

## 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 rigidity 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.*

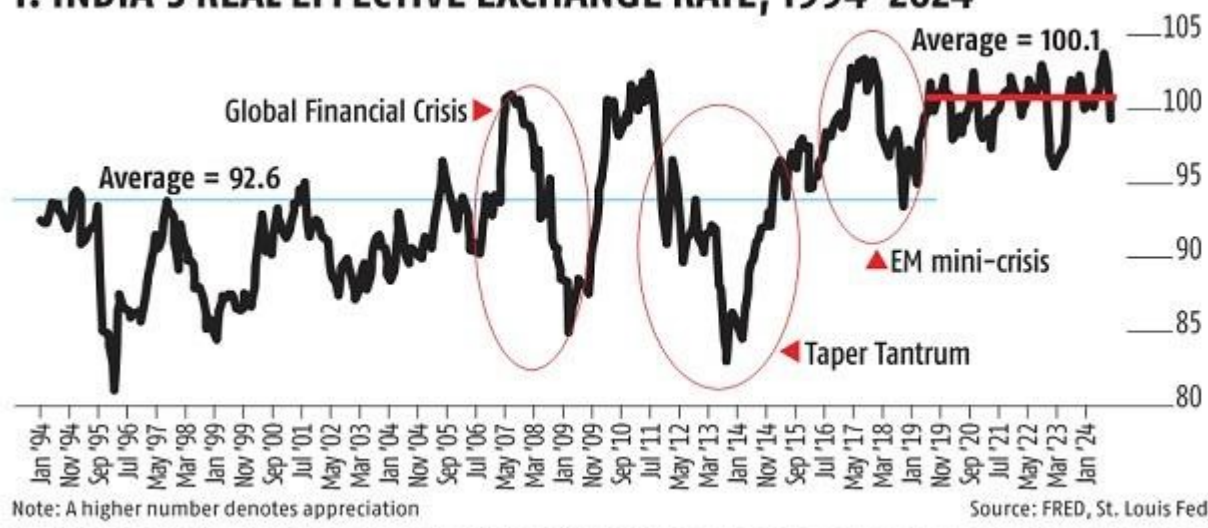
- **Maintain External Competitiveness** - From 1994 to 2019 the real effective

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.*

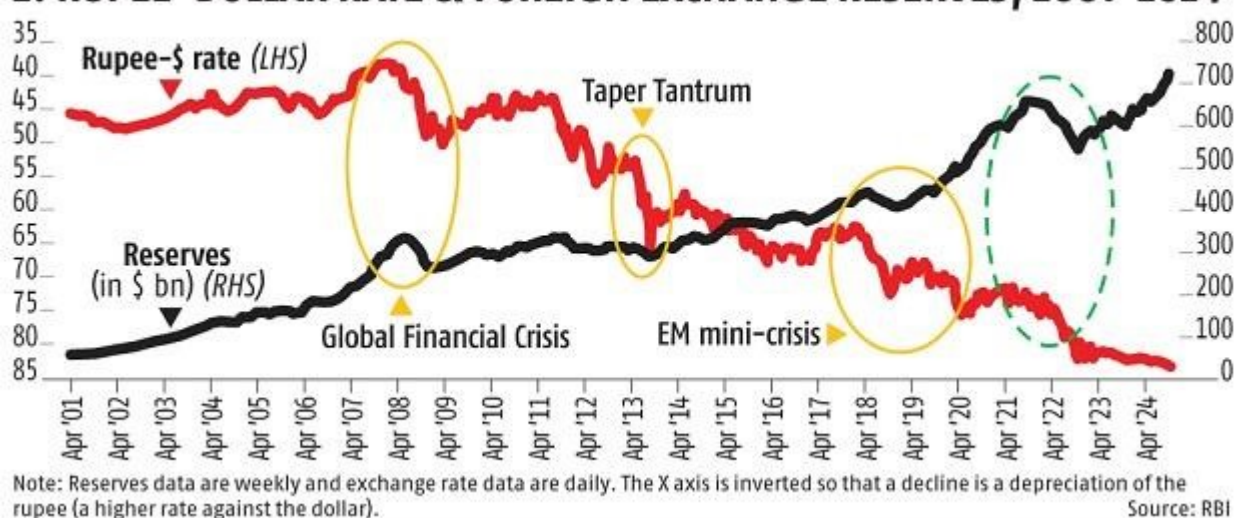
## 1. INDIA'S REAL EFFECTIVE EXCHANGE RATE, 1994-2024



- **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



- **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](#)

