Exchange Rate Developments

55. After reasonable stability lasting for a period of about eighteen months, the exchange rate of the rupee against the US dollar came under downward pressure beginning August 20, 1997 and the pressure on the exchange rate continued till September 8, 1997. Between August 19 and September 8, the rupee had depreciated against the US dollar by 2.7 per cent from Rs.35.71 on August 19 to Rs.36.69 on September 8. Thereafter, the rupee-dollar rate showed a tendency to appreciate. In early November 97, the rupee came under renewed downward pressure. At the end of March 1998, the exchange rate vis-à-vis the US dollar fell to Rs.39.50, recording a cumulative depreciation of about 9.1 per cent from the March 31, 1997 level.

56. The movement in the exchange rate of the rupee in late August 1997 may be partly attributed to the contagion effect of the currency turmoil in Southeast Asia (Box 6.2). To the speculative pressures generated by the Asian currency crisis

BOX 6.2

Recommendations of the Committee on Capital Account Convertibility

- The Committee recommended that the implementation of CAC be spread over 1997-98 to 1999-2000, and sequenced along with progress towards attainment of the pre-conditions / signposts stipulated for the relevant year, and depending on the assessment of authorities, the implementation of measures could be accelerated or decelerated.
- Fiscal consolidation, a mandated inflation target and strengthening of the financial system should be regarded as crucial pre-conditions/signposts for CAC in India. In addition, a few important macro economic indicators, viz. exchange rate policy, the balance of payments and the adequacy of foreign exchange reserves should be assessed on an on-going basis.

The measures recommended to be progressively phased over three years (in brief):

- For resident corporate/business : liberalisation of measures in respect of issue of foreign currency denominated bonds (rupee settlements), financial capital transfer abroad, loans from non residents, opening offices abroad, direct investments abroad, repatriation of dividends, and use of foreign exchange by the exporters and the foreign exchange earners. Long term ECB be kept outside ceiling. Queuing for the implementation of ceiling to avoid crowding out of the small borrowers by the big ones. Recommendation for the FCCB/FRNs same as that of ECB.
- For the resident banks: liberalisation in matters of Bank's borrowing from overseas market, use of funds and repayments, accepting deposits and extending loans in foreign currencies, investing in overseas market, use of funds and repayments, accepting deposits and extending loans in foreign currencies, investing in overseas market, fund based/non fund based facilities to Indian joint ventures, buyers' credit/acceptance for financing importers buying from India and forfaiting.
- For the non resident banks, allowing forward cover in Rupee Accounts, cancelling/re-booking, enhanced overdraft limit and limited investment.
- Overseas investments by SEBI registered Indian investors (including Mutual Funds), and short-term borrowing by the All India Financial Institutions within limits.
- Maturity restrictions on FII investments in debt instruments be removed, and investment in rupee debt securities be subjected to a separate ceiling and not ECB ceiling.
- For resident individuals: allowing foreign currency denominated deposits, foreign capital transfer, and liberalisation of repatriation norms.
- For non residents: capital transfers from non-repatriable assets held in India be allowed subject to ceilings.
- To allow forward market, derivatives, and futures.
- Participation in international commodity market.
- Deregulation of deposit rates with removal of minimum period restrictions. Level playing field for all banks, FIs, and NBFCs regarding reserve requirements and prudential norms.
- Development of Treasury bill market and access to FIIs in it.
- Prominent roles of the Primary Dealers and the Satellite Dealers.
- Setting up Office of the Public Debt to handle part of issue of dated securities and Treasury bills.
- Development of gold market with participation of banks and financial institutions, gold denominated deposits and loans, and gold derivatives.
- Replacement of the requirement of prior approval of the RBI with subsequent reporting, and dispensing with such requirements in case of dis-investment in a number of cases concerning investments by both residents and non residents.

was added an element of political uncertainty in November 1997. This may have contributed to the renewed volatility in the exchange rate in early November 1997. The RBI intervened in foreign exchange (spot and forward) markets and deployed a range of monetary measures to effectively counter the speculative pressures on the Indian rupee in the foreign exchange market.

57. The movement in the exchange rate till March 1998, nevertheless, corrected for the appreciation of the rupee in real effective exchange rate terms, which had occurred over the last one year or so because of the inflation differential between India and her major trading partner countries. The five-currency export weighted real effective exchange rate of the rupee, which by August 1997 had appreciated by 6.4 per cent from its average value during 1996-97, showed an appreciation of only 1.7 per cent by March 1998 (See Appendix table 6.6). This correction in the exchange rate of the rupee checked the erosion in the competitive position of Indian exporters against their competitors in South Asia and neighbouring countries, the currencies of which have depreciated sharply.

58. Exchange rate management continues its focus on smoothing excessive volatility in the exchange rate and maintaining orderly market conditions to ensure that the exchange rate remains consistent with economic fundamentals. India’s economic fundamentals are reasonably good, but in recent months there has been an unusual degree of uncertainty prevailing in the international arena and to some extent in the domestic area. The key priorities for macro-economic policy in the present environment will have to be a pragmatic and flexible exchange rate policy, careful monetary management, control of the fiscal deficit, continued tight controls on short-term external indebtedness and accelerated reform and strengthening of the financial sector, especially banking and insurance.

BOX 6.3
East Asian Currency Crisis

- The currencies of East Asian countries came under severe downward pressure during 1997. Fundamental changes in the external and internal environment of several Southeast Asian countries, resulted in substantial loss of foreign exchange reserves during the first half of 1997, because of unsuccessful attempts to maintain exchange rate pegs and bands.
- The crisis first came out into the open in Thailand where doubts about sustainability of the exchange rate peg (to a basket dominated by the US dollar) prompted a run on the currency in mid-May 1997. There were significant spillover effects on other countries in the region, notably Indonesia, Malaysia, and the Philippines. The Thai baht and the Philippine peso came under renewed pressure in late June 1997 and early July 1997, leading authorities to abandon their respective pegs in early July. The baht had lost around 16 percent against the US dollar in a single day on July 2, 1997. This unleashed a flurry of speculative activity in other ASEAN currencies. The Korean won, which was relatively stable until mid-October 1997, has depreciated sharply since then.
- Between end June 1997 and end March 1998, depreciation of these currencies vis-à-vis US dollar ranged between 11% and 74%: Indonesian Rupiah (74%), Thailand baht (37%), Malaysian ringgit (31%), Philippine peso (33%), South Korean won (36%), and Singapore dollar (11%).
- Investor confidence declined leading to sharp declines in equity prices in the stock markets of these countries. Compared with June 1997, the stock prices in January 1998 had declined in the range of 32 per cent (in Thailand) to 53 per cent (in Malaysia).
- Inflation is likely to accelerate sharply, partly because of the pass through effect of exchange rate depreciation, which is significant given their trade to GDP ratios of 50% to 120%.

Possible Causes

A number of possible causes have been advanced to explain the onset and spread of the East-Asian currency crisis, including :

- Absence of a lender of resort to stem panics.
- Imprudent lending by international lenders.
- High and unsustainable level of current account deficit.
- High short-term foreign debt.
- Large real effective exchange rate appreciation.
- Inefficient lending and fragility of the financial sector, arising from lack of adherence of financial intermediaries to prudential norms concerning capital adequacy, asset classification, provisioning, and absence of disclosure requirements.

Specific facts relating to these factors which have been cited for individual countries are,

- Indonesia, Malaysia, Philippines, Singapore and Thailand experienced sustained real effective exchange rate appreciation over the last five years. The cumulative real effective exchange rate appreciation during 1991 to May 1997 was about 47 per cent in Philippines, 17 per cent in Malaysia, about 16 per cent in Singapore, about 12 per cent in Thailand and about 11 per cent in Indonesia.
- The current account deficit as a per cent of GDP in 1996 was as high as 8.0 per cent in Thailand, about 5.0 per cent each in Korea, Malaysia, and Philippines and 3.4 per cent in Indonesia.
- External debt as a proportion of GDP in 1996 was very high at about 50 per cent in Thailand, Indonesia and Philippines. It was relatively high at 33 per cent for Malaysia.
- The proportion of short-term debt in total external debt had increased to 50 per cent in Thailand, 26 per cent in Korea, and 18 per cent in Indonesia.
- Inadequacies in regulation and intermediation were reflected in imprudent real estate loans. Such lending continued despite signs since 1993 that the property market was overbuilt while demand had weakened. Real estate exposure by banking sector was about 34 per cent in Singapore, 27 per cent in Philippines, 26 per cent in Malaysia, about 16 per cent in Korea and over 13 per cent in Thailand.

Indian Fundamentals

- In contrast, India's economic fundamentals are reasonably strong. During 1991-92 to 1996-97, the deficit on current account of balance of payments averaged about 1.1 per cent per annum and it is estimated to be about 1.5 per cent in 1997-98. India's external debt, as a per cent of GDP, declined from about 26 per cent at the end of 1996-97 to about 24 per cent at the end of September 1997. Short-term external debt as a proportion of total external debt was only 7.3 per cent at end March 1997 and has declined to 6.3 per cent at end September 1997. Debt service payments, as a proportion of current receipts, which was over 35 per cent in 1990-91, had declined gradually to about 21.4 per cent in 1996-97 and it is estimated to decline further to about 18 per cent in 1997-98.
- The financial sector prudential norms and supervision have been introduced in 1992-93 and gradually and continuously strengthened since then.