakh when they convert their dollar revenues into the Indian Rupee.

3. Job losses

The huge loss in exports and consequently production, due to an appreciation of the rupee, can also lead to a **shake-up of the employment level** of the economy. India's export sector mainly comprises of coffee, oil, processed foods, infotech, BPO and textiles—most of which are labour-intensive in nature. Hence a reduction in production levels creates a potential threat in the form of numerous job losses. For example, the **reduction in India's export levels as compared to last year has meant a loss of 11 lakh job opportunities!**

Conclusion

As is evident, the appreciation of a country's currency brings with it both desirable and undesirable fallouts, bundled together in an inseparable manner.

While a strengthening of the rupee creates havoc among the exporters' community, as well as the worshippers of economic growth, a reasonable amount of appreciation may appeal to those who take view of the larger picture—considering both the gains as well as the losses in an unbiased fashion.

An appreciating rupee provides various benefits by bringing our currency at par with other international currencies, greatly improving our purchasing power in the world market. It translates into cheaper high-quality (imported) goods, cheaper (world-class) higher education in American and European universities; cheap medical expertise abroad—the list can be endless. And all these things add up to a better and improved quality of life for the average Indian.

A rising rupee also imposes its own costs in terms of the loss in exports, decline in production and consequently unemployment. However, without being too strait-laced, we must understand that apart from the exchange rate, our exports depend on a plethora of other factors too—world income being one. **Therefore, to what extent an appreciation of the rupee will hit our exports becomes an important issue.**

A global economic recovery pulls up world demand, consequently creating more demand for Indian goods and services. And this upsurge in export demand has the potential to more than offset the brunt of an appreciating rupee.

Under current circumstances, with the world economy on its recovery path, a rising rupee spells hardly any bad news for India. While it enables us to reap the benefits of a strong currency, there has been minimal impact on our exports. Worldwide economic recovery has ensured that our exports continue to follow an upward trend and grow in double digits. Some are, in fact, of the view that there could *not* have been a better time for the rupee to build up its strength.

The little bad news that has cropped up from the IT and textile quarters has been countered by the gains to exporters from weakening of the rupee against the euro and the yen.

In conclusion, we can say that an appreciating rupee is like a half-filled glass of water. Our opinion on it depends on whether we are proponents of a strong currency and its accompanying material benefits or whether we want to airtight our export sector.

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