Impact of Financial Crisis on Financing Exports and Imports in India

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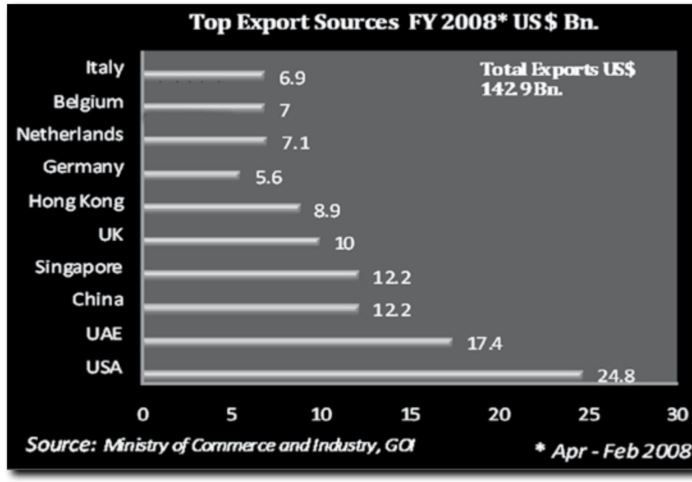
Financial crisis

The global financial crisis started showing its effects from mid 2008. The indicators for the downturn in the economies include high oil prices which led to soaring food prices and global inflation. The economic failure of large investment banks as well as commercial banks in nations around the world in the mid 2008 added fuel to the global economic downturn.

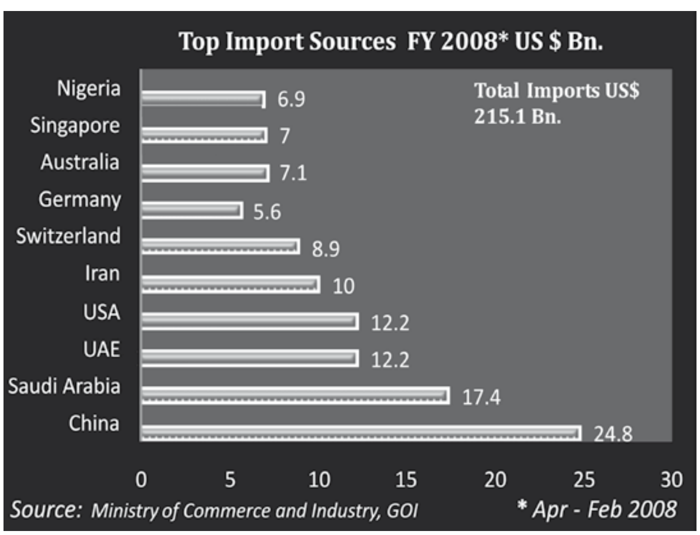
Around the world, stock markets have fallen significantly, large financial institutions have collapsed or been bought out, and governments in even the wealthiest nations have come up with rescue packages to bail out their respective financial systems.

Many industrialized nations like US, UK, Germany have slid into recession. The World economy is in turmoil and its cascading impact is being witnessed by all countries around the globe with varying degree. IMF world economic outlook for 2009 pegs negative growth in the US, Japan and the EU. Only emerging economies like India and China will have a positive growth.



Impact on India's trading Partners

The trading partners of India are badly hit by the global crisis which indirectly has negative impact on Indian business.



The US has officially entered into recession and growth is projected to be negative in 2009 as against 1.6% in 2008, similar is the case with Europe and Japan. This leaves the biggest challenge for Indian exporters. These three blocks (viz. US, Japan and Europe) account for about 40% of our exports and thus the slow down does not auger well for Indian exporters.

Importers on the other hand have to deal with a volatile and depreciating Rupee over and above lower country ratings leading to increasing costs of imports.

Impact on India

After a spell of sustained and enormous growth, the Indian economy is experiencing a downturn. Industrial growth is faltering, inflation remains close to double-digit levels, the current account deficit is widening, foreign exchange reserves are depleting and the rupee is depreciating.

The ongoing slowdown in US economy is likely to affect the future growth in India's exports. The financial turmoil and recessionary tendencies in major economies have already impacted India's export growth, which slowed to 10.4 per cent in September 2008 as compared to 20% in March 2007. The liquidity crunch is likely to lead to lesser employment generation, job cuts as well as stagnation in salaries. This would result in low demand for handicrafts, some segments of textiles, leather products and footwear. Also, the BPOs, and other software exports contributing to about 2 per cent of India's GDP are likely to be adversely affected.

The economic recession may not hit India as hard as other countries in Europe and North America; nevertheless growth is projected to drop significantly to 6.5% in 2009.

India's Exports

Indian exports is witnessing a shortfall of about 20% against their target of US$ 200 billion for 2008-09 as prevailing domestic economic conditions have caused severe dampening effects on potential exports segments of Indian economy. Job oriented export sector have shown up to 70% negative growth and there is a sharp decline in tea (-20%), handicrafts (-70%), carpets (-32%), oil meals (50%), man-made yarn (-17%), cotton yarn (-19%) and marine products (-19%).

Given that the US economy is expected to continue to weaken over the next couple of quarters at least, this does not bode well for the immediate future as far as exporters are concerned.

India's Imports

Imports rose 43.3% in September to $24.38 billion, mainly on account of rise in oil prices as well as weakening of the INR against the USD by about 25 % over the past 5 months. Oil accounts for more than a third of the country's total imports. Consequently, the trade deficit, which was at $ 10.6 billion in September, was more than double of that a year ago, is unlikely to widen significantly even if export growth is sluggish. Oil import bill went up by 57.1% to $9.09 billion in September, against $5.7 billion in the same month last year.

Impact on financing Export and Import in India – post Crisis :

Change in Prime Lending rate :

The average Prime Lending Rates (PLR) has been on the rise and between June and August 2008, it had increased by at least 200 basis points increasing the cost of credit for the SME export sector. Since export credit is linked to PLR, the increase in PLR had pushed export credit interest rates higher and most of exporters are getting credit at around 12% as against 5% at which it is available to most of our South East Asian competitors. The withdrawal of subsidy schemes has pushed the cost of credit by about 5% which needs to be addressed quickly.

Since September 2008, the Reserve bank of India has reduced CRR/Repo rates by about 200 bps. This measure is in conformity with those taken by Central Banks around the globe. Apart from infusing much needed liquidity in the financial system, these measures help restore calm in the markets and aid in bringing down the interest rates over the medium term. Some of the nationalized banks have already started cutting interest rates and the others are likely to follow suit.

Depreciating Rupee :

The Indian rupee has depreciated by about 20 per cent since April and breached the mark of Rs 50 recently. Depreciating rupee has made import of capital goods and raw materials more expensive. As inputs and other equipment that are imported are getting costlier, margins get reduced to that extent. As a result, companies with high import component and those with foreign currency borrowings are marked down in the stock market as the rupee depreciates.

Significant levels of foreign currency-denominated, especially dollar-denominated loans have resulted in forex losses for companies with dollar loans, because of increased interest payout and principal obligations caused by the weakening rupee.

With dollar liquidity shrinking, dollar denominated export credit is virtually unavailable to SME exporters as banks have limited supply of dollars and prefer to give it to larger Corporates. RBI norms require banks to give preference to exporter's foreign currency loan at LIBOR+100 basis points.

Line of Credit :

Banks specially the foreign banks have become more risk averse than the Indian banks. Many of the credit decisions relating to export/import are taken by their controllers, who attach a great deal of risk premium to Indian business. Some of the tightening seen in the export/import financing done by foreign banks in India is as follows :

- Export financing is done against firm orders or Letters of Credit. Once a particular export bill gets realized, banks are reluctant to disburse again. In addition, some foreign banks are reducing the sanctioned limits if utilization levels of sanctioned facilities have not been up to the mark.
- In stead of turning away business outright, the foreign banks are quoting interest rates that are a big dampener to clients.

As compared to the above, the nationalized banks are seeing business as usual. Having said that a few covenants that they have introduced to exporters are as follows:

- Encourage business with established long term clients only, i.e. new clients are being discouraged.
- Exercise more caution in financing related to iron and steel
- Avoid exports to China in view of the fact that Chinese banks have been found to reject shipping documents of Indian exporters on rather flimsy grounds.
- Due to the bankruptcy of U.S. banks like WAMU (Washington Mutual), export proceeds have remained stuck. As an offsetting measure, Indian nationalized banks are encouraging exporters to take more export insurance from entities such as ECGC.
- Hedge exports.

Likewise, the Indian banks have also introduced certain caveats for importers. Some of them are as follows :

- Hedge all imports on the back of massive volatility in currency markets.
- For petrochemical related imports, although the falling crude price is offsetting the weakening rupee, no speculation in currency markets is encouraged.

Margins on Bank Guarantee :

Increased margin money requirement for Bank Guarantees, in some cases as high as 100% as against 3 to 20% charged from established exporters is blocking the working capital requirement of exporters who are already squeezed for finance.

In order to cover part of their risk exposure many public sector Banks like SBI are tying up with Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) a subsidiary of SIDBI which levies a guarantee fee and annual service fee of 0.75% and 0.375% respectively which may also accrue to the SME borrower and raise the cost of credit.

Rediscounting Window :

Nationalized banks prefer to continue financing and resort to rediscounting of bills so as to get liquidity. Under the current market conditions the spread over LIBOR for rediscounting export bills has climbed from LIBOR plus 50 bps to LIBOR plus 200 bps.

Reassessing the credit worthiness of the importer :

The financial institutions are more alert on lending than ever before. The crises have left the importers with a substantial change in their credit worthiness emanating from a weaker rupee as well as a highly uncertain global market environment. Banks and other financial institutes will reassess the credit quality of their clients and would look to downsize the credit lines allocated earlier. Such downsizing of credit limits may not always be driven by reason since panic has gripped the markets, the importers may find it difficult to grow their business.

Guidance to Importers :

With ECBs having dried up financing for importing capital goods has to be met from domestic sources. While the nationalized banks are not imposing any strict guidelines on the already beleaguered importer, the foreign banks are reassessing the LC limits for both Usance and Sight LCs. This also emanates from the higher country risk associated with emerging market trade finance flows. A reduction in imports would adversely affect the growth levels in our economy. To mitigate this, most of the nationalized banks are going about doing business as is usual. The only covenant they have for their importer clients is that any speculative position building in the underlying imports and/or currency is to be strictly avoided.

Overcoming Financing Problems – A Few Suggestions :

i. The rate of export credit in Indian Rupee should be linked with Bank Rate instead of benchmark prime lending rate. Such export credit should be made available at bank rate + 100 basis points. Government subsidy as was the case in 70's – 90's.

ii. Pre-shipment and post-shipment credits in foreign currency should be made available to exporters at LIBOR + 100 basis points as stipulated by the Reserve Bank of India. RBI should also offer incentives to banks to provide such credits to exporters.

iii. Keeping in view financial crunch faced by overseas buyers demanding longer credit period, the post-shipment credit presently available only up to 90 days should be provided for tenure of 180 – 270 days.

iv. With increasing risk of default by buyers going up, banks will be more reluctant to sanction credits without adequate insurance cover. Regulatory authorities should incentivize Insurance companies to keep supporting exporters.

v. Export Credit Guarantee Corporations (ECGC) should adopt flexible single buyer policy and adopt case by case approach rather than taking a rigid stand not to give single buyer policy to exporters as the same will be detrimental to cause of diversification of exports in present scenario.

vi. Indian Banks should be encouraged to confirm Letter of Credit received from overseas banks and ECGC guarantee may provide necessary buffer in case of default which will be few and far between.

vii. Government should initiate to incentivize exporters to diversify their export to unexplored destination. The facility available under focus market may be increased nearly to 5% and new markets should be added to the list of focus countries.

Summary

The economic collapse across nations has invariably affected trade business in India. The steep rise in the cost of borrowing and a depreciating rupee has created a negative impact on business. Banks are more cautious than before towards providing credit to new customers. Many foreign banks in spite of having liquidity seem reluctant to provide credit whereas nationalized banks continue to provide credit only to their existing clients.

On the positive side, regulatory authorities are playing an active role to encourage exporters and importers to continue their business. The recent CRR cut enabled banks to provide better credit facilities. Also, extension in credit tenure from 90 day to 180 day pre shipment credit, revised ECGC policies and better provisions for insurance cover would calm the sentiments of exporters and importers. RBI has also announced that banks will soon receive an additional liquidity support of about Rs. 22000 crores as export limits under Export Credit Refinance (ECR) facility. This facility will cover extension of the tenure of the credit facility from 180 to 270 days. The specific manner through which this concessional facility is going to be made available to the exporters by the nationalized banks is yet to be seen but there is no doubt that these measures would help alleviate the current situation substantially.