Magadh Mahila College

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M A Economics

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Topic: Foreign Exchange Policy

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INTRODUCTION

- Exchange Rate Policy has emerged as a key policy variable.
- With rapidly integrating global financial markets and increased capital mobility across the world exposure to exchange rate risks has also increased.
- Mexican crisis in 1992, east Asian meltdown in 1997,etc. shows how the economies are connected through globalization.

TYPES OF FOREIGN EXCHANGE POLICY

There exist two polar cases of exchange rate regime :

1. **<u>Fixed Exchange Rate Regime :-</u>**

- The fixed exchange rate regime provides credibility, transparency, very low inflation and financial stability. Countries with pegged exchange rate are generally small economies with dominant trading partner that maintains a reasonably stable monetary policy.

- Example of countries with fixed exchange rate are small Caribbean island economies, some controlled American countries, some Pacific islands peg to US dollars.

2. **<u>Fully Floating Exchange Rate Regime:-</u>**

- Another type of exchange rate is flexible exchange rate regime. There exist no government or central bank intervention.
- The country's currency's value is determined by the market forces of demand and supply.
- The chief merit of this system is the simplicity of its operative mechanism.
- Opening up of economy pressurize the developing economies to adopt the flexible regime, at the same time it carries risk of volatility.

3. **Between these two extremes there exist a exchange rate that combines the features of both the polar extremes, called <u>Intermediate exchange rate regime.</u>**

EXCHANGE RATE MANAGEMENT IN INDIA

- Over the last six decades, the exchange rate system in India has transited from fixed exchange rate to market determined rates.
- **<u>PAR VALUE SYSTEM (1947 -1971):</u>**

❑ India followed the par value system of the IMF whereby the rupees par value was fixed at 4.15 grams of fine gold to pound sterling in September 1949.

❑ This remained unchanged till 1966 when it was devalued by 36.5% .

❑ Again remained the same till 1971 when the Bretton Woods System collapsed.

- **<u>PEGGED REGIME (1971-1991):</u>**

- Following the breakdown, there was a downward pressure on pound sterling. Misalignment of rupees occurs and the importance of UK in India's trade had declined.
- To overcome the difficulties associated with single currency peg, from 1975, Indian currency pegged to basket of currencies of its major trading partners.
- Indonesia and China depreciated their currency to 65% and 68% respectively but India only by 53% against US dollars, India's export competitiveness suffered a setback. Leading to increase in import demands and export stagnation.

- **<u>THE PERIOD SINCE 1991</u>**:

- ❑ Two – Step downward adjustment of 18-19 % of exchange rate was made on July 1 and 3, 1991, for placing it with theline of inflation differential with major trading partners to maintain competitiveness of exports.
- ❑ It was felt that small and frequent changes in the exchange rate would signalled by market forces is better alternative to large and delayed corrections necessitated by a basket- pegged regime.
- ❑ **<u>The currency was made fully convertible in India in two steps:</u>**

1) **Partial Convertibility**
2) **Market Exchange Rate**

1) LIBERALISED EXCHANGE RATE MANAGEMENT:

The Finance Minister announced the LERMS in 1992-93 Budget and introduced the Partial exchange rate convertibility.

Dual exchange rate was fixed under which 40% of foreign exchange earnings were to be surrendered at official rate, the remaining 60% at market determined rate.

2) MARKET – DETERMINED EXCHANGE RATE REGIME:

LERMS was only transitional mechanism . Since 1993, the day –to-day movement in exchange rate have been largely market – determined.

Under Budget 1993-94, 100% conversion was allowed in;

all merchandise trade and all receipts.

IMPACT OF THE CONVERSION

1. **March 1993 – August 1995:** This period shows positive investors confidence. There were surge of capital flow sterilized through timely intervention by RBI. Export growth exerted upward pressure on exchange rate.
2. **September 1995 – December 1996:** Rupees came under pressure till 1996 due to sudden and sharp reversal of market sentiments.

3. **<u>The period 1997 – 2001:</u>** This period marked by a number of adverse internal as well as external developments. Internal developments like economic sanctions after the nuclear tests. External development included Asian financial crisis, Russian crisis, etc. Prudent response of RBI enabled the to stave off the contagion effect of East Asian financial crisis.

The foreign exchange market witnessed uncertainty again in 2000 reflecting hardening of international oil prices, interest rate increase, etc. Tight monetary policy measures adopted coupled with inflow of Indian Millennium Deposits (IMDs) which eased the market pressure.

4. **THE PERIOD 2002 ONWARDS:** From 2002, the Indian rupee started strengthening against the dollar. During 2008-09 , the Indian rupee generally depreciated reflecting depreciated reflecting large capital outflows by FIIs, increased demand for dollars.

The pressure on rupee continued in 2013-14, continuing concern relating to the elevated level of the CAD (current account deficit) and its financing coupled with weakness in FII inflows played a major role in the weakening of the rupee.

While generally a depreciating rupee made exports cheaper, the steep fall in value has caused widespread concerns because combination of shrinking global markets and rising import content of Indian exports, weakening rupee does not necessarily enhanced export as the imports are largely inelastic in India like energy requirements.