EXCHANGE RATE REGIME AND CAPITAL FLOWS: THE INDIAN EXPERIENCE

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Introduction

- The magnitude and gyrations of capital flows becoming the primary determinant of exchange rate movements on a day-to-day basis for most EMEs rather than trade deficits and economic growth.
- The choice of shaping an appropriate exchange rate regime and the conduct of monetary policy, therefore, pose challenge to monetary authorities.

Outline of the Paper

- Section I: A brief discourse on the theoretical and empirical findings on the choice of exchange regime and the role of capital flows in this regard.
- Section II: Narrate the experience of India with respect to the management of exchange regime and capital flows and list out the lessons that have been learnt out of this experience
- Section III: List out some of the challenges that lie ahead in the conduct of exchange rate policies for the EMEs.

I. Theoretical Developments and Empirical Results

Key issues:

1. How does our perception of exchange rate regimes change with use of different classification types?
2. How has exchange rate regime evolved over the years? What is the effect of different exchange regimes on economic performance?
3. How far is the two-cornered solution of exchange regimes feasible for implementation in the EMEs?
4. How is the exchange regime orchestrated with other related measures to counter the perils of capital reversals/surges?

1. **Taxonomy of Exchange Rate Regimes**

- De jure: IMF “Annual Report on Exchange Rate Arrangements and Exchange Restrictions”. De facto regime classification: IMF (1999), Ghosh, Gulde, and Wolf (2003), Levy-Yeyati and Sturzenegger (2003), and most recently the “Natural” classification scheme by Reinhart and Rogoff (2004)

- Comparison of regime classifications across the de jure and Natural classifications:
  - only about one half of the observations were classified the same way by both the IMF’s de jure and the Natural classifications.
  - Among “free floats” (as per the IMF de jure) only 20 percent operated as true floats.
  - About 45 percent of the time official pegs were better characterized as managed or freely floating arrangements, or limited flexibility.
  - Of countries that were listed in the standard classification as managed floating, about half turned out to have *de facto* pegs, crawls or narrow bands to some anchor currency.

2. Evolution and Shifts in Exchange Regimes in the EMEs

- Bretton Woods collapse was much less of a watershed event for emerging markets and developing countries.
- The EMEs saw a gradual decline in the share of pegs in all regimes during the 1970s and 1980s, but not an abrupt shift.
- In recent years, increased capital mobility have played the most prominent role in determining the exchange regime and its durability in the EMEs.
- The regime shift has, however, been more in the direction of intermediate regime of flexibility rather than a pure free float or fixed rate (negating the Corner Solution Hypothesis).

3. Overall Experience of Exchange Regimes

- In relatively poor countries with little access to international capital markets, pegged exchange rate regimes had worked well, delivering both relatively low inflation and relatively high exchange rate regime durability.
- For emerging markets, the exchange regime did not appear to have a systematic effect on inflation or growth although pegs were distinctly more vulnerable to banking and exchange rate crises.
- As countries develop economically and institutionally, there appears to be considerable benefits in adopting a more flexible exchange rate system.
- The regime shift witnessed during the post-Asian crisis hardly transcended to a complete pure float or a super fix solution as propounded in the bi-polar hypothesis.

4. Measures to Counter Capital Flow Reversals

- maintaining “adequate” reserves to smoothen the impact of capital reversals and sterilize the reserve inflows through open market operations of domestic securities.
- raising the statutory reserve requirements on domestic/foreign deposits (on remunerated/non-remunerated basis)
- unremunerated reserve requirements
- limits on open foreign currency positions,
- use of forward exchange swaps by the central banks
- widening of exchange rate bands, thus allowing some exchange rate appreciation,
- provision for remunerated/uncollateralised deposit facilities for financial intermediaries with central banks
- issuance by the central bank of money stabilisation bonds/central bank bills and government/public sector deposits with the central bank
- liberalisation of capital outflows
- variants of “Tobin” taxes on capital inflows
- introduction of selective capital controls on short term capital inflows

II. The Indian Experience

1. Developments in India's Exchange Rate Regime and Capital Flows up to the Nineties'

Exchange Rate

- **1931- A de facto sterling standard for the rupee established.**
- **1966- The rupee devalued by 36.5 per cent.**
- **1975- The rupee pegged to an undisclosed currency basket.**

Capital Flows

- **1947-1980: Reliance on external flows was mainly restricted to multilateral and bilateral concessional finance.**
- **1980s': Traditional external sources of financing supplemented by commercial debt including short-term borrowings and deposits from the non-resident Indians (NRIs).**

2. Economic Condition in India at the advent of the Nineties'

- high current account deficit (about 3.2 per cent of GDP in 1990-91).
- fiscal excesses financed by debt creating flows, a substantial part of which was of a short-term nature.
- official exchange rate regime out of alignment with the market fundamentals.
- financial system characterised by administered interest rates, large pre-emption of resources by the authorities and extensive micro-regulations directing the major portion of the flow of funds to and from financial intermediaries.

3. Policy Overhaul in the Nineties': External Sector

- Two-step downward adjustment of 18-19 per cent in the exchange rate of the Indian rupee was made in 1991. Liberalised Exchange Rate Management System (LERMS) instituted in March 1992. Convergence of the dual exchange rates was made effective from March 1993.
- A liberalised trade regime was put in place.
- Current account convertibility achieved in August 1994. Subsequently legal framework (Foreign Exchange Management Act, FEMA, 1999) put into effect.
- Over time, both inflows and outflows under capital account substantially liberalised and deregulated.

Policy Overhaul in the Nineties': External Sector (cont.)

- Non-debt creating liabilities, especially in the form of foreign direct investment encouraged.
- Prudent management of external debt with the broad approach towards longer-term concessional flows.
- Cautious policy stance with regard to short-term debt flows. Short-term credits monitored and the overall limit confined within a prudential level.
- Encouraging direct overseas investment through joint ventures and wholly owned subsidiaries and provision of financial support.
- Ensuring that foreign exchange reserves remained "adequate".

Policy Overhaul in the Nineties': Financial Sector

The broad approach towards financial sector reforms in India been based on *panchasutra* or five principles:

(i) cautious and appropriate sequencing of reform measures,

(ii) introduction of norms that are mutually reinforcing,

iii) introduction of complementary reforms across sectors (most importantly, monetary, fiscal and external sector),

(iv) development of financial institutions and

(v) development of financial markets.

4. Episodes of Foreign Exchange Market Pressure

1. **March 1993-August 1995: Initial Phase of Inertia.**
2. **August 1995-February 1996: The First Taste of Turbulence.**
3. **March 1996- Mid September 1997: Overcoming the Pressure.**
4. **End-September 1997- mid August 1998: The Specter of Contagion.**
5. **End-August 1998- April 2000: Successfully Influencing International Sentiments.**
6. **May 2000-October 2000: Overcoming Cross-Border Tensions.**
7. **November 2000-August 2001: Restoring Orderly Conditions.**
8. **September 2001- May 2002: The 9/11 Effect.**
9. **June 2002- February 2005: The Period of Plenty**

5. Operational Responses during the Nineties'

- A variety of management tools were used to smoothen these swings and moderate their impact on exchange rate volatility:
- sterlisation through open market operations,
- changes in reserve requirements,
- foreign currency swaps,
- direct purchase and sales of foreign currencies in spot market,
- management of short term liquidity through repos/LAF,
- signaling through interest rate changes i.e. bank rate,
- reporting requirements for larger forex operations and open position by banks,
- interest rate changes applicable to export finance,
- relaxation of end use specification,
- liberalisation of capital outflows, and
- moral suasion.

6. Lessons from a Decade of Reforms

- Pace and sequencing of external sector reforms should be carefully calibrated.
- Management of capital account involves a distinction not only between residents and non residents or between inflows and outflows but also between individuals, corporates and financial intermediaries.
- A fair degree of trade and current account liberalisation should accompany/precede capital account liberalisation.
- There should be clear hierarchy in the nature of capital flows with equity flows getting more preference to short-term debt flows.
- External liabilities should be kept under constant watch and any eventuality of reverse movement should be factored in.
- Exchange guarantees, both direct and indirect, should be eschewed from to the extent possible.

Lessons from a Decade of Reforms (cont.)

- Foreign currency denominated assets within the country/ trading of domestic currency outside the country could have destabilising effects on the balance sheets and currencies.
- Management of the capital account involves management of control, regulation and liberalisation.
- Foreign exchange reserves should at least be sufficient to cover likely variations in capital flows or the “liquidity-at-risk”.
- The ability of the monetary authority to sterilise the capital inflows and yet retain control over money supply so as to pursue its stated objectives.
- Constant improvements in information base.
- Flexibility and pragmatism are the order of the day in exchange rate policy.

III. Challenges for the EMEs

- Authorities in the EMEs themselves need to learn how to conduct a monetary policy appropriate to a flexible exchange rate.
- It may take time for the central bank to refine the new internal procedures and communication strategies involved in inflation targeting.
- Continuous vigil on market developments, and the importance of building adequate safety nets.
- Management of asset portfolio acquires and innovative institutional measures for deployment of foreign exchange reserves become necessary.
- Regional/multilateral effort to with the issue of “constraint to sterilisation”.
- Coordinated international action to facilitate countries’ borrowing in their own currency.