Foreign Exchange Determination in India

February 2, 2021

The Reserve Bank of India has turned out to be the most active central bank among top emerging market countries this financial year, adding resilience to the rupee amid a virus-induced global economic crisis. RBI’s dollar stock swelled by about 20 percent to a record level during 2020, outpacing Indonesia, Malaysia, China, South Korea and South Africa, where local currencies performed better than the rupee again. The RBI is likely to spend at least $20 billion more to support the rupee and increase the forex kitty through the reminder of the financial year.

In news: Forex intervention by RBI to touch $93 billion by March: Report
Placing it in syllabus: Economy
Dimensions

- Foreign exchange Rate & Exchange Rate Regimes
- Liberalized Exchange Rate Management System (LERMS)
- Key features of RBI’s forex strategy
- Forex reserves in India

Content:

Foreign exchange Rate & Exchange Rate Regimes:

- **Foreign Exchange Rate** is a price of one country currency in relation to other country currency
- It is the amount of domestic currency that must be paid in order to get a unit of foreign currency.
- As per **Purchasing Power Parity theory**, the foreign exchange rate is determined by the relative purchasing

powers of the two currencies.

- An **exchange rate regime** is the system that a country's monetary authority, -generally the central bank-, adopts to establish the exchange rate of its own currency against other currencies.
- Each country is free to adopt the exchange-rate regime that it considers optimal, and will do so using mostly monetary and sometimes even fiscal policies.

Types of Exchange Rate Regimes are as follows:

1. Fixed Exchange Rate

- Under this system, the **government or central bank determines the official exchange rate** by linking the exchange rate to the price of gold or major currencies like the US dollar.
- The government also **intervenes if the exchange rate fluctuates** due to any reason and makes sure that equilibrium predetermined level is maintained.
- The only merit of a fixed exchange rate system is that it **assures the stability of exchange rate**. It prevents both currency appreciation and depreciation.
- However this systems has some glaring disadvantages
- For one, it puts a **heavy burden on governments to maintain exchange rates**. During the time of deficits, for example, the governments need to infuse a lot of money to maintain the exchange rate.
- The **foreign investors usually avoid investing** in such countries. They fear losing their investments because the exchange rate may not reflect the true value of the economy.

2. Floating Exchange Rate

- In such a system, the true value of the exchange rate is **determined freely by the market forces of demand and supply**.

- If due to any reason exchange rate fluctuates, the **government never intervenes** and allows the market to function
- This arrangement gives many advantages.
- It helps in **building trust among foreign investors** as the exchange rate usually **reflects the true value** of the domestic currency.
- In such cases a country can **easily access funds/ loans** from IMF and other international institutions.
- However, floating exchange rate systems **can be volatile.** The exchange rate fluctuates a lot on a day to day basis.

3. Managed Floating Exchange rate

- Manage Floating exchange rate is the middle ground between the two extremes of fixed and floating exchange rate.
- This system merges the best of both systems. Under normal circumstances, the exchange is allowed to move freely and determined by market forces (Demand and Supply).
- But when a difficult situation arises, the central banks of the country **can intervene to stabilise the exchange rate**.
- Currently, India follows this system for determining exchange rate of Indian rupee.

There are different sub-categories under managed floating exchange rate as follows:

Adjusted Peg System:

- In this system, a country tries to hold on to a fixed exchange rate system for as long as it can, i.e. until the country's foreign exchange reserves get exhausted.
- Once the country's foreign exchange reserves get exhausted, the country should undergo devaluation of

currency and move to another equilibrium exchange rate.

Crawling Peg System:

- Here, a country keeps on adjusting its exchange rate to new demand and supply conditions.
- Instead of devaluing currency at the time of crisis, a country will follow regular checks at the exchange rate and when required undertakes small devaluations.

Clean Floating:

- The exchange rate is determined by market forces of demand and supply.
- The exchange rate appreciates or depreciates as per market forces and with no government intervention.
- It is identical to a floating exchange rate system.

Dirty Floating:

- The exchange rate is to a very large extent determined by the market forces of demand and supply (so far identical to clean floating).
- But occasionally the central banks of the countries intervene in foreign exchange markets to smoothen or remove excessive fluctuations from the foreign exchange markets.

  Brief History of Exchange Rate Regimes in India India has evolved from a fixed exchange rate regime at the time of independence to the market determined exchange rate regime.

  Par Value System (1947-1971):

  - After independence India followed the '**Par Value System**'.
  - The rupee's external par value was fixed with gold and UK pound sterling.
  - This system was followed up to 1966 when the rupee was devalued by 36 percent.

Pegged Regime (1971-1992):

- **India pegged its currency to the US dollar** (1971-1991) and **to pound** (1971-75).
- After the breakdown of the **Bretton Woods system,** the value of the pound collapsed, and India witnessed misalignment of the rupee.
- To overcome the pressure of devaluation India pegged its currency to a basket of currencies.
- During this period, the **exchange rate was officially determined by the RBI within a nominal band of +/- 5 percent** of the weighted average of a basket of currencies of India's major trading partners.

The period since 1991:

- The transition to market-based exchange rate was in response to the **BOP crisis of 1991**.
- As a first step towards transition, India introduced partial convertibility of rupee in 1992-93 under **LERMS**.

Market-Based Exchange rate Regime (1993- till present):

- The **LERMS** was a **transitional mechanism to provide stability during the crisis period**.
- Once the stability is achieved, India transited from LERMS to a full flash market exchange rate system.

Liberalized Exchange Rate Management System (LERMS):

- LERMS was introduced from March 1, 1992 under which the **rupee** was **made partially convertible**.
- This **Dual Exchange Rate System** was introduced following the recommendations of the **High Level Committee on Balance of Payments** constituted under Chairmanship of Mr. **C. Rangarajan**.

- This system **combined official and market determined exchange rates.**
- The objective was to encourage exporters and induce a greater inflow of remittances through proper channels as well as bring about greater efficiency in import substitution.
- Under the system, **60% percent** of eligible foreign exchange receipts such as exports earnings or remittances was to be converted at the market rate and the **balance 40%** at the official rate of exchange.
- Importers could obtain their requirements of foreign exchange from authorized dealers at the market rate.
- Because of certain weaknesses, this system was replaced by **Unified Exchange Rate System,** in March 1993.
- This unification was recommended as an important step towards full current account convertibility by the committee on balance of payments under the chairmanship of C Rangarajan.
- Under the unified rate system all foreign exchange transactions through authorized dealers out at market determined rate exchange.
- The **RBI however, did not relinquish its right to intervene** in the market to enable orderly control.

Foreign Exchange Management Act (FEMA) 1999:

- The objective of FEMA is to **facilitate external trade and payments** and to **promote orderly development and maintenance of foreign exchange market** in India.
- FEMA, 1999 extends to the whole of India.
- It is also applicable to all branches, offices and agencies located outside India, which are owned and controlled by a person resident in India and

also to any contravention committed outside India by any person to whom this Act applies.

- **Contraventions of FEMA provisions are dealt with under civil law** for which separate administrative procedure and mechanism in the form of Compounding Rules, Adjudicating Authority are put in place.

Types of Transactions

- FEMA classifies all foreign exchange transactions into two broad categories viz. **Current Account and Capital Account Transactions.**
- A **"capital account transaction"** is a transaction which
    - Alters the assets and liabilities outside India of a person resident in India or
    - Alters the assets and liabilities in India of a person resident outside India.
    - Liabilities include contingent liabilities also.
    - Example – Foreign Direct investment, Foreign Portfolio Investment External Commercial Borrowings, Non-resident deposits, investment in immovable property, etc.

A **"current account transaction"** is a transaction other than a capital account transaction i.e. mostly of a revenue nature. Example – Exports, Imports, Personal remittances, Gift, Income etc.

Key features of RBI's forex strategy:

- **Reserve Bank of India Act** and the **Foreign Exchange Management Act, 1999** set the legal provisions for governing the foreign exchange reserves.
- RBI endeavours to ensure a sound regulatory framework for foreign exchange management in an economic environment wherein the rupee is fully convertible for current account flows and is partly convertible for the

capital flows.

- It **adopts an approach of gradual liberalization of capital account transactions**, with an aim to manage internal shocks such as inflation and to encourage investments in the real sector to augment growth.
- This, coupled with effective systems and procedures, reporting mechanisms, surveillance enhances the chances of the capital flows fostering sustainable economic growth free of sudden disruptions.
- This will also ensure a healthy integration of Indian economy with the world economy.

Currency Convertibility

- Currency convertibility refers to the **freedom to convert the domestic currency into other internationally accepted currencies** and vice versa.
- Convertibility in this sense is the **obverse of controls or restrictions on currency transactions**.
- **Current account convertibility** refers to freedom in respect of 'payments and transfers for current international transactions'
- **Capital account convertibility** would mean freedom of currency conversion in relation to capital transactions in terms of inflows and outflows.

Forex reserves in India:

- Reserve Bank of India accumulates foreign currency reserves by purchasing from authorized dealers in **open market operations**.
- Foreign exchange reserve forms the first line of defence to calm volatility in the forex markets and provide adequate liquidity for "sudden stop" or reversals in the capital flows.
- **Foreign exchange reserves** of India function as **a cushion against rupee volatility** once global interest rates

start rising.

- The RBI's **broad strategy for reserve management** including currency composition and investment policy is **decided in consultation with the Government of India**.
- The risk management functions are aimed at ensuring development of a sound governance structure in line with the best international practices, improved accountability, a culture of risk awareness across all operations, efficient allocation of resources and development of in-house skills and expertise.
- The risks attendant on deployment of reserves, viz., credit risk, market risk, liquidity risk and operational risk
- The Reserve Bank regularly publishes data relating to Foreign Exchange Reserves, its operations in foreign exchange market, position of the country's external assets and liabilities and earnings from deployment of Foreign Currency Assets and gold through periodic press releases

Foreign reserves in Sep 2020

- In 2020, reserves followed an increasing trend from **USD 477.81 billion** as at end-March 2020 to **USD 544.69 billion** as at end-September 2020.
- Although both US dollar and Euro are intervention currencies and the **Foreign Currency Assets (FCA)** are maintained in major currencies.
- The foreign exchange reserves are denominated and expressed in US dollar terms.

The Foreign exchange reserves of India consists of below four categories:

- Foreign Currency Assets
- Gold
- Special Drawing Rights (SDRs)
- Reserve Tranche Position

Within the overall framework of reserve management, the Reserve Bank focuses on:

- Maintaining market's confidence in monetary and exchange rate policies.
- Enhancing the Reserve Bank's intervention capacity to act in the event of undue volatility in the foreign exchange markets.
- Limiting external vulnerability by maintaining foreign currency liquidity to absorb shocks during times of crisis, including national disasters or emergencies.
- Providing confidence to foreign investors that all external obligations will be met, thus reducing the costs at which foreign exchange resources are available to market participants.
- Adding to the comfort of market participants by demonstrating the backing of domestic currency by external assets.

Mould your thought: How is foreign exchange rate determined in India? Also discuss the framework used by RBI for this purpose.*Approach to the answer:***

- Introduction
- Write about Managed float system in India
- Write about FEMA and its use by RBI to manage Foreign Exchange Reserves
- Conclusion