SRIRAM'sIAS

BALANCE OF PAYMENTS

Balance of payments is an overall statement of a country's economic transactions with the rest of the world over some period- usually one year. It includes all outflows and inflows (payments and receipts). Countries have either balance of payment surplus or a balance of payment deficit. Balance of payments can be broken down into balance of trade (export & import of goods); balance of current account (includes the balance of trade, the balance of services and remittances; and capital account (investment and borrowing). Trade account is a part of the current account. Capital account deals with investment and borrowings and the rest of the BOP is the current account of which foreign trade is a part.

India's Balance of Payments (BOP) Crisis in 1991

The 1990s witnessed some major changes on India's balance of payments front. The decade began with a crisis caused both by the immediate Gulf war and the cumulative problems of the Indian economy. It led to an IMF-sponsored bail out.

The Gulf crisis of 1990-91 and the subsequent rise in crude prices rudely exposed the inadequacy of reserves. India has been dependent on crude imports. International crude pirces are very crucial for out BOP condition. When there was geopolitical disturbance due to Iraq crisis, crude prices shot up as our import bill. Tourism dropped. It depleted our foreign exchange reserves. International rating agencies downgraded India. This fuelled the crisis further as India's credit worthiness plunged. A substantial outflow of deposits held by Non-resident Indian during 1990-91 added to the crisis. Reserves declined to a low of $0.9 billion in January 1991. India had to pledge gold in May 1991 and again in July 1991 to avoid a default on its short term obligations. Further, in October 1991, India forex through India Development Bonds and Foreign Exchange Immunity Scheme.

Confidence building measures were taken up after the new Rao government was formed in June 1991. The rupee was devalued and brought closer to the market value as earlier it was artificially overvalued. International investors saw in this reform progress towards market orientation. Indian exporters felt encouraged as their earnings in foreign currency would fetch them more rupees.

Devaluation is a precursor to the beginning of rupee convertibility. We need to pause and get clear about a cluster of concepts- all being interrelated.

Devaluation And Depreciation

When the exchange rate of a country's currency is fixed, the central bank may choose to lower its value by its decision. That is called devaluation. The result is a new rate that is fixed by the central bank with respect to a foreign reference currency, for example, US dollar. Depreciation also has the same effect of lowering the value of the domestic currency but market forces are behind it and not the policy decision of the central bank. Market forces operate under a floating exchange rate.

When the central bank increases the value of the currency, it is called revaluation. Same increase in value taking place as a result of market forces of demand and supply makes it appreciation. The causes and effects of these changes on value will discussed ahead in the book. *Exchange rate* is the value (price) of one currency in terms of another.

Convertibility of Rupee

Convertible currencies give freedom to the holders of the currency to convert them freely into other currencies at the prevailing market rate. For example, one who has Indian rupees with him can convert them into foreign currencies if rupee is convertible. Balance of payments lists covers a vast number of transactions from trade, remittances by foreign workers to loans and investment. All these transactions of a country with the rest of the world are classified broadly into current and capital accounts. Current account includes foreign trade in physical goods(merchandise) and invisibles which are foreign trade in services like software, knowledge process outsourcing based earnings , consulting services, shipping services, tourism, and royalty on patents; and also movements of money without exchange for goods or services called 'remittances' and may include money sent from one country to another by an individual, business, government or non-governmental organisations (NGO) – like charities. India was the topmost country for remittances in 2016 at $62.7 billion sent by its diaspora. It includes what is sent as a part of what is earned as wage, interest, profit or rent.

In the BOP when one overlooks the current account part that is detailed above, the rest is loan and investment and that is called the capital account. The same information helps us to differentiate between balance of trade and the balance of payments. 'Balance of trade' is the foreign trade part of the overall balance. Trade is a part of current account. But current account also includes remittances. Thus, BOP is trade which is a part of current account; and capital account.

The larger the scope of convertibility that is permitted by a country, the stronger and the more resilient its economy is said to be, according to its proponents. No country grants full convertibility - restricts it for certain purposes and excluding certain other purposes. For example, the trade account convertibility is confined to exports and imports and certain associated aspects like remittances (what Indians living abroad send to their friends and relatives in India), tourism, etc. Even here, restrictions are imposed after a point. Convertibility for investment and borrowing abroad comes under capital account convertibility.

Rupee Convertibility

The rupee's external value was regulated by the Reserve Bank of India till 1992. Unlike in the developed countries where, where by and large, the market forces dictate the exchange rate of the currency, the rupee was artificially valued by the RBI because the country did not have a policy that is pro-exports or pro-FDI. The policy changed irreversibly sine 1991.

As an important part of the economic reforms since 1991, rupee was made convertible since 1992 in phases. Devalution was done by the RBI in 1991 to set the stage for convertibility. The rupee was made partially convertible in 1992, under which 40 per cent of the foreign exchange earnings were to be traded at the official exchange rate and the remaining 60 per cent could be converted at market determined exchange rates. This was known as partial convertibility of rupee(PCR) and was a part of Liberalised Exchange Rate Management System (LERMS) that was introduced, from March 1992: a dual exchange rate system of 40:60 as explained above. Rupee was made fully convertible on the trade account in 1993 and it was further extended to current account in 1994. Thus, India assumed obligations under Article VIII of the International Monetary Fund, as a result of which, India is committed to adopt current account convertibility.The measures helped in international investors reposing faith in India once again.

India's response to the crisis was essentially tailored to build confidence of the international investing community in India. Foreign institutional investments (investments into financial assets like shares, bonds etc) were permitted and Indian companies were permitted to raise resources in the international capital markets in the form of GDRs. Norms for foreign direct investments were liberalised and multinational companies were wooed by Central/state governments to invest in white goods (consumer durables),infrastructure and other projects. The dramatic change in the environment led to a surge in capital flows. Foreign investments into India shot up dramatically.

Balance of Payments and Invisibles

Invisibles in international trade, is used as a synonym for "service." Invisibles trade is trade in services. Visible, in referring to international trade, is used as a synonym for "goods." "Visibles trade" is trade in goods.

Invisibles are in three parts

- Services
- Transfers and
- Income.

Services include transportation, financial services, travel, telecommunications, computer services and professional services. India's export of services increased to well over $110 billion (2012)

Transfers include remittances from Indians working abroad.

Income receipts are the income earned (as profits, interest and dividends) from the ownership of overseas assets by Indian companies, government and individuals

The net inflow on invisible account has continued to be a major support to the balance of payments. Invisible receipts have shown robust growth, increase being spurred by increased private transfer receipts (remittances by Indian living and working abroad).Tourism receipts have been on the rise. Software exports continue to show exceptional growth rates.

Remittances

India became the largest remittances receiving country at $72 billion in 2015 followed by China at $64 billion. Kerala, Gujarat, Maharashtra, and Punjab are the maximum inward-remittance generating states, according to the RBI. The largest remittances came from the UAE and USA.

In recent months, the rupee has weakened considerably vis-à-vis the dollar, and a surge in remittances is expected as non-resident Indians take advantage of cheaper goods, services and assets in India, says the WB report. Indian Diaspora which is one of the most prosperous in the world is sending money home. Controls are lifted and so there are greater inflows. The government has progressively reduced the red tape. Interest rates are high. RBI increased the amount that can be remitted home.

Convertibility has four dimensions:

- Freedom to convert
- Convert at market rate and

- Removal of restrictions on convertibility on current and capital account. That is, liberalization of flows. It means convertibility for more purposes (like FDI in retail); higher or no caps on existing convertibility regime (49% FDI in insurance etc); more of automatic than approval route; and Indians being allowed greater freedom to take their money abroad.
- Liberalization of outflows from India

The fuller the convertibility, the more the above four items are relaxed.

Current Account Convertibility: It refers to freedom to convert domestic currency into foreign currency and vice versa for the following purposes:

1. exports and imports
2. payments due as interest on loans etc
3. remittances
4. travel
5. education etc

Capital Account: It covers investment and borrowings. For example, foreign investment in India; how much Indian companies can borrow. Similarly, Indians to open bank accounts in foreign countries; invest abroad; hold assets abroad etc.

Capital Account Convertibility

Full convertibility means freedom to convert rupee into foreign currency and vice versa for both current and capital account purposes with least restrictions. That means, in the capital account, there should be 100% FDI and FII allowed across all sectors, more or less (except security related areas). Similarly, there should be very liberal regime for outflows- that is, Indians can invest abroad and borrow from abroad. There should be no controls on current account transactions either.

Full convertibility was the goal in India since the reforms began. We have a large measure of capital account convertibility for foreigners and NRIs for investing in India and taking out profits relating to FDI, portfolio investment and NRI bank deposits in India. For Indian residents and corporates, some limits still exist on how much they can invest abroad. Indian companies also need RBI permission to borrow funds from abroad for some designated purposes. The controls are being relaxed.

Why do we need fuller capital account convertibility?

Advantages

- we get foreign capital for investment
- FII flows can increase liquidity and also modernize our financial sector
- Creates competition for our domestic players
- All advantages of FDI will be available-technology, investment and trade(TIT) accrue
- There will be macro economic discipline
- Indians have a wider range of choice for investment and borrowing.

Fears are

- As the global financial crisis shows, adoption of fuller convertibility should be calibrated or it can be quite destabilizing

- Domestic interests in retail are hurt as it can create unemployment
- Rupee still not being a hard currency, can be subject to volatility with serious effects
- FDI hike in defence also needs to be discussed well before being adopted

Prerequisites for fuller convertibility

- Fiscal deficit should be minimal
- Forex reserves should be adequate
- NPAs of banks should be minimal
- Inflation and interest rates should be moderate

Unless these conditions are met, great steps towards fuller convertibility should be kept on hold.

Benefits of fuller convertibility:

First, India needs huge resources, especially to upgrade its infrastructure. Domestic savings alone are not enough. More foreign funds would come in only if they are sure of free entry and exit.

Second, Indian businesses (especially, the established companies) would be able to access cheaper foreign funds that would improve their international cost competitiveness.

Third, unhindered access to foreign funds would facilitate Indian companies taking over firms abroad and developing more Indian MNCs in the process. For example, Tatas acquiring Jaguar , the international steel major.

Fourth, Indian banks would be able to borrow foreign funds at lower rates which would, in turn, enable them to lend at a lesser rate to Indian small and medium enterprises which may not otherwise be able to borrow directly from the international capital market.

Fifthly, it exerts macro-economic discipline.

Sixthly, outflows are necessary to balance the inflows or the problem of appreciation will plague the economy.

Finally, ordinary Indian investors would be able to further diversify their asset portfolios. Fears relate to Dutch disease. Netherlands experienced Dutch disease as a result of its discovery of oil and related fuels in 1960s. The foreign exchange inflows led to the Guilder appreciating so much that the imports shot up and the competitiveness of Dutch industry was affected adversely. Exports suffered and imports increased due to appreciation. Deindustrialization is the result. The Dutch disease is something similar to what the emerging market economies have experienced due to capital inflows, particularly of the portfolio variety.

Tarapore Committee on CAC

Tarapore Committee on CAC that was set up in 1997 and gave a road map for introduction of capital account convertibility. The objective of the committee was to study economies that had implemented capital account convertibility and understand the prerequisites for it. They had to make recommendations on the measures to be taken and the time frame to achieve full capital account convertibility.

The report noted that India had adopted current account convertibility in August 1994, in accordance to Article VIII of the Articles of Agreement of the International Monetary Fund (IMF). It also noted that capital account convertibility already existed for foreign investors, both direct and portfolio, non-resident depositors and Indian corporates which take external commercial borrowings (ECB). The report said that implementing capital account convertibility would increase capital inflows and bring in all the other advantages cited above. The report said that the time was appropriate for India to take some steps towards but it should be done only when the prerequisites are met otherwise the CAC is a double edged sword. The report said that the move should be made in three phase: Phase I (1997–98), Phase II (1998–99) and Phase III (1999-2000). The transition from one phase to the next should be made, only if certain preconditions are met. The preconditions were reduction of fiscal deficit, keeping the inflation in a 3-5% range and reforming the financial sector, including reduction of non-performing assets.

But it could not be implemented as East Asian currency crisis struck in 1997.

Capital Account Convertibility Relaxations So Far

Capital account transactions continue to be regulated under the FEMA which is a highly liberalized version of the earlier FERA.

Foreign direct investment, barring a few strategic industries is put on automatic route, with most of the sectors permitted to have ever increasing foreign equity participation.

- The foreign portfolio investment by FIIs is allowed liberally.
- The external commercial borrowings (ECB) no longer require the RBI or Ministry approval up to a value.
- Inflows are liberalized far more than outflows for obvious reasons of security. The relaxation on outflows to balance the inflows have been significantly undertaken.
- Overseas investment limit (total financial commitments) for Indian companies enhanced.
- Aggregate ceiling on overseas investment by mutual funds enhanced.
- Prepayment limit of external commercial borrowings (ECBs) without prior Reserve Bank approval increased.
- an *Indian* citizen *can invest* up to *$2,50,000* per *year* in foreign markets (2016)

Tarapore II On Fuller Rupee Convertibility 2006

Tarapore Committee on Fuller Convertibility that presented its report in 2006 recommended that India should make the rupee more freely convertible over the next five years to realize the country's "maximum" economic potential. Tarapore committee said that in view of the huge investment needs of the country and that domestic savings alone will not be adequate to meet this aim, inflows of foreign capital become imperative. The shift toward fuller convertibility should be phased over three phases starting in 2006-07. A "comprehensive review" should be undertaken in 2011 to chart the future path.But, before making the rupee more freely tradeable, India must "improve regulatory and supervisory standards across the banking system" and get its financial house in order, including taming its worsening deficit, said the committee.

The report sought a ban on participatory notes as a mode of investment in Indian equities and easing the direct investment routes for foreigners. It suggested that foreign individuals investors should be brought at par with non-resident Indian investors. The committee recommended the restrictions on overseas borrowings by Indian firms and banks be eased. It said that the limit on outbound remittances by Indian citizens should be increased. It also recommended that the fiscal deficit be brought under control otherwise a large deficit will make India's economy vulnerable to shocks. It proposed the formation of a monetary policy committee (MPC) which has since been set up and operating (2017).

(**Participatory Notes (P-Notes)** are instruments issued by registered foreign institutional investors (FII) to overseas investors, who wish to invest in the Indian stock markets without registering themselves with the market regulator, the Securities and Exchange Board of India-SEBI. They prefer to buy PNs for a variety of reasons and not directly invest in India.Investing through P-Notes is popular amongst foreign institutional investors. Bu India's risks can be high if PNs invest heavily as they are very volatile.)

Internationalization of Rupee

The recent decision by the International Monetary Fund to include the Chinese renminbi in the Special Drawing Rights basket ; the issuance by International Finance Corporation (IFC) of the World Bank Group of rupee-denominated offshore masala bonds; and announcements by the Reserve Bank of India (RBI) allowing Indian companies to issue masala bonds started debate about 'internationalization' the rupee.

A currency is said to be internationalized when other countries' banks and firms and citizens hold its currency for financial security. It is associated with another feature: international currency markets trade actively in such a currency. It is accepted for international trade transactions. If rupee is internationalized, we can pay for our imports in rupees. Our firms can raise dollars in international markets and repay in rupees. Further, Rupee will be an international currency if non-residents are willing and able to trade in it and invest in rupee-denominated assets. For example, a Russian importer must be able to pay for her imports from South Africa in rupees. Similarly, a UK resident must be able to invest her savings in rupee-denominated bonds or shares. In these cases, non-residents take risks in the rupee as a currency.

These are the core features of an international currency. US dollar, Euro, Yen, Pound, and recently renminbi are some of the dominant international currencies.

To be an international currency is dependent on three prerequisites. First, the issuing country must have sufficient scale: there must be so much currency available for non-residents to hold it in terms of volume of international transactions. It is linked to macroeconomic fundamentals like strength of the economy, its exports, its resilience etc. Second, the value of the currency must be stable over time. Stability has multiple aspects: macroeconomic, financial and political. Third, the currency must be liquid. A currency is liquid if significant quantities of assets can be bought and sold in the currency, without noticeably affecting its price. This requires depth in financial markets, a large stock of domestic currency-denominated bonds .Scale, stability and liquidity can be achieved through strong economic fundamentals and once these are achieved, the rupee will come to be accepted as an international currency.

Internationalization of Rupee will facilitate greater degree of integration of Indian economy with rest of the world in terms of foreign trade and international capital flows. Key benefits of internationalization of Rupee include savings on foreign exchange transactions for Indian residents- we can pay in rupee for external transactions and need not route them through dollars etc. Reduced foreign exchange exposure for Indian corporates, reduction in dependence on foreign exchange reserves for balance of payment stability etc are other benefits.

One of the important drivers for internationalization of a currency is the country's share in global trade. India's percentage share in the global trade is still on the lower side and it limits the pricing ability of domestic businesses in Indian Rupee. Moreover, the share of Indian Rupee in the Global foreign exchange market turnover at present is also very low. Internationalization of Indian currency would also require full capital account convertibility. As a policy, we have followed a gradual and cautious approach in opening up the capital account. The capital account is being progressively liberalized in accordance with the evolving macro-economic conditions and requirements of the Indian industries, individuals and financial sectors. Government has been taking measures to promote the internationalization of the Indian Rupee. Recently, a framework was put in place for issuance of Rupee denominated masala bonds overseas by Indian corporate.

Capital Account Liberalization

Foreign Direct Investment (FDI) in India is subject to certain Rules and Regulations and is subject to predefined limits ('Limits') in various sectors which range from 20% to 100%. There are also some sectors in which FDI is prohibited. The FDI Limits are reviewed by the Government from time to time and as and when the need is felt and FDI is allowed in new sectors where the limits of investment in the existing sectors are modified accordingly. In order to revise the FDI Limits to attract more foreign investment in India, the Union Government constituted a committee named, Arvind Mayaram Committee. In 2013, the Government approved the recommendations given by the Arvind Mayaram Committee to increase FDI limits in 12 sectors.

Current Account Deficit

The current account of the balance of payments is the sum of the balance of trade (exports minus imports of goods and services), net factor income (such as interest and dividends) and net transfer payments (such as foreign aid). Both government and private payments are included in the calculation. The balance of trade is typically the most important part of the current account. This means that changes in the patterns of trade are key drivers of the current account.

CAD is said to be good upto a limit as the country uses foreign savings which are imports for its development. However, two points must be made to qualify the same. One, it should be financed from dependable inflows like FDI. Two, it should be within limits. Foreign investment inflows were encouraged into the country to finance the current account deficit (CAD). The steps include liberalizing long-term external commercial borrowings (ECBs), asking state-run companies to raise funds from overseas markets etc. The government also talked to sovereign wealth funds and pension funds to get them to invest in India. Promoting exports and measures to reduce imports, especially non-essential ones were taken up.

Deficit on the current account means a net outflow of foreign currency and depletion of forex reserves. In India's case, this means a dollar outgo.Therefore, a country with a current account deficit has to attract capital flows, which could be in the form of FDI/NRI deposits/FII etc to meet the shortfall. But when capital flows are insufficient to meet the deficit, the country's currency starts to depreciate as its capacity to defend its currency weakens. It has no forex to meet it debt servicing obligations. It runs into a sovereign debt crisis thus. This is why a current account deficit in excess of 2.5% of GDP is seen as worrisome in case of India. To act against CAD, India needs to promote exports and slow down consumption imports such as fuel and gold. Reduction of subsidies will also reduce the demand for imported fuel and thus balance trade.

Exchange Rate

Exchange rate is the price of one currency in terms of another currency. For example, approximately 66 India rupees are exchanged for 1 US dollar in 2017. That is the exchange rate. 25 years back it was 20 rupees. But that was artificially fixed by the RBI for the reasons stated above. Since the rupee exchange rate was deregulated- left to the market forces largely- rupee lost its value and came down to almost close to 70 rupees in late 2013 and since then recovered. The exchange rate depends upon many factors:

- Growth rate of the economy
- Future potential
- Foreign trade profile which includes import dependency
- Inflation
- Forex reserves with RBI
- Interest rates in the country and global majors like US
- Monetary policy of countries like USA
- International commodity prices
- External debt levels, particularly the short term commercial debt level
- The extent of convertibility of the currency
- Twin deficits – fiscal and external current account
- Political stability

Rupee is fully floated. RBI buys and sells foreign currency only to facilitate normal operations for foreign trade, debt servicing etc. That is, rupee exchange rate is not" managed" by the RBI. It is not even semi-managed (dirty float). RBI's significant marked forex market intervention is only when there is manipulation of forex market that can create instability internally and externally. The reason for $400 b is built up as the foreign currency reserve war chest is primarily for this reason.

Currency Mechanisms

There are many ways a currency's exchange rate is arrived at. Some are:

1. In floating rate , the forces of demand and supply determine the valuation and the role of monetary authority is nil or negligible except in indirect terms like buying and selling currency in the market, changes it makes in the interest rates , cash reserves ratio etc .

2. In dirty float the exchange rate is largely market determined but the central bank manages the rate in a specific band that suits certain national goals like export promotion etc. Management of the currency valuation is within a band called the target zone and it is declared by the central bank. The objective here is to make exchange rate conducive for certain macro economic goals like export promotion and balancing it with import liberalization; remittances etc. It is also called managed float.

3. In the fixed exchange rate, the Central Bank artificially and arbitrarily fixes the exchange rate which may not have any relation to market forces. India had the system till 1992 before trade account convertibility was introduced. India had the system as it did not need any FDI or exports.

4. In the pegged system the currency is pegged to the international hard currency like dollar so as to signal the commitment of the central bank to stability. Its movements may or may not be determined by the hard currency because the valuations that suit the local currency are independent of the hard currency. It is essentially meant for imparting stability and

credibility to the domestic currency in its exchange rate so as to invite investors. The stability, however, depends on the ability of the country to manage the rate that is necessary for its exports and gain other benefits. For that, the Central bank should have sufficient forex reserves to intervene whenever necessary. Otherwise, there will be speculative attacks and currency meltdowns. China is an example of currency peg. Crawling peg means, the Government accepts that the currency will crawl up or down gradually by a certain annual rate.

2013 And The Exchange Rate Of Rupee: Why Did The Rupee Slide To Historic Lows Of Nearly 69 In 2013

Rupee fell its lowest ever against the dollar culminating in 2013 - at little less than Rs.69 for which the external and internal reason are responsible

- Eurozone crisis
- Fed taper and rate hike
- .Flight to safety
- Dollar is relatively strong as the US economy came out of recession and growth resurfaced
- Risk aversion for the foreign investor
- GAAR/retro taxation laws
- CAD widening
- Weakening capital inflows: The capital account (the net flow of funds through investments and borrowings) surplus has been used to finance the current account deficit for many years. Capital inflows have reduced due to the improving economic situation in the US and other developed countries. Investors are exiting developing markets in expectation of the US Federal Reserve increasing the interest rates, impacting the currencies of emerging markets, like India, Brazil, Russia, Indonesia, Turkey and South Africa.
- Inflation: part of the depreciation is attributable to the adjustment of the rupee exchange rate to the inflation differential, i.e. India's relatively high rate of inflation versus other economies.

Steps taken by the RBI and the government of India to stabilise the currency markets:

Issue	Details
Capital Outflow	The RBI reduced the limit for outbound investment and remittances from India.
Encouraging Capital Inflows	RBI has removed administrative restrictions on investment schemes offered by banks to non-resident Indians, and removed ceiling on interest rates on deposit accounts held by NRIs.The government liberalised the FDI limits for 12 sectors, including oil and gas.
Limiting Imports and encouraging exports	The Finance Ministry increased the customs duty on importing precious metals including gold and platinum.20% of every lot of import of gold must be exclusively made available for the purpose of export of gold-related items
Oil Import Needs	RBI decided to provide dollar liquidity to three public sector oil marketing companies (IOC, HPCL and BPCL) to help them meet their entire daily dollar requirements. Government also considered increasing

	its import of crude oil from Iran, and pay for it directly in Indian rupees.
Trade Deficit	Ministry of Commerce explored the possibility of using local currency for trade with major trading partners.RBI allowed exporters and importers more flexibility in management of their forward currency contracts.
Curbing Speculative in currency	RBI increased the short-term emergency borrowing rates for banks. The daily holding requirements under the Cash Reserve Ratio for banks have been modified. MSF was increased to curb borrowing for speculation
International Cooperation	Government increased its currency swap limit with Japan from USD15 billion to USD50 billion. The BRICS nations also agreed on a USD100 billion foreign currency reserve pool as part of their plan to create a BRICS -CRA

As is evident, some were related to capital account; some others were long term and confidence boosting measures; few are related to immediate relief.From the above sub topic where the reasons and remedies were given, it is clear as to how the currency moves and what policy levers are available to ensure order. The reason for giving in such detail the case of rupee in 2013 is it is a good case study.

Since then rupee recovered and fell again in 2016 November to close to Rs.69 levels.

What is the Real Value of the Rupee?

Since 1991 when dollar fetched 16 rupees, rupee has depreciated to Rs. 65 per dollar by 2017 October. Erosion is caused by the fact that unlike the arbitrary value fixed till 1991, the rupee is finding its market value according to demand and supply in the market. The factors that influence the value are:

- Demand and supply
- Net Capital flows
- Performance of economy and its prospects
- Forex reserves with the RBI
- Interest rates
- Short term debt and the Current Account Deficit(CAD) or CAS
- International prices of the commodities on whom the nation depends. For example, the crude prices in the international markets influence exchange rate of rupee as India depends for more than 80% of its requirements on imports
- speculators
- Political stability – current government has overwhelming majority in the Lok Sabha and gives an edge

The prevailing official exchange rate is called the nominal effective exchange rate (NEER) Adjustment –upward or downward –according to inflation shows real effective exchange rate (REER). REER is an inflation adjusted exchange rate – the differential between the inflation in India and India's trading partners is factored to arrive at the REER. NEER always tends towards REER even though there may be a time lag to suit the macro-requirements of the economy.

Forex Reserves

RBI holds foreign exchange reserves which are made up of

- foreign currency held in US Dollars, Euro, British Pound , Japanese Yen etc
- foreign bank deposits
- foreign government securities
- gold reserves
- Special Drawing Rights of IMF and International Monetary Fund reserve positions

Reasons For Accumulation of Forex

Today (2017) RBI has $400b of reserves. It is acquired by the RBI for the following reasons

- To gain external account security
- To defend the rupee when needed
- To import essentials for economic and social security
- To enable the country to globalise further
- To deter speculators
- To enjoy favourable rating by sovereign credit rating agencies which in turn will confer advantages like borrowing cheap from offshore currency market etc.

The foreign currency assets (FCAs), a major component of the overall reserves, were at $375 billion in September when RBI had $400 billion forex reserves for the first time.

Expressed in US dollar terms, FCAs include the effect of appreciation or depreciation of non-US dollar currencies, such as the euro, the pound and the yen held in the reserves.

Gold reserves were $21 billion.

The special drawing rights with the International Monetary Fund (IMF) were $1.5 billion.

The country's reserve position with the IMF was $2.3 billion.

These are reserves and not resources and can not be used for infrastructure etc as the investors want to see the country hold enough of these reserves to give them confidence to come and leave without uncertainties.

Adequacy or Otherwise of The Forex Reserves

Whether it is adequate or not is determined by the composition of our flows and external debt. NRI deposits and FII investment (hot money) are vulnerable. Global crude prices are also a factor in estimating the quantum of forex that is necessary. Drought and resulting food position is one more. Short term debt is another input. With all these factors, including the import cover required, we have to decide the extent of forex necessary.

RBI is diversifying the reserves into SDR and gold since 2008 and the US-centered global recession.

Problems of Plenty With Large Forex Reserves

But there are problems with huge forex reserves as to

- Cost of acquisition is high

- Sterilization costs are high, that is, when rupees are printed to buy dollars, the rupees that put into market have to be absorbed by floating government securities carrying significant interest cost through MSBs(discussed in the Monetary Policy Chapter)
- Market risks associated with their deployment in US securities are evident since 2008
- Returns on such deployment is also miniscule

RBI is diversifying the reserves into SDR and gold since 2008 and the US-centered global recession.

China, Japan, Switzerland, Saudi Arabia, Taiwan, Russia, Hong Kong and India are the top eight countries in terms of forex reserves- in the descending order.

Strong Rupee 2017: Causes And Effects

Indian rupee has turned out to be one of the best-performing currencies in the world with a gain of well over 6% against the U.S. dollar by August 2017. The rupee has been appreciating because of strong capital inflows. These include portfolio inflows into equities and, more importantly, debt markets. They also include higher levels of foreign direct investment and instruments such as masala bonds. These are driven partly by global liquidity and partly by the improving fundamentals of the Indian economy. The Reserve Bank of India's (RBI) relatively hawkish stance on the policy rate has attracted funds searching for yield.According to the Reserve Bank of India, foreign portfolio investors invested $15.2 billion in India's equity and debt markets this year until the end of July. In addition, foreign direct investment in April-May doubled compared to last year. Oil prices remaining stable at around the $50 mark too has helped as it helps reduce forex outgo on oil imports. This is reflected in the improved current account deficit, which stood at 0.7% of GDP in 2016-17 compared to almost 4.8% in 2012-13.

Foreign exchange reserves are at a record level of $393 billion.

However, strong rupee can cause concerns if our object is to stimulate investment, create employment and foster growth, it is a cause for serious concern.

The exchange rate is a determinant of the price competitiveness of exports in world markets and the price competitiveness of imports in the domestic market. Similarly, it exercises an important influence on the profitability of domestic firms that produce goods which are exported, or produce goods which compete with imports. The relative profitability of domestic firms is particularly important in a large economy such as India, because most exports are goods that can be sold either in the world market or in the domestic market, while most imports are goods that can be bought either from abroad or at home.

It is possible that any currency is overvalued or undervalued. Overvaluation of the rupee means that its price in terms of foreign currencies is too high, compared to what it would be with a more appropriate exchange rate. This makes our exports expensive in foreign markets and our imports cheap in the home market. Undervaluation of the rupee means the opposite. Its price in terms of foreign currencies is too low, so that it discriminates against imports and in favour of exports.

In 2017, almost every currency appreciated against the dollar, but the rupee rose the most (along with the Korean won).

India's export performance in the past three years has seen setbacks. India's share in world exports, around 1.65%, was maintained but not increased. The slow growth in world trade does impose a demand constraint on total exports from developing countries taken together. But China, Korea and even Bangladesh, managed to increase their shares in world exports. Thus, it would be misleading to blame the world economy for India's dismal export performance. Some part of the explanation lies in domestic economic factors such as infrastructure or quality but these have been problems for a long time. The exchange rate of the rupee has been the main reason in recent years. Software exports, which have continued to grow—from \$98 billion in 2014-15 to \$108 billion in 2015-16 and \$117 billion in 2016-17—appear to be an exception to the rule, but these would have done far better if the overvalued and appreciating rupee had not dented the profitability of domestic firms.

The essential underlying factor was the exchange rate of the rupee, which also made imports distinctly cheaper than home-produced goods, whether fruits, mobile phones, consumer electronics or household goods. Every consumer in India is familiar with the overwhelming presence of Chinese manufactured goods. The consequent switch in domestic expenditure from home-produced goods to imports did lead to a contraction in demand and jobs which in turn had a dampening impact on jobs and economic growth

High interest rates to sustain portfolio investment led to strong rupee as seen the first paragraph above. These capital inflows drive prices up in stock markets and add to foreign exchange reserves. But this solution can cause considerable collateral damage to the economy.

First, portfolio investment flows have a significant impact on the exchange rate. The appreciating overvalued rupee erodes the price competitiveness of exports and enhances the price competitiveness of imports, which hurts the profitability of domestic firms and is bound to enlarge the trade deficit. At a macro level, this also leads to a contraction in domestic demand so that economic growth is slower than it would have been in the absence of an appreciating rupee.

Interest rates have been kept at high levels, said to combat inflation—at its lowest in years—but substantively to ensure profitability of short-term foreign capital inflows and maintain confidence in international financial markets. As inflation rates have come down sharply while nominal interest rates have not, real interest rates have risen sharply in the past three years. This has tended to crowd out domestic investment in the real sector of the economy, whether agriculture, manufacturing or services. Such dampening of domestic investment also means that economic growth is slower than it would have been in the absence of high interest rates.

It is essential to recognize that the exchange rate is a price which matters for the economy in many spheres. It is far more important than portfolio investment inflows that can be volatile. The overvaluation of the rupee, which makes exports difficult and imports attractive, must be corrected. The time has come to let the rupee depreciate not just in nominal but in real terms. A more appropriate exchange rate would stimulate exports and dampen imports, just as it would help domestic manufacturing firms to be more competitive, both abroad and at home, to "Make in India" and combat the onset of deindustrialization.

The way forward, now, is to drop interest rates, which would also help the exchange rate depreciate. Together, these would stimulate investment and revive exports, which in turn will drive economic growth and employment creation from the demand side. The time is also most opportune as the consumer price annual inflation rate has dropped to 1.5% in June 2017.

Sovereign Wealth Fund

It is a fund of foreign currency that is meant to be invested in global assets. It is set up and managed by the central bank or a special body (special purpose vehicle) of the government. It is commonly seen in countries that have substantial foreign currency assets earned by them from exports or by foreign investors like MNCs. The fund is invested in shares, bonds, property or other areas of potential growth- like energy assets like oil and gas fields, uranium and agricultural fields. It may also be used to acquire foreign companies. The main reason for it s to earn more than making investments in government bonds of foreign central banks. It helps in energy and food security. Some of the countries that use sovereign wealth funds (SWFs) have economies that are rely on one source of income- oil revenues in Norway and the Middle East.

SWFs diversify their incomes and help them with external account security. India has not set up an SWF because our reserves are not adequate for our needs and contingencies. Besides, the forex held by the RBI is not earned through exports or FDI but is essentially borrowed resources. Our external debt is about $475 billion and our forex reserves are $ 400 billion.

Rupee Devaluation/Depreciation and Export Performance and Promotion

It is argued that when a currency depreciates due to market forces of supply and demand or is devalued by the Central bank, exports go up as in price terms as the country's goods and services will be cheaper especially in relation to similar goods and services from competitive countries. In fact, in the case of India, since the beginning of reforms in 1991 one of the reasons for the growth in exports in dollar terms was the depreciation of rupees. With depreciated rupee, FII will also flow in. Remittances will increase. Inessential imports will reduce. More money in rupee terms is realized for the loans in foreign currency that Indian firms take.

However, when rupee loses its value externally, debt servicing becomes costlier. Inflation will rise as imports will become costlier. Government's subsidy bill and fiscal deficit may rise as it will have to make imported goods like petroleum products and food affordable to the general public. At the same time, a cheaper rupee making the imports costly may drive the domestic import – dependent firms to become either import-substituting or cut corners and raise productivity. The result can be innovation and indigenous production.

To boost exports, pricing the external value of the rupee low is not the strategy beyond a point. Sclae, quality, reliability, packaging and so on matter. Price-elasticity of our exports is also to be considered before depreciation is advocated. That is, price may not boost consumption beyond a point. Further, competitive devaluation will harm the economy as elaborated above. Also, import elasticity of Indian exports- about 50% exports like engineering goods, gems and jewellery etc is high and thus depreciation hurts them.

J curve effect is a theory stating that a country's trade deficit will initially worsen after the depreciation of its currency. This is because higher prices on foreign imports will be greater than the reduced volume of imports and the growth in exports initially. When exports become price-competitive and imports are reduced due to high cost, the BOP turns positive.

Rupee Appreciation: Why And What It Does

Normally, currencies appreciate when the economies are doing well. An appreciating currency is the result of a booming economy. Performance of economy brings in FIIs; huge FII inflows into financial asset markets and an increasing reliance on low cost foreign loans (ECB) add to the foreign currency glut, and help power the rupee higher. NRI deposits also explain the appreciation.

The resentment is among exporters while importers, borrowers from abroad and the consumers are gainers. Borrowers gain as they can prepay at reduced cost. Importers are delighted with the rupee's appreciation to the dollar as most imports and external borrowings are denominated in dollars. Borrowings through Masala bond does not make the debtors relieved as the borrowing and repayment both are in rupees and so is the interest.

The Indian consumer is a beneficiary too, as costs of a host of imported goods — from petro products to electronic, electrical and consumer items — would be cheaper.

The effect on exporters too is not all negative. With increasing global integration an ever-increasing proportion of exports consist of imported raw materials and components. This is particularly true of the diamond, high-end textile and engineering industries that use a high proportion of imported goods in their exports.

The rupee's rise has helped these exporters to rein in their costs and increased their competitiveness in the global market place. However, exporters, in general, have seen their profit margins erode as a result of the rupee's unexpected appreciation.

Appreciation is suggested for the following reasons:

- Helps manage inflation
- Puts pressure on export sector to scale up the value chain and export niche products
- Forces the industry to cut costs and be competitive on quality terms.

Currency Manipulation

A country depends on the price of its currency in overseas markets- the exchange rate, for a variety of its macroeconomic objectives. Some want it weak so as to export more etc and some want it balanced if they also have a need to import substantially. China is in the former category and India in the latter. China keeps its exchange rate weak by having the yuan (renminbi) fixed (pegged) to a basket of currecnies since 2015 and till then to the US dollar. By artificially keeping it devalued, it has posed a threat to other countries that also want to export but can not weaken the currency for the purpose. For example, India. When a country dmages its competitors through a weak currency, it is called a "beggar they neighbor policy." The decline of India's exports and the huge trade deficit that India runs with China (about $50 billion in 2017) may be cited as an example of such policies. It is the result of currency manipulation. The United States accused China of keeping the yuan, artificially low by massively accumulating foreign reserves, in order to give Chinese exports an advantage over competitors.

US wants to have Chinese yuan to move freely in foreign exchange markets and find its value.

A weak currency cheapens the price of a country's exports, making them more attractive to international buyers by undercutting competitors.

China's economy is primarily export-driven and international competition could be killed only by currency manipulation. Other countries can not join this currency war as they do not have such large scale manufacturing capacity nor the population to supply cheap labour skills nor the authoritarian government that can take decisions against popular will, for examples environmentally incompatible projects. Other countries lose by way of growth, jobs, fiscal receipts, competitiveness, welfare and so on as they lose their global and domestic markets.

Certain professional economists and policy makers are apprehensive that the devaluation driven growth could overheat the economy and hardland the country into a rapid slowdown hindering the world recovery.

Other countries also reacted in a similar manner. US started quantitative easing one of whose objectives was to oversupply dollar to weaken it to check imports and boost exports. President's Trump's "America First" is also a response to it. Protectionsim is spreading across the world as a result.

Currency War

In 2010 by Brazil's Finance Minister Guido Mantega coined the term while describing the competition between the United States and China to cheapen their currency- US having joined the war started by China by introducing the QE .As detailed in the note on currency manipulation, some nations deliberately weaken their currencies to gain in terms of exports etc. When the other nations join the race of devaluation, it is called a currency war. Currency cheapening is made possible by the central bank following an expansionary monetary policy to lower the value of its money. The central bank buys foreign currency and keeps a war chest of it like China with which it ensures that its domestic currency has a low valuation vis a vis other currencies to aid exports. That helps businesses and boosts economic growth.

Other countries may not be able to join as their currencies are not fixed but are floated; imports will be costlier; inflation will shoot up; growth will suffer; jobs will be lost and financial sector may be destabilized as banks may accumulate non-performing assets(NPA).

A central bank has many tools to lower the exchange rate: increase the money supply by expanding credit. It can lower interest rates. It can also add credit to a money supply through open market operations an extreme form of which is Quantitative Easing.

Governments can also aid in currency losing its value through expansionary fiscal policy: by spending more or cutting taxes. But its effects can be severely destabilizing and anti-growth unless the entire ecosystem is in place to take relative advantage of the weak currency from the global market.

Dollarization

When a country uses the currency of another country along with its own currency or by official substitution, it is called Dollarization. Currency substitution can be in complete replacement of domestic currency or along with it. Nepal and Bhutan people hold Indian rupee along with their own official currencies Nepalese rupee and Bhutanese Ngultrum respectively for financial security and for trade across the border. Similarly, residents of Zimbabwe hold British Pound or South African Rand along with Zimbabwe dollar.

Currency Board

In recent times, currency board came into international headlines in 2001-02when Argentina adopted it to flush out its extra currency that was losing its value due to fiscal profligacy. When foreign investors were leaving the country ad the exchange rate of peso was plunging, the decision was taken to adopt the currency board mechanism. It set a fixed exchange rate to US dollar. It ruled that the country should print so many pesos as it had dollars- the ratio between the two being fixed at a certain level. Thus the country retrieved its financial stabilityand FDI and FII resumed. Thus, like a central bank, a currency board is a country's monetary authority that issues notes and coins. That is its only function and is performed in line with the fixed currency exchange rate. In other words, CB, unlike a central bank, is not the lender of last resort, nor banker to government nor is it the bank's bank.

Global Reserve Currency

There are some national currencies that are held by central banks around the world as a part of their foreign exchange reserves as they are accepted in the international markets for all types of transactions like payment for imports, debt servicing etc. For example, US dollar, Japanese yen, Euro etc. It is held not only by the central banks but also firms and individuals as it is considered a hard currency or safe-haven currency. U.S. dollar is the most preferred and makes up 64 percent of all known central bank foreign exchange reserve. More than 85 percent of forex trading involves the U.S. dollar. 39 percent of the world's debt is issued in dollars. The reason for the dollar gaining the predominant position was that in 1944 the Bretton Woods Agreement assigned a unique status to the US dollar - it took the world off the gold standard and made the US dollar the basis for other counties printing their currencies. That is, US dollar ws made the global reserve currency. They could hold US dollars instead of gold. When they wanted to convert the dollars into gold, US would exchange. US dollar was printed on the basis of gold holding. It meant that all countries held dollar; dollar dominated the world; all others used the dollar to buy US goods; dollar was in huge demand; others were grossly undervalued. But they felt inflationary pressures. It worked well when the US held sway over the world- till the end of sixties. When Japan and Germany and others were coming up, they defied it and wanted their own currencies also to emerge as global reserve currencies. When they wanted gold for dollars, Richard Nixon changed the system and discontinued with the gold standard for the USA. That is, even the US dollar was not tied to the gold reserves. In other words, since 1971, the amount of currency that US printed is not linked to gold. Each country followed its own standard (gold standard is followed when a country promises the holders of its currency to redeem their currencies for their value in gold upon demand). The next most popular reserve currency is the euro. About 20% (2017) of known central bank foreign currency reserves were in euros.Most of the other currencies are only used inside their own countries. Whether a currency becomes a reserve currency or not does not depend on the size of the currency. Swiss economy is worth only $660 billion (2017) but has been one for many years. China was more than $5 trillion 10 years back and was not.

(Bretton Woods Agreement 1944 was decided upon at the United Nations Monetary and Financial Conference held in Bretton Woods, New Hampshire, in 1944. The creation of the International Monetary Fund (IMF) and World Bank Group and valuation of gold and foreign exchange rates was the contribution of 44 countries that met to create a new international monetary system. The main goals of the meeting of the 730 delegates were to ensure a foreign exchange rate system, prevent competitive devaluations and promote economic growth.)

The reasons for any national currency to emerge as a global currency are that it should have strength in the form of a large economy; it should have performed well for decades; it should be stable which the central bank should be able to ensure; there should be adequate amount of the currency in global markets to convert it into other currencies and vice versa. If a currency satisfies these features, it can be accepted across the world.

If a currency is held by others, it has a great advantage: other countries will hold it. They do not hold it as currency as it does not fetch returns. They buy government bonds with it. For example, US dollar is held, it is held as US government security which fetches some returns. It means, world will give USA the dollars that it holds and US will exchange it for US government securities. These securities are thus sold for an interest rate that is negligible-1% or so. It means, the rate at which US raises loans is very cheap. That reflects on the global trust in these bonds. US spends the money for its own growth and consumption.

Hard And Soft Currency

In line with the explanation of global reserve currency above, hard currency is any globally traded currency that is liquid(adequate supply) and stable (does not fluctuate much). Such currency is in global demand as a store of value. Long-term stability, fiscal and economic policies of the country, strength of the economy etc are the relevant factors behind the emergence as a hard currency.It becomes a safe haven currency.Soft currency exhibits opposite features.

Flight of Capital

When financial assets or money rapidly leave a country due to the understanding that the economy is not doing well; or is imposing controls that will mean losses; or is likely to makes policies that are inimical for investments, government facing sovereign debt crisis defaulting on its debt etc. Any of these events will cause loss of confidence in the economy. When flight of capital takes place, exchange rate drops thus causing even greater flight and harm to the economy. The country's currency will lose value and the purchasing power. High inflation will result .The problem is worse if the country is import dependent. In such a situation- either before after the capital flight, the country will resort to capital controls.

Capital Controls

In 2017, China imposed regulations targeting "irrational" overseas investments in the property, entertainment and sports sectors. In 2015, Greece imposed capital controls on foreign currency outflows. In India, in August 2013, the Reserve Bank of India (RBI) imposed partial capital restrictions on companies and individuals to stabilise the rapidly weakening rupee. Overseas direct investment by Indian companies was cut by three-fourths, making it more difficult for local corporate entities to buy overseas assets. RBI also lowered overseas remittances by locals to $75,000 a year from $200,000, and prohibited investments in overseas property. These measures were rolled back after the rupee stabilized.

These measures constitute 'capital controls': Any measure taken by a government, central bank or other regulatory body to limit the flow of foreign capital in and out of the domestic economy. These controls include taxes (Tobin tax), quantitative restrictions etc.

They are not confined to capital account as the above mentioned RBI policies include remittances too which are in the current account. These controls can be economy-wide or specific to either a sector or industry as can be inferred from above.

Capital controls are temporary and are aimed at stabilization. In the long run they limit economic progress and efficiency.