Changes in India's Exchange Rate Regime

Why in News?

Over the past few years, the Reserve Bank of India (RBI) has radically altered the nation's exchange rate policy, shifting from a relatively flexible regime to an inflexible one.

What is exchange rate?

- **Foreign Exchange Rate** - Forex Rate is the price of one currency in terms of another and it links the currencies of different countries to compare international costs and prices.
- **Determination of the Exchange Rate** - It can be determined through
  - Flexible Exchange Rate
  - Fixed Exchange Rate
  - Managed Floating Exchange Rate
- **Flexible Exchange Rate** - This exchange rate is determined by the market forces of demand and supply.
- **Benefits** - In a completely flexible system, the Central banks do not intervene in the foreign exchange market.

Depreciation is the increase in exchange rate meaning that the price of foreign currency (dollar) in terms of domestic currency (rupees) has increased.

Appreciation is the price of domestic currency (rupees) in terms of foreign currency (dollars) increases.

- **Fixed Exchange Rates** - In this exchange rate system, the Government fixes the exchange rate at a particular level.

Devaluation in a fixed exchange rate system is the increase in exchange rate to make the domestic currency cheaper and Revaluation is the decrease in exchange rate to make domestic currency costlier.

- **Managed Floating** - It is a mixture of a flexible exchange rate system (the float part) and a fixed rate system (the managed part).
- Under this system, also called dirty floating, central banks intervene to buy and sell foreign currencies in an attempt to moderate exchange rate movements.
- **Three-pronged strategy of RBI**

  - Allowing depreciation when capital outflows put downward pressures on the rupee.
  - Allowing appreciation when particularly rapid export and productivity growth created upwards pressure.
  - Building up reserves during episodes of strong capital inflows.

What are the recent changes in India's Exchange rate policy ?

- Reserve Bank of India (RBI) has been shifting from a relatively flexible regime to an inflexible one.
- **Depreciation Control -** After 2019, the RBI embarked on a policy of selling reserves during periods of downward pressure, to limit the depreciation of the rupee.

From February to October 2022, RBI sold $105 billion in reserves to prevent depreciation after the US Federal Reserve started to raise interest rates aggressively to fight inflation.

- **Impacts of the changes** - The shift has had important implications for the nation's competitiveness, its export performance, economic growth, and external resilience.
- Average level of the real exchange rate has been 10 % stronger since 2019 than it was during the 1994-2018 period.

The real exchange rate (RER) between two currencies is the product of the nominal exchange rate (the dollar cost of a euro, for example) and the ratio of prices between the two countries.

- **Loss of competitiveness** – The rigidness of depreciation affected the competitiveness of the relative price of indian goods and services at international markets.
- **Declined Export Growth** - Non-oil export growth has been quite subdued, averaging just 4½ % a year in dollar terms between 2018-19 and 2023-24.

Why exchange rate volatility is essential for economic flexibility?

- **Reduced stress on Forex Reserve** – The floating system gives the government more flexibility and they do not need to maintain large stocks of foreign exchange reserves.
- **Automatic BoP Management** - Movements in the exchange rate automatically take care of the surpluses and deficits in the BoP.
- **Responsiveness** - It allowed the exchange rate to respond to cyclical market forces and adjust for differences in inflation between India and its trading partners.

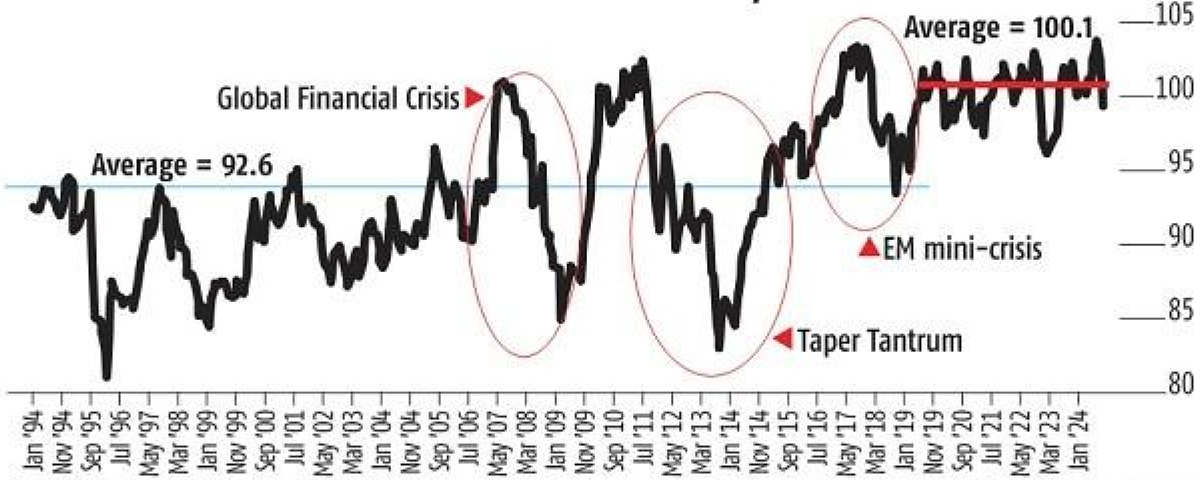
During the boom from 2002 to 2011, the rate appreciated by 16 % thereby dampening the excess demand and inflation that emerged during this period.

- **Maintain External Competitiveness** - From 1994 to 2019 the real effective exchange rate oscillated around a stable level , helping the country's export sector to thrive and compete in foreign markets.

- **Foreign exchange reserves buildup** - The strategy has allowed India to build up its foreign exchange reserves over the longer-term.

From June 2002 to September 2018, reserves swelled from $59 billion to over $400 billion as the RBI absorbed large capital inflows.

1. INDIA'S REAL EFFECTIVE EXCHANGE RATE, 1994-2024



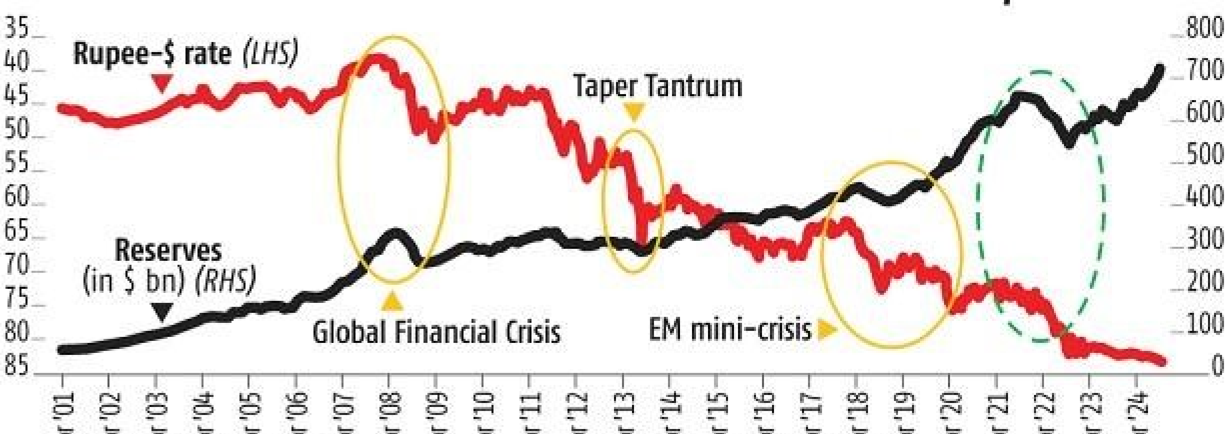
Note: A higher number denotes appreciation

Source: FRED, St. Louis Fed

- **Crisis Management** - During the Global Financial Crisis, the Taper Tantrum, and the EM panic, the RBI largely aimed to smooth the adjustment, rather than deplete its reserves trying to fight depreciation.

The taper tantrum refers to a period of market volatility in 2013 triggered by the US Federal Reserve's announcement to gradually reduce its bond-buying program.

2. RUPEE-DOLLAR RATE & FOREIGN EXCHANGE RESERVES, 2001-2024



Note: Reserves data are weekly and exchange rate data are daily. The X axis is inverted so that a decline is a depreciation of the rupee (a higher rate against the dollar).

Source: RBI

- **Financial Shock Absorber** - In good times, the rupee appreciates, which crimps the economy and vice versa to stabilise the macroeconomy.
- **Difficulties in Price Fixation** - Deciding the correct exchange rate is analytically and politically difficult.
- **Wastage of Public Money** - A fixed exchange rate acts like government subsidy mechanism for private persons in currency risk management at the cost of public money.
- **Moral Hazards** – Protecting private sector from currency risk makes them take on more currency risk and make the country's system vulnerable.
- **BCD Trinity** - Floating system is essential to build a sophisticated bond-currency-derivatives (BCD) nexus, with an inflation target.

What lies ahead?

- Ensure a balanced approach between floating system and the currency stability.
- Create a framework similar to inflation target framework based on volatility range to intervene with the exchange rate system.

References

1. Business Standard | India's exchange rate regime change
2. Business Standard | Essentiality of exchange rate volatility