State’s Monetary Intervention through Sterilization and Crawling Peg during Domestic Currency Appreciation – A Lesson for India from China

Sukanta Chandra Swain  
Faculty Member, IBS, Bhubaneswar, Orissa  
E-mail: sukantha_swain@yahoo.com/sukanta@ibsindia.org

ABSTRACT

Multi-faceted human wants and very complex division of labour have forced the economies of recent years to be outward-oriented. To add this, the liberalization and globalization policies adopted by the economies now pave the way for free flow of international capital, thereby insisting the values of the currencies to fluctuate. Specifically, the currencies of highly progressing economies like China and India are facing tremendous pressure for their appreciation. As domestic currency appreciates, the exporters of the country lose international competitiveness, as exports become costlier and imports become cheaper, which may lead to severe macroeconomic imbalances like unexpected outflows of capital and unemployment. To avoid these repercussions of currency appreciation, the central bank of the country may try to resist currency appreciation by buying foreign exchange from the market in exchange of domestic currencies, thereby adding more money and inviting inflationary pressure to the system. In order to manage excess liquidity, the central bank resorts to sterilization, i.e. operations meant to suck out excess liquidity from the system. In recent period both china and India are experiencing the tendencies of currency appreciation backed by excess liquidity and inflation. While China has become successful in managing this complex problem with its protected exchange rate regime (Crawling Peg) and sterilization operations, India has failed to do so. This paper tries to focus on tackling this problem of India in line with the Chinese experience, of course not exactly imitating China.

Key Words: Currency Appreciation, Sterilization, Crawling Peg, Exchange Rate Regime, Excess Liquidity, Inflation, India & China

INTRODUCTION

The appreciation of Indian rupee (INR) against the US dollar (USD) has been the topic for hot discussion since last couple of months as it has pushed down the exporters’ revenues. Particularly the Indian outsourcers, who were as such struggling with rising staff salaries, have got tremendous pressure as an appreciated rupee has added considerably to their worries. As a consequence, for their sustenance, they have started firing the employees without looking into the bread and butter of the skilled workers. Still some analysts comment that the present rupee appreciation is not a matter of concern as it has been cropped up automatically by the good performance in our BoP and the exporters may lose their revenue now for a shorter span but must not erode their competitiveness as other currencies too have appreciated against the US dollar. Those analysts are right on their stand as the rising rupee has two edges - to some it’s a boon, where as for some others a bane.

But looking into the gloomy career of the skilled workers, particularly software personnel, we should think of how to manage the present situation in order to maintain a competitive exchange rate like China. Indian economy now is not facing the singular problem of exchange rate management. Rather, along with it, the problems of liquidity management and inflation have made the problem a composite one for the economy. Because of low credit off take in so called busy season, the bankers are as such having surplus liquidity with them and to it, rupee appreciation also adds fire as to counter excess inflow of foreign currency, the monetary authority has to purchase those from the public in order to resist rupee appreciation, thereby adding further liquidity to the system, which aggravates the inflationary pressure. Thus the present composite problem of rupee appreciation, excess liquidity and inflation is to be properly managed for the
betterment of economic health of India.

The objective of this paper is to focus on managing the present problem of currency appreciation in India through monetary intervention in exchange rate regime, as very effectively done by China in order to sustain its competitive exchange today in spite of every possibility of its currency appreciation considerably. More specifically, this paper tries to highlight two monetary tools – Sterilization and Crawling Peg for managing the present problem of rising rupee, as a lesson from China.

Currency of a country is said to be appreciated if one unit of it can command more of any foreign currency or for one unit of any foreign currency less of it is required to pay as compared to previous period. Domestic currency appreciates as the supply of foreign currencies goes up via more foreign inflows either in current account or in capital account or in both the accounts of the country’s BoP. Since last couple of months the Indian rupee has been getting appreciated in terms of a basket of foreign currencies. However, this paper will primarily highlight the Indian rupee appreciation in terms of the US dollar. It’s because the Indian outsourcers, who are the hardest hit for a rising rupee and basically for whom an appreciated Indian rupee is considered as a problem for the economy as a whole, have two-thirds of their business with the US. Thus the present composite problem of India economy is inherited from the Indian rupee appreciation in terms of the US dollar. To resist the rising trend of India rupee, the Indian government/the RBI may go for sterilization or Crawling Peg or both. While sterilization is an indirect approach to resist currency appreciation by de-motivating foreign investors, the crawling peg is a direct approach to it by setting the official exchange rate of the domestic currency in terms of foreign currencies periodically as per requirements.

Sterilization is a form of monetary action; say lowering the bank rate, initiated to counteract the effects of a changing monetary base resulted from excess inflow of foreign exchange. But a Pegged exchange rate (or Fixed exchange rate) or simply a Peg is a rate the central bank of the country sets and maintains as the official exchange rate, which may be higher or lower than the market exchange rate (or floating exchange rate) depending upon the situation. If the central bank of the country reassesses the value of the peg periodically and changes the peg rate accordingly to stabilize the economy, then that peg is called crawling peg (or floating peg). In spite of much larger inflow of foreign currencies (particularly, the US dollar) to China than to India, China has succeeded maintaining a competitive exchange rate by adopting these two tools. This paper tries to explain whether the Chinese experience to manage exchange rate, liquidity and inflation will work in Indian scenario.

The plan of the paper is as follows. While section-2 of this paper highlights the choice of India’s exchange rate regime, in past and present, out of alternative regimes, section-3 outwardly focus on the present problem of Indian rupee appreciation vis-à-vis the US dollar; its causes and worries. In order to know the Chinese experience in such a situation or even in a graver situation, China’s exchange rate regime has been briefly placed in section-4. Section-5 concentrates on the strategies during rupee appreciation; adopted so far and to be adopted in India in order to manage the problem of exchange rate and liquidity. And last but not the least is concluding remarks and suggestions placed in section-6 of the paper.

2. India’s Exchange Rate Regime

The rate at which the currency of one country gets exchanged internationally is called the exchange rate of that currency. Due to rapidly increasing integration of global financial markets and increased capital mobility across the world, exposure to exchange rate risks has also increased in recent years. Accordingly, the problem of choice of an appropriate exchange rate regime has been cropped up in order to manage the foreign exchange reserves. Particularly, in countries like China and India this problem is very sensitive as the foreign exchange reserves in these countries are accumulated very fast in last couple of years.

2.1. Alternative Exchange Rate Regimes

The problem of choice is there where alternatives are there. In the context of exchange rate regime also three alternatives are available, out of which one is to be picked up, keeping the economic scenario of the country concerned in mind. Out of these three, two are extreme cases of exchange rate regime, such as the Fixed (or Pegged) exchange rate regime and the Floating (or Market-determined) exchange rate regime. And the third one refers to a number of intermediate
regimes which combine some important features of these two extreme regimes in different ways.

2.1.1. Fixed or Pegged Exchange Rate Regime

Fixed or pegged exchange rate regime is the protected one as the monetary authority of the country determines the official exchange rate of own currency keeping the economic situation of the country in mind. And to maintain the official exchange rate so determined, the authority buys and sells the domestic currency in exchange of the foreign currency with which the former is pegged. However, this pegged rate is not fixed for ever. The authority may change the official exchange rate by changing the pegged band whenever the economic situation demands to do so. As a pegged exchanged rate regime provides credibility, transparency, very low inflation and financial stability, it is suitable for developing countries in order to achieve the planned economic development.

2.1.2. Floating or Flexible Exchange Rate Regime

Under floating (or flexible) exchange rate regime, the rate of exchange of a domestic currency gets determined by the free play of demand and supply forces. In this case, there is no government/central bank intervention in the exchange rate regime of the country. If the demand for any foreign currency is more than its supply in a country then the exchange value of that foreign currency in terms of domestic currency will be more or alternatively, the exchange value of the domestic currency in terms of that foreign currency will be less and the vice versa. In this process, while the fall in the exchange value of a currency in terms of other currency/currencies is called currency depreciation or simply depreciation, the rise in the exchange value of a currency in terms of other currency/currencies is called currency appreciation or simply appreciation.

Floating exchange rate regime is quite simple in its operative mechanism as under this system, the exchange rate moves automatically and freely to equate supply and demand, thereby establishing equilibrium in the balance of payments of a country. Some critics of this regime advocate that because of frequent fluctuating exchange rate, the exporters and importers get discouraged as they lose confidence on their returns. But that can be easily avoided. The technique of forward exchange transactions can protect the importers and exporters from financial losses consequent upon fluctuating exchange rate.

2.1.3. Intermediate Exchange Rate Regime

Neither a constantly flexible nor a rigidly fixed rate of exchange is in the interest of any country for all time to come as both of these regimes have their situational flaws. While fixed exchange rate places the burden of adjustment in the balance of payments of a country on domestic income and prices, the floating exchange rate leads to massive capital outflows or unnecessary capital inflows as it encourages speculative activities. Between the two extremes of 'hard peg' and 'full float', there is a large spectrum of exchange rate systems, conveniently clubbed to designate 'intermediate exchange rate regime', that combine features of these two regimes in various degrees.

Under intermediate exchange regime, two alternatives are there to be highlighted; 'fixed but adjustable exchange rate' (or crawling peg) and 'managed floating exchange rate'. Fixed but adjustable exchange rate regime or Crawling peg regime is an exchange rate regime usually seen as a part of fixed exchange rate regimes which allows depreciation or appreciation in an exchange rate gradually for the sake of stabilization of the economy. In fact, it is a system of exchange rate adjustment in which a currency with a fixed exchange rate is allowed to fluctuate within a band of rates. Under this regime, the term 'adjustable' may mean to a tight band (or Target Zone) or crawling band. Under tight band or target zone, the exchange rate is restricted to moving in the space, defining the lower and upper limits of fluctuation. As in the tight band, there are also upper and lower bounds for the exchange rate in a crawling band system. However, the fluctuation band (range) is not constant but fluctuating each period as per requirements. If the crawl rate is sufficiently high, the crawling band is similar to a free float regime.

Intervention in the foreign exchange market by the monetary authorities or governments of the economies now is very common. Even those who claim for having a freely floating exchange rate are also not an exception. In most cases floating means 'managed floating' which, in fact, a form of intermediate exchange rate regime. Although the managed floating exchange rate is basically floating in nature, it invites state intervention in the exchange rate market if movements
are believed to be destabilizing in the short run. Due to full emphasis on 'opening up' in international trade by eliminating any sort of artificial restrictions, there is an increasing pressure on the developing countries to adopt a fully floating exchange rate regime. But most of these countries have resisted these pressures as free float carries the risk of volatility, which would unsettle entire external sector of these economies via speculative market activities.

Between the two intermediate exchange rate regimes, while 'crawling peg' or 'fixed but adjustable exchange rate regime is more fixed and less floating, the 'managed floating exchange rate' is more floating and less fixed. If a country is in transition from underdevelopment to developing or development, it should go for crawling peg as that will cause sustainable development of the economy.

2.2. India’s choice: Past and Present

Among the alternative exchange rate regimes explained in the previous section, picking up the suitable one/s is vital as present day economic scenario of any country has strong bearing with the country's exchange rate regime. In fact, effective exchange rate management is now primary concern of any country and only befitted exchange rate regime will be capable to manage exchange rate effectively. Sustainable current account deficit and manageable foreign exchange situation are the indicators of an effective exchange rate management with minimal volatility and negligible destabilizing activities. The following paragraphs show India’s choice of exchange rate regime in different periods and varied situations.

Over the last five and half decades since independence, the exchange rate regime in India has transitioned from a fixed exchange rate regime to the market-determined (floating) exchange rate regime. Up to 1970s since independence, Indian rupee was pegged to the Pound Sterling on account of historic link with Britain. During 1970s and 1980s it was pegged to a basket of currencies (most of the major currencies). But a market determined exchange rate regime has been prevailing in India since March 1993.

2.2.1. The Par Value Regime

During India’s independence, the par value system of The IMF was operational in exchange rate regime of almost all the countries. Under this Par value system, country's currency was valued in terms of gold. Accordingly, the external par value of Indian rupee, after India’s independence, was fixed at 4.15 grains of the fine gold as per the Par value system of the IMF. In terms of currencies, the exchange rate was equivalent to one pound sterling = 13.33 Indian rupees (or one US dollar = 4.76 Indian rupees) in September 1949. The country had been practicing this par value system of the IMF till the collapse of the Bretton Woods System in 1971.

2.2.2. The Pegged Regime

Since the break down of Bretton Woods System in 1971 the pegged regime replaced the traditional par value system and was operational up to 1992. India pegged its currency to the US dollar from August, 1971 to December 1991 and to the pound sterling from December, 1971 to September, 1975. After the break down of the Bretton Woods system, there was downward pressure on the pound sterling vis-à-vis major international currencies. As Indian rupee was pegged to pound sterling, there was misalignment of the Indian rupee vis-à-vis other currencies. Thus India experienced the flaws associated with a single currency peg. To overcome these flaws, with effect from September, 1975, Indian rupee was delinked from the pound and pegged to a basket of currencies of India's major trading partners. This system remained operational till 1992. So during the period 1975-1992, the exchange rate of Indian rupee officially determined by the Reserve Bank of India within a nominal band of ± 5 per cent of the weighted basket of currencies of India's major trading partners.

2.2.3 Market-Determined Regime (Managed floating Regime)

The transition to a market determined system was sequenced on the basis of the Report of the High Level Committee on Balance of Payments (BoP) chaired by C. Rangarajan. The first step in this transition was the introduction of partial convertibility of rupee in 1992-93 Budget, known as Liberalized Exchange Rate Management System (LERMS). This was followed by market-determined exchange rate regime in 1993. Under LERMS, a dual exchange rate was fixed, on the basis of which, 40 per cent of foreign exchange earnings were to be surrendered at the official exchange rate while the remaining 60 per cent were
to be converted at a market-determined rate. That was nothing but 60 percent convertibility of Indian rupee. Since the official exchange rate was lower than the market rate, this system meant taxing the exporters to subsidize the government's bulk imports. Due to LERMS India achieved a fair degree of stability as it helped to build up a considerable foreign exchange reserves in the country.

Looking into the size of our foreign exchange reserves, the government felt necessity to abandon the dual exchange rate so far existed in the system. Therefore Indian Union Budget 1993-94 adopted the unified exchange rate regime under which the 60:40 (i.e. market-determined to official) ratio was extended to 100 percent conversion. This 100 per cent conversion was extended for almost the entire merchandise trade transactions and all receipts, whether on current or capital account of BoP, but not all payments. On the contrary, the official RBI rate also stayed on for the conversion of items not permitted under the unified market rate. Thus more than half a dozen of invisible items of current account as well as capital account were covered by the official RBI rate.

It clearly shows that the 1993-94 Budget adopted full convertibility on trade account, i.e. a part of current account. However, in February 1994, the RBI undertook several steps towards achieving current account convertibility. It announced relaxations in payment restrictions for a number of invisible transactions and liberalizations of exchange control regulations up to a specified limit relating to i) exchange earners' foreign currency (EEFC) accounts, ii) basic travel quota, iii) studies abroad, iv) gift remittances, v) donations, and vi) payments of certain services rendered by foreign parties. Current account convertibility was finally achieved in August 1994.

Regarding capital account convertibility, India has been bit conservative as the financial crisis witnessed in a number of countries across the world during 1990s was due to the problems in capital account of BoP. However, capital account transactions were gradually liberalized in India. Restrictions on inflows were relaxed first. While liberalizing the inflows, there was an emphasis on encouraging foreign direct investment and portfolio investment which were progressively liberalized. Liberalization of commercial borrowings was also undertaken but focus here was concentrated on liberalization of long term borrowings while short term borrowings were discouraged. Recently, with consolidation in the external sector, restrictions on outflows have also been liberalized. In fact, a number of steps have been taken in recent years to liberalize the capital account of India's BoP but we are still far away from full capital account convertibility as capital account convertibility has more risks than benefits. Therefore, although India's present exchange rate regime seems to be floating, it's in reality a managed floating exchange rate regime. However, the regime is more floating less managed.

3. Recent Indian Rupee Appreciation: causes and worries

As we flex our economic muscle, rupee appreciation would be a natural consequence as a currency reflects the brand image of a nation. Since we have been performing better in the economic arena for last couple of years, our currency has to do well in terms of others and also has done the same. It's in fact not all of a sudden or very strange as we have been struggling for the same. But in reality the point to analyze is 'are we really good in our performance?', which can be well-assessed by looking into the BoP statements of our country. The subsequent part of this section of the paper deals with this issue. It is not right to show our indifferent attitude by feeling that the extent of rupee appreciation is not enough to create worries. The very fact that the rupee has moved from Rs 46.20 for an US dollar in May 2006 (or Rs 49.00 for an US dollar in 2002) to the recent level of Rs 39.58 (October 4, 2007), with intermittent ups and downs is a clear indication that the RBI has allowed some flexibility in the key exchange rate. The table - 3.1 shows the performance of Indian rupee in terms of major foreign currencies in recent period.
The table above clearly depicts that Indian rupee has been appreciated in terms of all four major foreign currencies in recent period. Although the percentage wise it has been appreciated the maximum in terms of Yen, even higher appreciation than in terms of the US dollar, this paper concentrates on Indian rupee appreciation vis-à-vis the US dollar because of the following two points. First, India's economic condition is largely dependent on the US, the most important trade partner of India. For example, the Indian outsourcing companies, which are the worst affected due to rupee appreciation, have two thirds of their business with the US. Second, Most of India's international trade is invoiced in the US dollar. And from the table it's found that between May 2006 and October 2007 there is 14.32% appreciation of Indian rupee in terms of the US dollar. Being a developing economy, this percentage of rupee appreciation is really a point for headache. And accordingly, pondering over the reasons for the same is inevitable.

3.1. Causes of INR appreciation vis-à-vis USD

While appreciation refers to the rise in the price of currency in terms of another currency, depreciation refers to the fall in it. Generally the demand for and the supply of any currency determines the price of the said currency. In recent period the INR has been appreciating in terms of the USD or the USD has been depreciating in terms of the INR. How is that? Pertaining to this query, following three genuine alternatives come into mind; i) if the demand for the USD remaining unchanged, the supply of it increases in India, ii) if the supply of the USD remaining unchanged, the demand for it falls in India and iii) if both the supply of and demand for the USD in India increases but the rate of increase in supply is more than that in demand. Out of these three, the third alternative is responsible for the INR appreciation in terms the USD.

After knowing the above mentioned fact, any one will definitely be keen to know the sources of the demand for and the supply of the USD in India. The items of the Balance of Payments (BoP) statement of India will best explain this point. BoP of India is a systematic record of its monetary transactions with other countries of the world during a given period. While the receipts side of India's BoP exhibits the supply of the USD in India, the payments side of it reflects the demand for the USD in India. The current account and the capital account taken together constitute the BoP statement of the country. The items such as export of goods, export of services, unilateral receipts or transfers (receipt of gifts, donations, grants, etc.), factor income received and investment income received are the sources of the supply of the USD in India under current account, the items such as import of goods, import of services, unilateral payments or transfers (payment of gifts, donations, grants, etc.), factor income paid and investment income paid are the sources of the demand for the USD in India under capital account. Similarly under capital account, the items such as external assistance to India, commercial borrowings (both short term and long term) to India, NRI deposits in India and foreign investment (both direct and portfolio) in India are the sources of the supply of the USD in India, the items such as external assistance by India to abroad, commercial lending (both short term and long term) to abroad, Indian deposits in abroad and investment (both direct and portfolio) made by India in abroad are the sources of the demand for the USD.

As we know, the appreciation of the INR vis-à-vis the USD is the result of the higher rate of increase in the
supply of the USD in India as compared to that in the demand for it. If this situation is due to the better performance in current account of BoP then it is good and for that no need of resisting the INR appreciation. But if this outcome is due to greater surplus in capital account of BoP, then that is not good and for that our trial to resist the appreciation of the INR is useful. Again if the supply of the USD in India is more due to large exports of goods and services, the situation is still better and is most welcome. And if it’s due to more export of goods (visibles) only, i.e. due to merchandise trade surplus or simply trade surplus, then the situation is the best. To know which of the above alternatives is to take the credit of recent appreciation of INR vis-à-vis the USD, we have to look into the BoP performance of India in recent periods.

The data presented in table 3.1.1 reflect the BoP statement of the country in the first half of the financial year 2007-08, where in the partially revised (PR) data of the first quarter and the preliminary (P) data of the second quarter are considered.

<table>
<thead>
<tr>
<th>Table 3.1.1: Major Items of India’s BoP: April-September 2007 (US $ million)</th>
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</thead>
<tbody>
<tr>
<td>Item</td>
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<tr>
<td></td>
</tr>
<tr>
<td>1. Exports</td>
</tr>
<tr>
<td>2. Imports</td>
</tr>
<tr>
<td>3. Trade Balance (1-2)</td>
</tr>
<tr>
<td>4. Invisibles, net</td>
</tr>
<tr>
<td>5. Current Account balance (3+4)</td>
</tr>
<tr>
<td>6. Capital Account Balance*</td>
</tr>
<tr>
<td>7. Change in Reserves# (- indicates increase)</td>
</tr>
</tbody>
</table>

*: Including errors and omissions. #: On BoP basis excluding valuation. P: Preliminary. PR: Partially Revised


On the basis of the information presented in table 3.1.1 pertaining to the BoP of India for the first half of the financial year 2007-08, the following legitimate conclusions can be drawn.

1. As per the data released by DGCI&S (Director General of Commercial Intelligence and Statistics), the widened merchandised trade deficit of USD 42.4 billion in the first two quarters of 2007-08 as compared to USD 33.8 billion during the same period in the previous fiscal was due to fall in export growth and hike in non-oil imports. In such a situation there is no point to give the credit to merchandise trade for highly increasing supply of USD in India leading to the appreciation of INR.

2. The invisible surplus was higher at USD 31.7 billion in April-September 2007 as compared to USD 23.4 billion in April-September 2006 only because of larger private transfers (USD 19 billion in April-September 2007 as compared to USD 12.7 billion in April-September 2006) and substantial investment income (USD 6142 million in April-September 2007 as compared to USD 3816 million in April-September 2006).

3. Despite an invisible surplus, the current account deficit increased to USD 10.7 billion in April-September 2007 from USD 10.3 billion in April-September 2006 due to higher trade deficit. So the credit of increased supply of USD in India leading to appreciation of INR vis-à-vis the USD can never go to current account items.

As there is no contribution from current account of India’s BoP for recent appreciation of the INR vis-à-vis the USD, it’s the capital account which is solely responsible for this. As per the above BoP statement,
the capital account balance (including errors and
omissions) in April-September 2007 (USD 51,149
million) is nearly three times of that in April-September
2006 (USD 18,989 million). To know, under capital
account, which are those items mainly responsible for
this exceptional hike in capital inflows to India, the
contribution of different items to this is compiled below
in table 3.1.2.

<table>
<thead>
<tr>
<th>Item</th>
<th>April-September</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2007-08</td>
</tr>
<tr>
<td>1. Foreign Direct Investment</td>
<td>3,880</td>
</tr>
<tr>
<td>2. portfolio Investment</td>
<td>18,334</td>
</tr>
<tr>
<td>3. External Assistance</td>
<td>729</td>
</tr>
<tr>
<td>4. External Commercial Borrowings (ECBs)</td>
<td>10,557</td>
</tr>
<tr>
<td>5. NRI Deposits</td>
<td>-78</td>
</tr>
<tr>
<td>6. Other Banking Capital</td>
<td>5,341</td>
</tr>
<tr>
<td>7. Short-term Trade Credits</td>
<td>5,711</td>
</tr>
<tr>
<td>8. Rupee Debt Services</td>
<td>-44</td>
</tr>
<tr>
<td>9. Other Capital</td>
<td>5,978</td>
</tr>
<tr>
<td>Total (1 to 9)</td>
<td>50,408</td>
</tr>
</tbody>
</table>


As per the table 3.1.2, under net capital flows, portfolio
investment, External commercial borrowings (ECBs),
banking capital and short term trade credits showed
higher growth during April-September 2007. So these
items are the real players for recent appreciation of
the INR vis-à-vis the USD as they cause considerable
inflow of the USD to India. Because of these items of
capital account, foreign exchange reserves recorded
an increase of the USD 48.6 billion during April-
September 2007 as against an increase of the USD 13.7 billion during the corresponding period of
the previous year. In this context, a pertinent question
comes into mind – why this substantial change? The
reasons for this great change are:

- Sustained momentum of domestic economic
  activity
- Better corporate performance
- Positive investment climate
- Long term view of India as the investment
  destination
- Favourable liquidity and interest rates in global
  market

However, the major sources of net capital flows to India
were ECBs and portfolio investment. The causes of
higher net ECB flows to India were favourable liquidity
and the interest rates in the global markets on the one
hand and rising financing requirements for capacity
expansion domestically on the other hand.

Under portfolio investment, two items are covered – i) i)
Foreign Institutional Investment and ii) Overseas equity
issues of Indian companies via Global Depository Ratio
(GDR) and American Deposit Ratio (ADR). Net inflows
by foreign institutional investors were USD 7.1 billion
during Q, of 2007-08 reflecting the better corporate
performance as well as strong domestic equity markets
in consonance with the trends in Asian stock markets.
The inflows under ADRs/GDRs amounted to USD 308
million in April-September 2007. Taken together, net
portfolio flows amounted to USD 7.5 billion in Q, of
2007-08. Participatory Notes (PNs) also contribute a
lot for capital inflow to India. An estimate entails that
out of total foreign portfolio inflows, the share of PNs
was around 50 per cent by October 2007 as compared
to 32 per cent during 2006.

However the RBI's choice to remain passive in foreign
exchange market and considerable relaxation on
capital account transaction of the country are the route
cause of greater capital inflows mostly through the
ECBs and portfolio investments.

3.2. Worries of recent appreciation of the INR vis-à-vis the USD

Capital is the basis of economic growth. If domestic capital is not enough to achieve the required rate of growth of the economy and the gap inherited thereof is filled by foreign capital, it is so far so good. When the foreign investors find favourable atmosphere for investment, the surge of capital inflows will be inevitable as both supply and demand sides are ready to interact. In the context of the rate of growth of the economy, one will definitely consider this as a welcome phenomenon. However, like a double-edged sword it has its dark side too as high capital inflows may force the domestic currency to appreciate, what is now experienced in India.

As a currency appreciates, the exporters of the concerned country can get higher returns in terms of foreign currency, as for their same goods and services the foreign buyers are going to pay more, provided the demand for domestic goods and services in foreign market remains unchanged. And the demand for domestic goods and services in foreign market remains unchanged provided these goods and services have strong monopoly power in supply side of foreign market. But Indian exportable goods and services face strong competition in the world market as these goods and services are widely exported by almost all the developing countries. As a result of which, Indian rupee appreciation discourages the foreign purchasers of Indian goods and services as the currencies of other competitive countries are not appreciated at all or if at all appreciated, it's very meagre. In such a situation, as the demand for our exports falls, the producers of exportable goods and services get a setback and to get rid of that they may go for the minimum use of factors to save cost there by leading to massive unemployment, what the Indian textile and software industries are facing now. The subsequent discussion focuses on this issue. However, not just exporters but also domestic manufacturers competing with imports also lose competitiveness due to rupee appreciation as domestic consumers will get the imported product by paying less because imports become cheaper during rupee appreciation.

During Indian rupee appreciation, Indian imports become cheaper although the prices of the imports remain unchanged. So the sectors like auto, engineering and aviations appropriate the gains in the form of reduced costs from rupee appreciation as they are highly dependent on imported raw materials and fuels. But this benefit is of no use for the sectors like leather, textile and handicrafts as they rarely use imports for their production and on the other hand primarily depends on exports for their revenue generation. Hence the appreciating rupee does not fetch any gain in the form of cost savings to these sectors. Instead, the revenue earning in rupee terms of these companies has been hit hard. As a result, these sectors which provide huge employment, due to appreciated rupee, registered a negative growth. The negative growth in these sectors has direct link with unemployment. We can cite the case of Indian textile industry in this context. As India is the biggest cotton grower in the world, it exports finished yarn and in international market India's strong competitors are China, Pakistan, Sri Lanka and Bangladesh. Because of strong international competition, India textile exporters were exporting at a very reasonable price with only manageable margin. Now because of appreciated rupee, for the Indian finished yarn, the foreign buyers had to pay more although the price of it is unchanged. If the same product becomes available to them from other countries by paying the same amount as before, why will they prefer Indian product?

However, if the Indian textile industry can go for a price cut to an extent that the impact of appreciated rupee on the foreign buyers be nil, then the existing export demand can be kept intact. But this is impossibility as the exporters are already operating on edge, so far as the profit margin is concerned, due to strong international competition. As a result, India is losing the international orders in textile sector as the foreign buyers are getting that from other countries with the same payment. In fact, China, Pakistan, Sri Lanka and Bangladesh are getting the orders that India lost. It's because the currency of Pakistan, Sri Lanka and Bangladesh are not appreciated like India as their capital inflows are much less than that in India and the currency of China, which ought to be appreciated at a higher rate than Indian rupee because of much larger capital inflows to China and greater trade surplus in China's BoP, was resisted by the government and the central bank to be appreciated. In fact, China does not allow its currency to appreciate to preserve jobs, what India couldn't do for which five lakh textile workers lost jobs.
The effect of Indian rupee appreciation has already been felt in the economy as in a number of sub-sectors; the export down-turn is already set in. For substantiating this claim, we can cite the case of Indian apparel sector, one of India's major export industries. On year-on-year basis, in January-April 2007 there has been a 3.5 per cent decline in the value of exports to the US in Indian apparel sector, while as there has been a 57 per cent rise in the exports of Chinese apparel to the US during the same period. As a result, while India is losing its importance in international market, its most important competitor China is gaining its dominance. The same situation is also there in IT and BPO industry. As such the Indian outsourcers were already struggling with rising staff salary and with the appreciated rupee, as their margins are affected further; they started adopting pay cuts and job cuts in order to save cost. If we look into the BoP data, we can conclude that a stronger rupee has started taking its toll on software receipts. While the rate of growth of software receipts was 37.2% in April-September 2006, it has been reduced to merely 15.2% during the same period in 2007.

Because of this, now almost all the software companies are firing their employees. TCS, the well known name for employee retention in software sector, is also not an exception from the attack of rupee appreciation. Just recently, TCS, as a measure of pay cuts, has opted for deducting 20% of variable pay of all its employees and it insisted 500 employees at different management levels to resign voluntarily on performance ground. In an attempt to assuage fears, the IT majors, however, say such sackings are routine and part of their 'quality control exercise'. As per the views of the employees of IBM, in the month of January 2008, about 1500 employees of the company have already been sacked. Thus, rising rupee and recession in the US economy are causing uncertainty and insecurities among the techies.

A stronger rupee also hits the companies with global commodity stocks (i.e. Indian Multinationals) like Reliance, Hindalco, Tata Steel and Software companies like Satyam, Infosys, etc. The biggest problem posed by rupee appreciation in recent time is not an export slow down and the resultant job losses. The problem is that it creates the belief among market players that the rupee has become a one way bet. This belief of market players along with higher interest rates in India compared to other countries will cause further huge capital inflows as the market players will expect windfall gains from Indian financial market. Then the gravity of rupee appreciation will be stronger which will lead to a serious export slowdown and massive unemployment.

4. China’s Exchange Rate Regime

After taking the control of the government in China in the late 1940s, the communists established the People’s Bank of China (PBC) in December 1948. Immediately after its advent, the bank started issuing the Renminbi or the Yuan (the official symbol CNY) and in the early 1950s, the government started focusing on financial and monetary system of the country in order to maintain stabilized prices and centralized exchange rate management. At that time, like most currencies, the Renminbi was also not convertible. Initially, the foreign exchange rate of the Yuan was fixed taking into account price comparisons of China’s imports and exports. The value of Yuan was gradually rising from 1972 and it reached to 1.50 to the USD by 1979. However, this value of Yuan was in fact considered an over-valuation. Because of this over-valuation, exporters lost a lot. Since a majority of exporters were government companies, the losses were compensated by benefits that accrued due to cheap imports.

In the late 1970s, the Chinese government started relaxing controls on foreign trade and adopted a ‘dual track currency’ system. As per that system, an ‘internal settlement rate’ of the Yuan was maintained for China’s trading firms to settle foreign exchange earnings/payments with the government and the official rate of around 1.5 was maintained for non-trade related foreign exchange transactions. As the internal settlement rate was quite low in value, Chinese exports became competitive and that led to an increase in exports. As a result, Chinese exporters were able to make quick profits. The USA, a major trading partner of China by then, and the IMF raised objection against the Chinese dual system. And under compulsion, China scrapped the internal settlement rate and fixed the official rate at 2.8 Yuan to the US dollar in 1985. In 1989, the Yuan was devalued to 4.72 to the US dollar and further to 5.8 in 1993. In spite of these devaluations, the Yuan was still regarded as overvalued. However, the late 1990s and early 2000s saw the Yuan stabilize at around 8.3 to the US dollar. However, for the sake of the obligations pertaining to
the IMF Articles of Agreement, China with much hesitation opted for current account convertibility in 1996.

After becoming a member of WTO in 2001, China got integrated into the global trading system, giving the economy greater access to foreign markets and helping attract foreign investors who now felt secured about working in China's domestic market. Trade between China and the USA increased significantly after China joined the WTO. Despite the increasing trade between these two countries, the USA was not satisfied with China’s efforts to implement some of its WTO commitments like the subsidies given to Chinese manufacturers and the under-valuation of Yuan. In spite of exceptionally large trade balances of China against the USA, as represented in table 4.1, the Yuan continued to hover around 8.0 to the dollar.

<table>
<thead>
<tr>
<th>Year</th>
<th>Exports (US $ Millions)</th>
<th>Import (US $ Millions)</th>
<th>Balance of Trade (US $ Millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>11,753.7</td>
<td>45,543.2</td>
<td>-33,789.5</td>
</tr>
<tr>
<td>1996</td>
<td>11,992.6</td>
<td>51,512.8</td>
<td>-39,520.2</td>
</tr>
<tr>
<td>1997</td>
<td>12,862.2</td>
<td>62,557.7</td>
<td>-49,695.5</td>
</tr>
<tr>
<td>1998</td>
<td>14,241.2</td>
<td>71,168.6</td>
<td>-56,927.4</td>
</tr>
<tr>
<td>1999</td>
<td>13,111.1</td>
<td>81,788.2</td>
<td>-68,677.1</td>
</tr>
<tr>
<td>2000</td>
<td>16,185.2</td>
<td>100,018.2</td>
<td>-83,833.0</td>
</tr>
<tr>
<td>2001</td>
<td>19,182.3</td>
<td>102,278.4</td>
<td>-83,096.1</td>
</tr>
<tr>
<td>2002</td>
<td>22,127.7</td>
<td>125,192.6</td>
<td>-103,064.9</td>
</tr>
<tr>
<td>2003</td>
<td>28,367.9</td>
<td>152,436.1</td>
<td>-124,068.2</td>
</tr>
<tr>
<td>2004</td>
<td>34,744.1</td>
<td>196,682.0</td>
<td>-161,938.0</td>
</tr>
<tr>
<td>2005</td>
<td>41,925.3</td>
<td>243,470.1</td>
<td>-201,544.8</td>
</tr>
<tr>
<td>2006</td>
<td>55,224.2</td>
<td>287,772.8</td>
<td>-232,548.6</td>
</tr>
<tr>
<td>2007 (till March)</td>
<td>14474.2</td>
<td>71425.0</td>
<td>-56950.8</td>
</tr>
</tbody>
</table>

Source: www.census.gov

That’s why the USA claimed that the Yuan had been undervalued and hence it emphasized that the exchange rate should be determined by market forces. In fact, the US Chamber of Commerce advocated a gradual shift to a floating system in China. However, China didn’t share American views on the matter. Rather, in defence of China's currency policy, the Governor of the PBC said that the fixed exchange rate helped maintain China’s high levels of employment and the Chinese government claimed a stable Yuan was in the interest of China and the world.

Till July 21, 2005, China's economy was under the umbrella of a fixed or pegged exchange rate regime. On that day, the Chinese authority announced a new regime called 'crawling peg' under which the daily trading price of the US dollar against the Yuan was to be allowed to vary by as much as 0.3 per cent each day above or below the central parity published by the central bank and the trading prices of the non-US dollar currencies against the Yuan were to be allowed to move within a certain band announced by the central bank. Under this system, Yuan was to have link not only with the USD but with a basket of currencies.

On this move of China, both the IMF and the US government officials expressed their satisfaction as they felt that the change in China's exchange rate regime was a move in the direction of greater exchange rate flexibility. But surprisingly, on July 27, 2005, contradicting the announcement of July 21, the Chinese central bank announced that no further changes in the value of the Yuan were to be expected in the near future. Immediately after the July 21 announcement, the Yuan strengthened marginally moving from 8.28 to 8.11 to the dollar. This prompted some analysts to conclude that Chinese authority was adopting a managed float but in reality, the regime they followed was the crawling peg.
The performance of China in international market has been remarkable since last couple of years. Its massive trade with the US has conferred it the second largest trading partner position of the US in 2006. The US trade deficit with China, as shown in table 4.1, hit all-time high of the dollar 232.5 billion, the largest ever recorded between any two countries. FDI to China rose to 13.2% in October as compared with the same month a year ago. In the first 10 months of 2007, FDI rose to 11.2% from the same period in 2006 to US $ 54 billion. Inflow of ‘hot money’, as the domestic stock and property markets surge in China, also contributes to the massive foreign exchange reserves. Thus the credit of the present foreign exchange reserve position of China goes to larger FDI flows, huge inflow of hot money and the accelerated exports.

Looking into the facts – ballooning trade deficit of the US with China and the world’s largest foreign exchange reserves in China, many analysts argued that the Yuan was still undervalued. Besides the undervalued Yuan, some other factors like Chinese subsidies to its manufacturing sector, low labour costs, etc. are also there behind Chinese exports being competitive. The Chinese central bank is increasing its US dollar reserves to keep the Yuan weak by absorbing excess dollar in the market and issuing Yuan instead. And if the central bank stopped intervening in foreign exchange market, then the value of the Yuan would rise. Critics of Chinese currency policy opine that managing the currency tightly in the early stages of country’s economic development is legitimate but it is no longer right for China to continue doing so, given the size of its economy and the impact of its policies on the world economy. In spite of persistent pressure from the IMF and the US, China is not ready to revalue its currency drastically because of the following reasons.

- An abrupt increase in the value of the Yuan could lead to a fall in foreign investment and a slow down in Chinese exports, thereby creating unemployment.
- Yuan appreciation will cause a rise in Chinese imports of food articles.
- It may have adverse effect on China’s agricultural exports.
- As the Chinese banks are burdened with sizeable non-performing assets, they would not be able to deal effectively with speculative pressures in the currency exchange market arising from the transition to a floating exchange rate system.

China continued to deny allegations of currency manipulation, claiming that its currency policy was shaped by national interest. Chinese government officials claim that it is not reasonable or fair to blame China for problems in the US economy. All these claims of China are just not to allow Yuan to appreciate as the appreciated Yuan might invite lot of troubles to the economy as pointed earlier in this section. Then question comes – how does China manage such a massive reserves owing to greater trade surplus and larger capital inflows through FDI and hot money? China’s strategy in this context is so simple. As China is well aware of the weakness of its financial system, it’s adopting more fixed exchange rate regime, i.e. crawling peg and protected capital markets in spite of lot of pressure to adopt a flexible exchange rate regime and to open its capital markets. It’s because China knows, due to a weak domestic financial system, the floated exchange rate and an opened up capital markets could generate large scale capital flight and sharp currency depreciation.

In order to prevent appreciation of the Yuan the Chinese central bank buys the US dollar in exchange of Yuan. By printing Yuan, the bank raises the currency in the country, which in turn, other things remaining unchanged, raises the domestic price level, thus raising the economy’s inflation rate. But if the central bank is just printing enough Yuan to buy and hold US assets and the volume of Yuan used to purchase the dollar assets is not flowing back into the Chinese economy, then there will be no chance of domestic inflation. However, in this strategy of the Chinese monetary authority, the fear of inflation is there as generally additional printing of money augments the domestic demand.

As China’s inflation rate touched a record high at 6.5% in October 2007, the critics of Chinese currency policy blamed the exchange rate regime of the country. But the Chinese authorities declined to accept the claim of the critics and opined that real inflation is within a controllable range and the spike of inflation in October 2007 was overwhelmingly led by a rise in food prices, which went up 17.6% in October from a year earlier. To ease the situation, the central government welcomed price rises of agricultural products as it would boost farmers’ income. The Chinese authorities
feel, in order to control inflation, we can remove excess Yuan from circulation by selling domestic bonds, which is referred to as sterilization. In spite of a lot of criticisms levelled against Chinese strategy, it proved its credibility as the economy grew at 11.5 per cent pace in the first three quarters of 2007-08. However, to keep the inflation rate under the manageable range, i.e. to manage the present liquidity problem of the economy, China has increased the proportion of deposits; banks have to hold in reserve, six times this year in order to keep a lid on cash in the banking sector. Again the one year deposit rate rose to 3.60 per cent and one year lending rate rose to 7.02 per cent. Besides, the Chinese authority also reduced the interest income tax on bank deposits to 5% which was earlier 20%. These steps would encourage people to park money in banks and because of a hiked statutory liquidity ratio; the banks’ credit creation capacity would be restricted. From the discussion above we can conclude that the Chinese authorities, through crawling peg and sterilization, have been so far capable to manage both exchange rate and liquidity.

5. India’s Strategies during Appreciation of the INR vis-à-vis the USD

The quick climb of rupee in recent period and the worries related to it in Indian economy, as mentioned in section – 3 of this paper, clearly fingers towards the credibility of Indian macro economic policies relating to the management of exchange rate and liquidity. An appreciated and appreciating rupee would bring forth more capital inflows, which would further complicate monetary management. Already the rupee has emerged a sought-after currency in the Asian market. If we allow the rupee to climb still further, it will be simply suicidal. Therefore, a limit must be set on the rupee in reflecting the dollars weakness and capital flows in order to maintain price stability and exchange rate stability, which are equally important to facilitate growth. The following discussion will highlight how effective India has been in fixing a cap on rupee’s upward movement.

5.1. Strategies Adopted so far

Since last couple of months India has been experiencing the pinch of twin developments- higher inflation rate and surging capital inflows. While combating inflation requires a tightening of monetary policy, which can be achieved by a combination of rising interest rates and an appreciating currency, maintaining international competitiveness requires resisting the appreciation pressures inherited from the capital flows. While the fear of rupee appreciation was very grave, the RBI preferred to remain passive by allowing rupee to appreciate sharply in mid-2007. Because of that Indian export sector lost its international competitiveness to some extent. After that great set back, the RBI realized the fault and started intervening in the foreign exchange market. It started buying the dollars in exchange of rupee for which it had to print excess rupee. Thus buying of dollars by the RBI enhanced the supply of liquidity in the economy, thereby inviting inflationary pressure.

To check liquidity expansion the RBI issued interest-bearing securities to the banks. As these securities were coming to the market not because of the demand from the commercial banks but because of the RBI to suck excess liquidity from the system, the RBI had to make it attractive by offering a higher rate of interest on them. As commercial banks got higher rate of interest from these securities, the returns from which was very sure, they accordingly charged still higher rate of interest on their loans to public and corporate because the returns from those loans were not that sure like that from the government securities. Therefore, domestic agents, especially corporate, found it advantageous to borrow in dollars, which would be resulted in further inflows. Thus the problem before the RBI is to achieve two objectives – containing inflation and maintaining a competitive currency, with only one instrument – monetary policy.

The RBI and the Indian government have been busy themselves trying to use the various tools they have at their disposal to try to manage the inflows and the potential impact on liquidity and inflation with a variety of forms of foreign exchange intervention and sterilization. As the RBI possesses a very limited quantity of government securities it is not possible for the RBI to control monetary expansion through open market operations. The continuous sterilization of capital inflows in the past has depleted the stock of government securities. The RBI’s constraints in conducting open market operations has led to the creation of market stabilization bond (MSB). Along with MSB, CRR and repo rate hikes are resorted to so as to sterilize the excess liquidity. Following are the different strategies they have adopted so far in this regard.
The RBI has raised the repo rate to 7.75% in March 2007 from 6% in April 2005 in seven times.

It has raised the reverse repo rate to 6% now from 4.75% in March 2004 in five times.

The reserve requirements (or CRR), which is like a kind of tax on banks, have been increased considerably by 50 basis points to 7.5% effective from November 10, 2007.

The banks have been forced by the apex bank to hold a quarter of their deposits (i.e., SLR is 25%) in government bonds and to purchase the low return sterilized bonds.

The bank loans to mutual funds have been curbed.

The pace of sterilization has been accelerated by issuing the Market Stabilization Scheme (MSS) bonds.

The SEBI has ruled that a mutual fund may borrow only up to 20 per cent of its assets and for periods of not more than six months.

Foreign institutional investors are now denied of getting financial assistance from domestic banks.

On capital account front, the RBI has imposed soft controls on inflows and eased outflows.

Foreign investment in the stock market in the form of PNs has been banned.

To discourage capital flow, the RBI resorted to a few administrative measures like fixing the interest rate on NRI deposits on a par with the LIBOR (London Interbank Offered Rate) rate, which is the world’s most widely used benchmark for short-term interest rates, and preventing non-banking financial companies from accepting NRI deposits.

As an administrative measure, the RBI had recently chosen to restrict foreign borrowing.

The RBI is now encouraging overseas borrowings by Indian companies.

In spite of all these strategies adopted by the RBI, it couldn’t succeed to resist appreciation of rupee or to check inflation. In fact, the rate of appreciation of rupee was much higher than that of Yuan as shown in table - 5.1.1.

<table>
<thead>
<tr>
<th>Month</th>
<th>INRs to 1 USD</th>
<th>Yuan to 1 USD</th>
<th>Days average</th>
</tr>
</thead>
<tbody>
<tr>
<td>January</td>
<td>44.2117</td>
<td>7.78881</td>
<td>23</td>
</tr>
<tr>
<td>February</td>
<td>44.012</td>
<td>7.74982</td>
<td>20</td>
</tr>
<tr>
<td>March</td>
<td>43.7936</td>
<td>7.73695</td>
<td>22</td>
</tr>
<tr>
<td>April</td>
<td>42.0176</td>
<td>7.72471</td>
<td>21</td>
</tr>
<tr>
<td>May</td>
<td>40.5561</td>
<td>7.67618</td>
<td>23</td>
</tr>
<tr>
<td>June</td>
<td>40.5905</td>
<td>7.63329</td>
<td>21</td>
</tr>
<tr>
<td>July</td>
<td>40.28</td>
<td>7.55201</td>
<td>22</td>
</tr>
<tr>
<td>August</td>
<td>40.6791</td>
<td>7.57335</td>
<td>23</td>
</tr>
<tr>
<td>September</td>
<td>40.1735</td>
<td>7.52097</td>
<td>20</td>
</tr>
<tr>
<td>October</td>
<td>39.3661</td>
<td>7.50192</td>
<td>23</td>
</tr>
<tr>
<td>November</td>
<td>39.3168</td>
<td>7.42088</td>
<td>22</td>
</tr>
<tr>
<td>December</td>
<td>39.3752</td>
<td>7.36718</td>
<td>21</td>
</tr>
</tbody>
</table>

Source: www.x-rates.com

From January to December of 2007, while Yuan got appreciated by 5.41% (from 7.78881 Yuan for one dollar to 7.36718 Yuan for one dollar), the Indian rupee got appreciated by 10.94% (from 44.2117 rupees per a dollar to 39.3752 per a dollar). That means during that period, the rate of appreciation of Indian rupee was more than double of that of Yuan. After April, the RBI tried to intervene in the foreign exchange markets and applied all the techniques to resist appreciation of rupee but without success. From May to December 2007, while the rate of appreciation of Yuan was only 0.04%, that was 2.91% in case of Indian rupee.
5.2. Strategies to be adopted

Both China and India have experienced large foreign exchange flows, of course the volume of inflows to China has been much larger than that to India. While China has been capable to manage the problems like currency appreciation, interest rate hike and inflation inherited from large inflows, India has been badly failing to do so. To resist currency appreciation, the central banks of both the countries purchased the foreign exchange by domestic currencies. As a result, both the countries faced the problem of excess liquidity in their systems, which is pro-inflationary. To manage the excess liquidity situation, both the countries went for sterilization. But while China succeeded achieving its objective, why couldn't India? The reason, on exchange rate management front, is the different exchange rate regimes adopted in both the countries. While China follows crawling peg, which is more fixed and less market-determined, India follows managed float, which is more market-determined and less fixed. Because of this, the sterilization operations became more effective in China than in India. So the point of concern is, if the existing strategies of India are not effective, what should India do?

As China effectively managed the twin problem – currency appreciation and excess liquidity with one instrument – monetary adjustments that India couldn't, this prompted some commentators to state that the RBI should learn how the Chinese do their exchange rate management. In fact, the Chinese authorities succeeded because of two things – their highly protected exchange rate regime and stricter sterilization operations. If India wants to follow their way of functioning then it has to change its exchange rate regime & adopt stricter sterilization operations in line with the requirements as done by China.

5.2.1. Exchange Rate Regime to be shifted from Managed Float to Crawling Peg

Any economy in developing stage should opt for an intermediate exchange rate regime, either crawling peg or managed float, depending upon the adaptability of economy. And the adaptability of any economy depends upon its economic condition. If the economy is at the door step of development but yet get the developed status, then it should go for managed float and slowly as it gains the developed status, it should make the regime free, i.e. completely market-determined. On the other hand, if the economy is developing but little away from achieving the developed status, it should go for crawling peg so as to protect the economy by providing competitive environment in international arena. As the rate of growth of the economy takes the momentum and starts marching towards higher rate of development, then it will shift its regime to managed float and subsequently, at developed stage, it'll make the regime free.

If we compare India and China, China is the developed country while India is yet to achieve the developed status. Actually with present economic status of China, it should go for market-determined regime. In spite of tremendous pressure from the IMF and the USA for the same, it is not even adopting managed float. Still the Chinese authorities are relying on crawling peg because they feel it's suitable for their economic set up. But India, in spite of being far behind China in development race, has adopted managed float regime for which the RBI is unable to effectively resist rupee appreciation. Therefore the need of the hour is to go for crawling peg, may be with pegging at a wider band, unlike China.

5.2.2. Result-oriented Sterilization Operations to be sought

India's reserve inflow is mainly due to mounting external commercial borrowings and considerable foreign institutional investments. To offset the reserve inflow, it has been applying many sterilization techniques as mentioned in the previous sub-section of this section, but unable to manage the problem of rupee appreciation and excess liquidity. In fact, in sterilization front, we are also not like the Chinese. While our interest rates are considerably at a higher side, the Chinese interest rates exceptionally high and even negative. The central bank of China issues debt at about 2 per cent most of which has to be bought by domestic state-owned banks. On administrative grounds, the banks are forced to involuntarily hold this debt. Like China, the RBI is also using Market Stabilization Bonds (MSBs), the interest rate of which is less is less as per the requirements of the situation. Still the Interest rate in India is 3-4 per cent higher than global rates. A higher interest rate will invite capital because foreign investors will find more returns depositing in India and on the other hand, as the Indian corporate find loans in India costly, they will prefer dollar loans. That means the sterilization operations adopted
so far by the RBI are not effective. Along with the existing sterilization operations, it has to go for some result-oriented sterilization operations as mentioned below.

- Foreign exchange swap may be opted to reduce the domestic currency base.
- Public sector deposits may be shifted from commercial banks to the central bank. Under this operation, there will be no fiscal cost if the interest paid on government deposits at the central bank is just equal to that at the commercial banks.
- The RBI may offer a forward exchange facility to domestic investors by which they will get the opportunity to hedge the value of their foreign investments by locking in a forward exchange rate.
- The RBI should relax the surrender requirements on foreign exchange earnings.
- The RBI should permit local institutions to make investments abroad.
- Non-domestic entities are to be allowed to issue local currency bonds in the domestic market.
- The authority should go for imposing interest equalization taxes on foreign borrowings.
- The access of banks at the discount window is to be tightened.
- With all these operations the RBI may expect some positive development in managing the twin problem of rupee appreciation and excess liquidity.

As China, under more difficult circumstances with larger foreign capital flows and a current account surplus, has been capable to sustain its competitive exchange, the pertinent question comes into mind, ‘can India be able to perform like China on the said issue?’ The answer will be yes, provided India imitates China’s exchange rate regime and sterilization operations. But the point to discuss is, ‘should India imitate China?’

China’s foreign exchange reserve is mainly due to huge trade surplus and larger FDI. The Chinese economy is not in the need of foreign investment as it has sufficient domestic investment and existing huge FDI. Due to a very high rate of investment in the past, China’s domestic consumption falls short of the domestic production, thereby landing China to a demand-constrained economy. So the objective of the Chinese economy is to find market for surplus production. For that, they are pegging their currency in a narrow band to avoid appreciation and maintain the competitiveness of their product internationally. Again they can go for and are also going for stricter sterilization operations like taxing banks and keeping interest rates artificially at a very low level, because they don’t mind if foreign investment to China comes down drastically.

But the Indian situation is different. As India’s import volume and value both are very large, it needs its currency to be appreciated to some extent so that its import expenditure can be reduced. Therefore it can’t strongly peg its currency like China. As at the same time, it needs to protect the exporters’ interest, which are losing a lot because of rupee appreciation, it will not allow rupee to be appreciated much. Therefore, India should go for pegging, i.e. crawling peg with wider band so that currency can vary within a greater range as per requirements. Because of insufficient past investment, the Indian economy is facing capacity constraints. But because of high population, there is rapid growth in consumption. As a result, India’s economy is supply-constrained. To augment the supply, huge investments are required but the domestic investment in India is not sufficient to do so. Therefore, foreign investment is a must for India. So it can’t go for those strong sterilization operations which will obstruct foreign investment. That’s why it can’t also imitate China in taxing banks or keeping interest rates artificially low.

Thus, India should not exactly imitate China but should learn from it so that it can have suitable operations for its economy. In fact, it has to follow China for its exchange rate regime but with greater flexibility, i.e. crawling peg with wider band and stricter sterilization operations which will resist capital inflows in the form of ECBs.
6. Conclusion

India is still in developing stage with massive poverty and ample unemployment. In the context of India’s exchange rate, two contradictory views are to be taken into account. First, the real exchange rate is to be market determined as it is the outcome of development. Second, as the long run growth of the country depends on the real exchange rate, it needs to be managed. As per these two views, India should go for an exchange rate which is more managed and less market determined as long run growth has been the most important target before India. Thus the belfitted exchange rate regime for India will be crawling peg with wider band, which invites greater intervention of monetary policy and exchange rate policy. As experienced, large and sudden capital in-flows and outflows can be destabilizing to the economy and hence the economy can face the problem of boom and bust. To offset the large and sudden capital inflows and outflows, the RBI should go for sterilization operations but with optimum care without distorting economic health of the country. Capital inflows and outflows depend largely on the interest rate policy of the domestic economy. As large changes in interest rates become disruptive, the RBI should change the interest rates by a very low percentage and Indian real interest rates would need to be better aligned with international real interest rates.

Higher economic growth can be achieved in two ways – a) via investment and exports and b) via consumption. In former case, the economy will become dependent on exports and more vulnerable to fluctuations in external demand. Therefore, there will be a question mark on the sustainability of growth achieved in this way. China’s growth is an example of this way. On the contrary, the growth through consumption is steady and sustainable. In this context, in spite of a slower rate of growth than China, India shouldn’t be worried pertaining to its growth as India’s growth is via consumption, which is sustainable. However, the Chinese authorities are now looking for a reform so as to convert their growth as the outcome of consumption.

In the emerging scenario of greater integration of domestic and international markets, there will be a continuous need to adapt the strategy of liquidity management as well as exchange rate management for effective monetary management and short term interest rate smoothing. To maintain a competitive exchange rate, India should strengthen its key factor that underlies value creation in India. As India has surplus manpower, i.e. labour, it has to find ways to create value among surplus labour. In spite of having a huge manpower, India lacks the skilled labour. Therefore, instead of concentrating only on interest rate management, if India tries hard to eliminate distortions in labour market, it might help the economy in finding a better route to maintain a competitive exchange rate.

In order to fight out the problems inherited from the recent rupee appreciation vis-à-vis the USD, National Association of Software and Service Companies (NASSCOM) suggests the government to provide export incentives to the Indian outsourcers. The government may give weight to the suggestion of the NASSCOM in order to help the Indian outsourcers from their present crisis but providing incentives to the export sector can not be a sustainable policy in a growing market oriented economy. However, the RBI can be able to convert the excess liquidity into productive investment by strengthening the monetary policy transmission mechanism. For this, the RBI has to look into how to eliminate the rigidities in the financial markets.
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