



THE UNMIGHTY RUPEE

Importers and exporters feel victimised by vacillating exchange rates but a host of risk preventative and mitigatory measures are available at hand to mollify exchange rate risk

By **Saurabh Sharma**

India is among one of the prominent importers and exporters of the world. But when it comes to electronics, India depends heavily on imports. This engagement in imports has exposed Indian businessmen to a hazard known as the exchange rate risk, which sometimes acts in favour of the importer, while other times can lead to financial havoc. Last year, due to recession and some other factor, Indian rupee (INR) depreciated greatly, impacting Indian importers immensely as it has led to an increase in the cost of product acquisition.

Impact of rupee depreciation

Shreeji Semiconductors imports its products from various nations and,

hence, is extremely vulnerable to an exchange rate jeopardy. “Unstable exchange rates effect our business tremendously as it is not possible to change the prices of products as soon as the exchange rates change,” says Kishor Vithlani, director, Shreeji.

“Recession and depreciation of rupee have collectively affected our business adversely. The demand for products is meagre while their prices have increased, which is diminishing the demand even further. Our business has gone down by 40 to 50 per cent,” Vithlani shares.

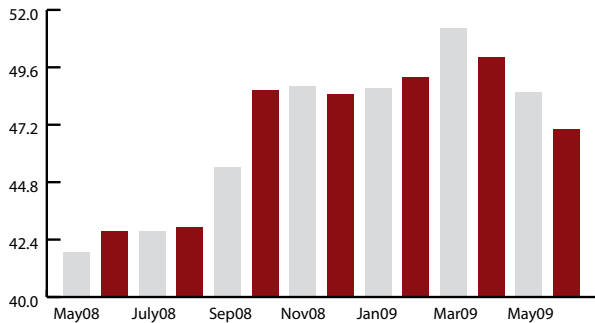
Another exchange rate related problem that concerns the players is that buyers expect sellers to reduce the price of products as soon as the rupee

appreciates and conveniently decrease their buying volumes when it falls.

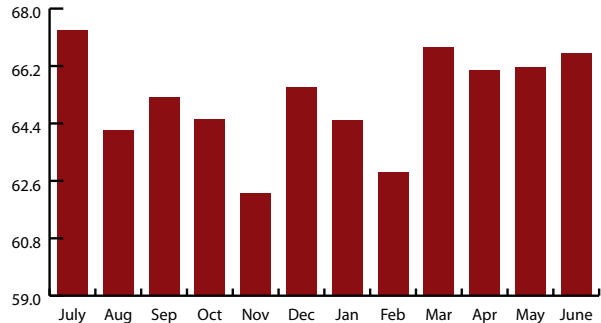
Whether to stock products or not is also a tricky dilemma because when the exchange rate wavers, it could lead to heavy risks. “If we buy products in large quantities and the rupee appreciates, then it is an enormous loss for us. On the other hand, if we don’t stock and then the rupee depreciates, then, too, we end up facing losses,” remarks Vithlani.

“Most importers are making losses due to this problem and are unaware that there are financial tools which can be used to avoid this impediment. A number of banks and government organisations help companies that are extensively involved in importing ac-

Pattern of Indian rupee in comparison with USD



Euro fluctuating lesser than USD



tivities,” comments the head of SME risk of a financial institution.

Export contracts with foreign companies are consummated in foreign currency or in INR. When the contract transactions are to be made in rupees, the required documents are also prepared in accordance with the Indian currency and no conversions are involved. However, when contracts are drawn in foreign currency, the businessman receives his payment in rupees only after conversion from foreign to Indian currency has taken place, at the current exchange rate. This makes exchange rate a crucial determinant in calculating the payable amount of INR.

A favourable exchange rate could fetch one more rupees and vice versa. It, therefore, becomes vital for the players to acquire some basic knowledge about exchange rates, factors determining exchange rates in the market and the precautions one can take to avoid potential losses caused by sporadic movement in the same.

Often, businesses come up with non-financial techniques to combat exchange rate risk. Ajay Gupta, Advance Tec Services Pvt Ltd, an importer of soldering and desoldering equipment, reveals, “We order in bulk so that we can negotiate the prices of the products. This tactic helps us to bring the cost down to some extent.”

Types of Exchange Rates

Two ways to quote exchange rates

Direct quotation and indirect quotation

TT selling rate: This rate is applied to all clean remittances outside India. Banks sell foreign currency to customers for issuance of bank drafts, mail/telegraphic transfers, etc.

Rate: This rate is applicable to all foreign remittances outside India as proceeds of import bills payable in India.

TT buying rate: This rate is applicable to the purchase of foreign currency from banks when the cover has already been obtained by banks in India. Thus, all foreign inward remittances, which are made payable in India are converted by applying this rate.

Bills rate: This rate is applied to the purchase of sight export bills, which will result in foreign remittance to India after realisation. Furthermore, interest is also sought by the bank for the period for which it was out of funds.

Factors determining exchange rate

The exchange rate works on the principal of demand and supply. If the demand of the INR rises in comparison with its supply, then the exchange rate will ascend and if the demand of the INR deflates, then it will move down.

Factors that determine the demand and supply of the INR

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

Law of one price: Ideally, the same goods should be sold at one price around the world. This implies that either the price of goods or the exchange rate should be aligned in order to achieve price parity across the world.

Macroeconomic factors: A positive macroeconomic environment like government policies increase the demand of a currency. The stable government scenario in India recently caused the strengthening of the rupee. Other data, like consumer price index, wholesale price index, gross domestic product, international trade, productivity and industrial production also contribute to the determination of the exchange rate.

Stock market: Major stock markets also influence the exchange rate. The equity demand of a country gives rise to its currency demand.

Tools to assuage exchange rate risk

It is very crucial for an enterprise to assess its foreign exchange risk and decide upon its risk mitigation

strategy. It should determine to what extent it wants to reduce or eliminate risk and then select an adequate risk reduction tool. A firm should be aware of the percentage of receivables and payables in foreign currency.

There are various methods and tools that one can employ to allay exchange rate risk but a company must first ascertain and identify the best tool for itself.

Selective hedging: The company hedges only a part of its foreign exchange risk. This method is best for companies which have a short term exposure to risk.

Systematic hedging: The company hedges only when it enters into a commitment involving currency exchange.

Risk mitigating tools

Currency diversification: Which currencies one is exposed to, other than the dollar, also establishes what kind

of risk he stands to face, as fluctuation rates differ from currency to currency. A firm can quell risks by diversifying its currency base. It can limit its dependence on the USD by accepting orders from countries with other currencies, such as, euro, pound, yen, sterling, etc.

Forward contracts: This contract facilitates the exchange of the given currency at a particular amount, at a stipulated rate, on a particular date. This is the best option when rupee depreciation is anticipated but not if the rupee is expected to inflate.

Swaps: In swaps, a party agrees to pay in currency other than the currency of the cash flow. This is a good option when a firm has receivables and payables in the same currency.

Call and put options: In this option, the company has to a pay premium just like one has to pay in in-

surance. In the “call option”, the company acquires the right to purchase the currencies at a predetermined rate and date but is not under any obligation of definite purchase. With the help of this option, importers can fix a particular price for themselves and shield themselves from the perils of exchange rate risk.

In the ‘put option’, an enterprise is authorised to sell the currencies at a predetermined rate and date without any obligation of definite sale.

This is a relatively complex but useful tool. Not only does it save one from the potential pitfalls of exchange rate fluctuations but also one stands to gain from it if the rupee moves in a positive direction. It is unlike other risk alleviating tools, which only protect from adverse rate movements but cannot generate benefits, should the rupee grow robust. eb