

Effect of RUPEE Depreciation on SME SECTOR

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The fluctuation of Indian rupee has resulted in its significant depreciation against major currencies. The fluctuation of exchange rate is one of the uncertainties associated with International Trade. This exchange rate fluctuation has an impact on both large and small scale industries, across all the types of industries. An undue volatility of the exchange rate is detrimental to growth and stability of any economy and business and curbing that volatility is the need of the hour. The primary concern of Indian companies with foreign currency exposure is to protect their profit-and-loss arising on foreign current assets/ liabilities. Exchange fluctuations pose various significant economic risks. Exchange rate fluctuation or the volatility in the exchange rate has direct impact on the importers and the exporters in a short run as well as in the long run, which may act as favorable or unfavorable factors on business. Generally, rupee depreciation negatively impacts import-oriented companies as input cost increases. Many of these companies may not be able to raise the selling price due to cut throat competition.

Since nearly 20 per cent of SMEs in India are exporters and the rest catering to domestic market (being import-dependent) so it is clearly visible that the long term depreciation is counterproductive for SMEs. Current fluctuation is quite high and affects exporters costing and final pricing dearly.

Impact of exchange rate volatility varies in the timeline of business

Short Run	Long Run
The unforeseen exchange rate may affect the revenue or the profit of the business for a certain period of time or for a certain transaction.	Prolonged changes in the exchange rate may affect the demand of the importers and exporters, where the price of the goods changes drastically.
Exchange rate fluctuations impact on the current value of uncertain/ uncommitted future cash flows and future revenues and expenses to a great extent.	

During 1991, when the economy just emerged as a globalised, liberalized and privatized, the rupee had entered in a floating zone, where it floated freely. Prior to this period, rupee was less managed or less taken care by RBI. The golden days were from 1992 to 2008, where the rupee actually appreciated and post that, it again began to depreciate. The reason behind this is nothing but the change in the inflation rate and the change in the exchange rate or the difference in the interest rate.

A country with a consistently lower inflation rate exhibits an appreciation in its currency value, as its Purchasing Power Parity (PPP) rises when compared to other countries. The interest rate and the exchange rate are highly interrelated to each other. A slight change in the exchange rate will have a drastic impact on the inflation which results in changes in the currency value. A higher interest rate offers lenders in an economy a higher return as compared to other countries. Thus higher interest rate attracts foreign investors or foreign capital which causes exchange rate to rise. But if the inflation rate is higher in a country the opposite relationship exists, resulting in decrease in interest rate, i.e., lower interest rate tends to decrease exchange rates.

The RBI lowers the discount rate, i.e. by lowering the rate that bank can borrow from the government, cause an oversupply of money that to be lent to borrowers at lower rates. Excess supply of money in the economy will lower the value overtime.

The higher inflation rate will result in less buying of rupee by foreign countries, which means when exchanging rupee into a foreign currency, will get lower “buying power.”

The steep fall of the rupee has made the SME sector more vulnerable. The industry is still unable to pass on the burden to the consumers on account of the increase in input cost due to recessionary condition, as a result of which the segment is affected by the poor market sentiments. Importers still loose, as they pay in foreign currencies. The cotton prices including other input costs have also gone up while clients are putting pressure to revise the rates.

The issues of concern

- 1) It depends on the time frame of the business.
- 2) In short span, it is not that easy to adjust act upon or to adjust the prices, so the nominal exchange rate is one of the source for exchange fluctuations.
- 3) To a certain extent, the business finds a relation between the exchange rate and the price, where they try to reduce their uncertainty around exchange rate fluctuations.
- 4) In the long run, both the exchange rate and the prices gets adjusted , but the cost of traded goods across the country gets affected.

Characteristics of SMEs and various issues of Exchange Challenges:

- 1) Lack of access to finance :
 - Financial Constraints – limited opportunities to expand exports when the exchange rate is in favourable condition.
 - Vulnerability when the exchange rate is unfavourable.
 - Informal finance may limit the hedging opportunity.
- 2) Lack of knowledge , skills and management :
 - Are the SMEs aware of the available hedging opportunities?
 - SMEs may not have that resource or that scope to keep a track to measure the exchange rate alteration and the cost of traded goods in the market.
- 3) Small Scale of Production:
 - Does SMEs have that option or the scope to adjust that cost and those suppliers?
 - The availability of opportunity is very limited.
 - Selling in only few markets limits the ability to offset Exchange Rate losses in one market and a gain in another market.

Adopting the Exchange Rate Volatility:

In the short run, the exchange rate volatility can be adopted by hedging strategies and by currency invoicing.

Hedging Strategies

- Lock in future exchange rates using forward contracts.
- Purchasing an option at a specific rate.

Hedging with forwards, hedging refers to managing risk to an extent that makes it bearable. Change in the foreign exchange rate can have a significant impact on business decisions and the instrument used for exchange rate risk management is the forward contract.

Forward contracts are agreements between two parties to fix the exchange rate for a future transaction. This simply eliminates the exchange rate risk, but it has some drawback, particularly getting a counter party who would agree to fix the future rate for the amount and time period. By entering into a forward contract, it simply transfers the risk to the counter party, which will now have to bear this risk.

The shortcomings of the forward market, particularly the need and the difficulty in finding a counter party, the futures market came into existence. The futures market basically solves some of the shortcomings of the forward market. A currency futures contract is an agreement between two parties – a buyer and a seller – to buy or sell a

particular currency at a future date, at a particular exchange rate that is fixed or agreed upon today. This sounds like the forward contract. In fact the futures contract is similar to the forward contract but is much more liquid.

Hedging using Options , an option may be defined as a contract between two parties – a buyer and a seller , where the buyer of the option has the right but not the obligation to buy or sell a specified currency at a specific rate , at or before the a specific date , from the seller of the option. The buyer of the option enjoys the right but not the obligation, the seller of the option has an obligation in the event of the buyer exercises the right. There are two types of options:

Call Option gives the buyer the right to buy a specified currency at a specified exchange rate, at or before a specified date.

Put Option gives the buyer the right to sell a specified currency at a specified exchange rate, at or before a specified date.

Currency Invoicing

- Transfers risk to the buyers; set contracts in the currency of the exporters.
- Set contracts in a currency that is perceived to be more stable.

In the long run, the exchange rate volatility can be adopted by pricing to the market, adopting globalised strategies, cross subsidize and specialized products.

Pricing to the Market:

- Competitive pressure in the specific market may limit pricing chances.
- Lower or raise the export price.

Adopt Globalised Strategies:

- Purchase inputs or gaining different strategies from foreign suppliers.
- Restructure production to lower the cost.

Cross Subsidize:

- Sell into various markets where changes tend to offset each other.

Specialized Products:

- Export of niche products with lower price elasticity of demand.

For an exporter, with a weaker demand from traditional markets in the West, but with rupee depreciation, the margins are further shrinking as the bill component for procuring raw material has become much higher for exporting finished goods. Rupee depreciation is affecting exports to a great extent not only due to weak external environment, but more because the exporters are depending upon foreign exchange rate for profits instead of focusing on their core competency and making manufacturing more competitive. Exporters practicing forward contracting or hedging will not benefit in the long term because foreign clients keep an eye on foreign exchange movement in real time and will soon force exporters to cut down their quotations. SME manufacturers are critically hit by poor infrastructure, huge input and logistics costs which make local manufacturing 25 to 30 per cent costlier than other emerging nations. Hence gaining stability in currency movement is the need of the hour so that the speculations on businesses will stop throwing more challenges to SME friendly business environment.

IMPACTS OF RUPEE DEPRECIATION on SME Sector

Exchange rate risk is simply the risk to which businesses and investors are exposed to because changes in exchange rates may have an adverse effect on them. An exporter is likely to find its sales falling or its gross margin shrinking, or both when an appreciation occurs in its domestic currency. Therefore, fluctuation in exchange rate can impact a business, especially SMEs to a significant extent

Fluctuations in exchange rates affect different stakeholders differently. In general, when the domestic currency

appreciates, importers benefit and exporters are adversely impacted and vice versa. However, the impact varies from sector to sector. Furthermore, the ability of different sectors to withstand is different. As the IT sector has higher margin than the handicraft sector, an IT company has a greater capacity to withstand the adverse impact of the appreciation of the rupee

Increase in Import Bill:→ A depreciation of the domestic currency results in higher import costs for the country. Failure of a similar rise being experienced in the prices of exportable commodities is going to result in a widening of current account deficit (CAD) of the country.

Higher Inflation→ A weak rupee will increase the burden of Oil Marketing Companies (OMCs) and this will surely be passed on to the consumers as the companies are allowed to do so following deregulation of petrol and partial deregulation of diesel. If the OMCs increase fuel prices, there will be a substantial increase in overall cost of transportation which will stoke up inflation.

Direct Impact on Consumers→

- a. Gold has become more expensive and hit an all-time high first three quarters of 2013
- b. Travel expenses rise as crude oil gets costlier
- c. Foreign Travel and Overseas Education becomes costlier: Students who are studying abroad will bear the brunt most owing to depreciating rupee. Expenses incurred towards the university/college fee as well as that of living will shoot up, thereby spelling a huge burden on the students.
- d. Inflation leading to price rise in essential goods.

RBI's monetary policy:→ If the depreciation in rupee continues, it will further increase inflation. In such a situation RBI will have very less room to cut policy rates. No cut in policy rate will add to the borrower's woes who are eagerly waiting to get rid of the high loan regime. If RBI cuts rates further, the interest rate arbitrage (between Indian government bonds and US Treasury yields) becomes less attractive, thus compromising the possibility of further capital flows.

Current Account Deficit→

- a) Exporters refrain from repatriating export proceeds because they knew that the dollar would earn more rupees if they wait a little longer
- b) Those holding stashed funds abroad continue to hold them in perpetuity. They watch the situation in silent appreciation, as they witness the rupee sinking to new depths effortlessly
- c) Repatriable yield in dollar terms of foreign investors (foreign direct investments as well as portfolio investments) diminishes, thereby dampening the investment climate in India
- d) Foreign currency non-resident (FCNR) deposits become less attractive for banks since the swap cost of funds soars due to a higher forward premium of the dollar.
- e) NRIs tend to avoid non-resident external (NRE) repatriable rupee deposits since repatriable yield in dollar terms diminishes

Capital Account deficit – Lower FII Investments and Lower FDI→ The rupee's weakness may make foreign investors think twice before investing. Foreign capital inflows are typically at risk when the local currency weakens. Portfolio flows into both debt and equity will taper, with investors subscribing to the view that the local currency could depreciate further. This shoots up the Capital Account Deficits.

Higher burden of Debt for Companies and Government:→ The interest burden would increase on foreign currency denominated debt. For companies that have availed of foreign currency loans for implementation of projects, the rupee depreciation will stretch their balance sheets, as the amount of debt will increase in rupee terms. As these loans mature, the cash flows will also be impacted. According to government statistics, out of India's \$376 billion outstanding external debt, about 23% or \$85.3 billion comprises external commercial borrowings, or ECBs. Similar behavior can be observed in case of Government for repaying and servicing foreign debt.

Slowdown of growth and Unemployment→ Falling rupee is a recipe for slowdown in economic growth. If the fall of rupee continues, the foreign investment will dry in India thereby creating a gap between investment

required for growth and the actual investment made. Although this does not impact immediately, over the period, unemployment rises in the economy.

Volatile domestic equity market:→ Our equity market has been volatile for some time now. Equity is nothing but the investments in Indian companies made by Foreign Institutional Investors (FIIs). Some examples of Private equities investing in India are Blackstone, IFC, Berkshire Hathaway etc. So, the FII's are in a dilemma whether to invest in India or not because of the lack of overall confidence in the Indian economy. Even though they have brought in record inflows of dollar to the country this year, chances are they may be thinking of taking their money out of the equity market, which might again results in less inflow of dollars in India. Therefore, decrease in supply and increase in demand of dollars results in the weakening of the rupee against the dollar.

Exporters→ Importers will strongly feel the pinch of falling rupee as they will be forced to pay more rupees on importing products. Conversely, a feeble rupee will bring delight to the exporters as goods exported abroad will fetch dollars which in return will translate into more rupees. Also, a weak rupee will make Indian produce more competitive in global markets which will be fruitful for India's exports.

Overseas Indians:→ Money saved is money earned. Depreciation of rupee is certainly a good news for the overseas Indians. Those working abroad can gain more on remitting money to their homeland.

IMPACTS ON FEW SECTORS

Real Estate→ The rupee depreciation provides a psychological boost to both NRIs and developers who like to invest in India. This is because they find it cheaper to invest in real estate in India as they will have more money to invest in the local markets as inquiries go up and developers concentrate their marketing efforts to attract more NRIs.

A typical purchase transaction for an NRI buyer will take a period of up to 3 months. During this period, the rupee may strengthen and the notional advantages that could accrue due to the rupee's depreciation could be lost. This could get further compounded, if the purchase is not outright and the NRI buyer needs to either pay in installments or he is booking an under construction property as again there is no guarantee that he will continue to enjoy the benefits of a depreciated rupee during the payment lifecycle.

In the short term, the depreciation of the rupee may mainly benefit those buyers who are already in the process of finalizing an existing transaction where they have still not converted their foreign exchange in to rupees to pay for their purchase. However, if the rupee maintains its current levels, developers could see more interest from NRI buyers as long as the capital value levels are also maintained and do not see a big hike during the period. At current rupee levels and sluggish market conditions in many markets that are expected to remain for the next few months, NRIs could possibly benefit substantially from some attractive options available in the markets.

IT Industry→

It will be positive for the IT industry in the short-term, as the foreign investments in the industry will increase and making them more cost-competitive. In the long run depreciation in currency fuels inflation, affects market sentiments and it will affect signing of new contracts by domestic IT firms

Companies face more problem when they bid for next project, they find it hard to predict what the currency rate is going to be. At this time they will be confused whether shall I do it at Rs. 60, Rs. 65 or Rs. 70 to the US dollar. So, the problem is if I don't see stability, on what basis do I price? What do I tell my customer, what is the rate? Adding to this the rupee has been declining nearly every year, like it has declined nearly 25 per cent from Rs. 54.28 against dollar on April 1, 2013, to Rs. 68.85.

This has been a real problem as companies don't know where to hedge, and even customers don't know where to hedge. If we see three months down the line, the decline in rupee will translate into some gains in terms of top line of the companies. However, as most companies have a hedging policy the positive impact will be slight.

Tourism→

The fall of the Indian rupee in comparison to the US dollar has adversely affected the tourist outflow to foreign countries, especially Europe, America and South Asian countries. With cheap air fare rates and lucrative tour packages, there was a big surge in the number of tourists visiting abroad earlier. But now with the rupee depreciating steeply against the dollar, as low as Rs 68 the scenario has changed almost overnight.

People have started to look for shorter trips and destinations within India. Various Indian destinations, which are the favorites of foreigners like Kashmir, Ladakh, Darjeeling, Andamans, Kerala, Goa, and Rajasthan, have reemerged as top draws for tourists. The rupee depreciation has its positive side too. The inflow of foreign tourists increases as India will become a much cheaper destination for tourists originating from the US and Europe. So rupee depreciation has both positive and negative impacts.

Pharmaceutical Sector—

The size of the Indian pharmaceutical industry is \$20 billion with exports accounting for \$9 billion. Indian pharma companies are likely to benefit from rupee depreciation. However, we analyze various factors associated with the rupee vulnerability and its impact on the companies.

Key Factors:

Level of raw material / capital goods input

Level of exports

Level of foreign currency debt

If exports \geq import + debt payment = positive/ no impact

If exports < import + debt repayment = negative

Level of raw material/ capital goods input: Companies which import substantial inputs will have to sacrifice margins Ex: Aurobindo, Cipla.

Level of exports: Export oriented companies may witness a higher value turnover. Rupee's decline increases price competitiveness of Indian products in overseas markets, which may aid the volume led growth Ex: Sun Pharma, Divi's Labs, Dr Reddy's Labs, Glenmark, Lupin.

Level of foreign currency debt: Companies which have un-hedged borrowings may face the heat. Also, ones which have high US\$ denominated loans may find it expensive to service their loan commitments Ex: Ranbaxy, Aurobindo, Glenmark.

Other Factors: While domestic business oriented companies may remain largely unperturbed by the declining rupee, yet they too may find the inflationary impact in their business. Also, companies using domestic input and exporting most of output will gain the most from rupee depreciation. If rupee sustains at current level, the loans to be repaid in FY2014E would cost higher. Aurobindo, Glenmark and Dishman who intend to reduce their loan books this year are likely to get impacted the most.

1. Impact on exporters: Currency fluctuation impact exporters significantly. Currency appreciation adversely impact exporters while currency depreciation benefits exporters.

2. Impact on importer: Currency appreciation or depreciation impacts importers as well. Currency appreciation impacts the importers favourably as it reduces the cost of imported goods.

3. Impact on borrowers: Increasingly, Indian firms are availing of loans in foreign currencies as these loans are cheaper than Rupee loans. However, when taking a foreign currency loan, there is a risk related to exchange rate fluctuations.

How market forces affect exchange rate movements

Similar to any other goods or services, the exchange rates are also driven by the demand-supply principle i.e. if the demand of any good is more than its supply, the price would increase and vice versa. The USD/INR exchange rate is nothing but the price of dollars in terms of INR. If the demand for INR increases vis-a-vis its supply, the exchange rate will move up. If the supply of INR increases vis-a-vis its demand, the exchange rate will go down

Some of the important factors affecting the demand and supply of any currency are-

1. Interest rate parity: If capital is allowed to flow freely, exchange rate becomes stable at a point where equality of real interest rate is established. The real interest rate is the nominal interest rate adjusted for the prevailing inflation rate in the country.

2. Law of one price: In an ideal situation, the same goods should sell at the same price anywhere in the world (net of costs arising out of barriers of free trade). This implies that either the price of goods or the exchange rate should adjust so that one price remains the same everywhere.

3. Macro-economic environment: A positive macro-economic environment like government policies, competitive advantages, etc. increases the demand for a currency. Economic data such as Consumer Price Indices (CPI), Producer Price Indices (PPI), Gross Domestic Product (GDP), international trade, productivity, and industrial production also affect fluctuations in currency exchange rates.

4. Stock market: The major stock indices also have a correlation with the currency rates. The demand for the equity of a country gives rise to the demand for the currency of that country.

5. Political factors: All exchange rates are susceptible to political instability and anticipations about the new government.

As exchange rate fluctuations can adversely impact SMEs, each and every SME should determine how much exposure it has to foreign currency risk. If the risk is significant then it should hedge to the extent required. SMEs should always keep in mind that while it is very difficult to predict exchange rate movements, it is comparatively easier to prepare for adverse fluctuations. Prevention is the best way for SMEs to keep themselves protected from the adverse effects exchange rate fluctuations.