A stronger rupee makes sense now

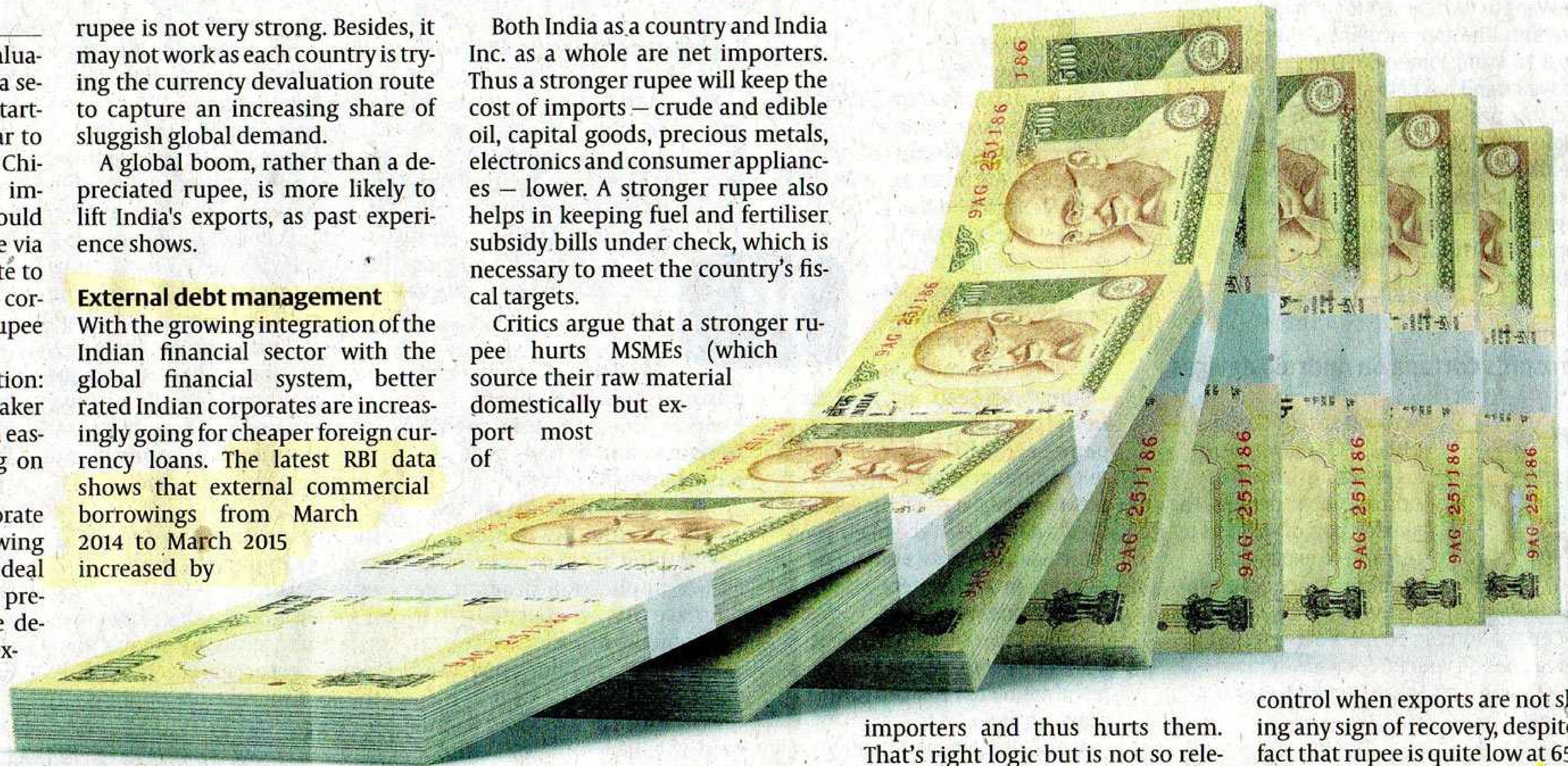
A weak currency in a context of competitive devaluation will ramp up import costs, debt and inflation without helping exports

RITESH KUMAR SINGH

The recent yuan devaluations have generated a series of controversies starting from currency war to growing divergence between Chinese and US economies to its impact on the Indian rupee. Should the RBI let the rupee depreciate via rate cut or raise the interest rate to defend it? What will happen to corporate profitability if the rupee fluctuates?

That leaves us with the question: what is better for India — a weaker or stronger rupee? And one can easily get several experts arguing on both sides.

We have an anxious corporate sector already troubled by slowing demand. And now it also has to deal with a volatile rupee. Let me present the corporate side of the debate. A look at how the rupee exchange rate is going to impact the four key items — exports, external debt, imports and inflation management.



WAEL KHALIL ALFUZAI/SHUTTERSTOCK.COM

Impact on exports

Over the years, India's export basket has undergone serious transformation. The country now exports more of income elastic goods (chemicals, engineering goods and refined petroleum products) and less of traditional price elastic goods (textile, apparel and leather).

Thus, a much higher depreciation of rupee would be needed to boost India's exports when global growth prospects are bleak.

Besides, services are more important in India's overall exports. These depend more on growth prospects in the developed markets than rupee exchange rate, though a weaker rupee does help India's IT services providers in offering lower prices to their clients. So, the case for promoting exports through a weaker rupee is not very strong. Besides, it may not work as each country is trying the currency devaluation route to capture an increasing share of sluggish global demand.

A global boom, rather than a depreciated rupee, is more likely to lift India's exports, as past experience shows.

External debt management

With the growing integration of the Indian financial sector with the global financial system, better rated Indian corporates are increasingly going for cheaper foreign currency loans. The latest RBI data shows that external commercial borrowings from March 2014 to March 2015 increased by 32 per cent to $181.9 billion. This is 38 per cent of India's total outstanding external debt. The hedging ratio (as per RBI) was 41 per cent. Thus, more than half the forex exposure of Indian companies remains open, and that increases currency risk.

Most of the sales, however, are contracted in rupee terms. A weakening rupee increases the rupee cost of their overseas commercial liabilities.

That, in combination with slowing demand, affects corporates' profitability and, in turn, their ability for future capital expansion and job creation.

To cut a long story short, a stronger rupee helps corporates with unhedged forex loans. Hedging costs could erode any benefit of taking loans in forex currencies.

Both India as a country and India Inc. as a whole are net importers. Thus a stronger rupee will keep the cost of imports — crude and edible oil, capital goods, precious metals, electronics and consumer appliances — lower. A stronger rupee also helps in keeping fuel and fertiliser subsidy bills under check, which is necessary to meet the country's fiscal targets.

Critics argue that a stronger rupee hurts MSMEs (which source their raw material domestically but export most of their finished products overseas), and that such an approach is nothing but anti-poor. Really?

With import duties being no longer as high as they used to be in pre-reform era and trade logistics costs falling each passing day owing to slowing global trade, import parity pricing of inputs is the prevalent norm.

Thus, whether you use imported inputs or not, your input cost will be determined by the would-be cost of their imported substitutes. A stronger rupee helps in minimising the cost of production of any manufacturer — small or big.

If you import your inputs and export your finished products, you are naturally hedged, irrespective of the rupee exchange rate.

One can still argue that stronger rupee makes exports expensive to importers and thus hurts them. That's right logic but is not so relevant because our export basket is now more income elastic than price elastic. What if you source your raw material domestically and sell your produce in the domestic market. Even so, a stronger rupee will ensure that your raw material cost does not go haywire, though you may have to compete with relatively cheaper imported goods.

Inflation management

Inflation is no doubt more anti-poor than it is anti-rich. A stronger rupee, by making imported goods cheaper, keeps a tab on the activities of hoarders and black marketers of essential items.

The RBI should use interest rate to defend the rupee, especially when US Fed rate hike is imminent. A stronger rupee will at least help India in keeping import bills under control when exports are not showing any sign of recovery, despite the fact that rupee is quite low at 65 to a dollar. That may be partly because of competitive devaluation of the currencies of India's export competitors. A stronger rupee will affect exports negatively for sure, though not as much as we think.

India's exports suffer from several non-currency internal and external factors that need to be tackled on an urgent basis, such as a poor trade facilitation regime and increasing trade barriers erected by importing countries.

The latest example is EU banning sale of 700 generic medicines tested by GVK Bioscience. Problems like this can't be tackled by exchange rate management.

The writer is a former government official and currently a corporate economic advisor based in Mumbai. The views are personal