Propping the Sliding Rupee: Is Mid-way Intervention the Right Way?

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Abstract

In the post liberalization era, India has been operating on a managed floating exchange rate regime introduced in March 1993, where rupee exchange rate is market determined with provision for timely intervention by the RBI to counter volatility. Openness and integration in the post liberalization era have resulted in manifold increase in the flow of foreign capital to India and boost in trading activity. Increased capital mobility has posed serious challenges before the regulators in managing exchange rates as rupee has shown considerable volatility. The RBI has intervened time and again to moderate demand and supply of rupee and foreign currency to control erratic fluctuations in rupee value over the past two decades. Unlike the strong intervention in 2008-09, in 2013 RBI has been cautious in direct intervention in propping rupee and has instead undertaken a number of indirect measures to defend the rupee. It has shown a more disciplined adherence to a hands-off forex policy.

The history of RBI intervention and its recent role in propping the plunging rupee is the central theme of the paper. RBI's selective control in the forex market has come under scanner in the recent months, as it has been unable to control the free fall in rupee. Analysts are now wondering whether it is time for the RBI to consider alternative exchange rate policy options in place of managed float. The current study examines whether it is the right time to move away from the current system or it is beneficial to the country to continue with the same system of intermittent intervention in the times of volatility.

The author believes that in the given set of circumstances, continuation of managed float is the best alternative as the Indian economy is too fragile to absorb the adjustments required in the wake of leaving rupee completely to the market.

Introduction

The exchange value of a currency is a primary financial parameter that affects foreign exchange investors, exporters, importers, bankers, businesses, financial institutions, students, policymakers, stock markets and tourists in the advanced as well as emerging economies. Volatility in exchange rate affects international investment portfolios, competitiveness of exports, forex reserves, external debt servicing burden, balance of payments and the cost to tourists and students studying abroad. Fluctuations in exchange rates have important implications for the economy's business cycle, trade balances and capital flows.

Like any other country, exchange rate movement of rupee is always a focus of intent observation by policymakers, economists and analysts in India. Volatility in rupee value has serious implications in terms economic well being of the nation. In the post liberalization era, India has been operating on a managed floating exchange rate regime introduced in March 1993, where rupee exchange rate is market determined with provision for timely intervention by the RBI to counter volatility.

Currently, RBI follows a mid-path — that is, selectively controlling foreign capital movement and partially regulating rupee exchange rate. The chequered

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history of rupee is littered with instances of not so successful intervention by RBI and the alarmingly plummeting rupee in 2013 has brought the focus back with vengeance on RBI's role in maintaining stability in rupee.

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Mechanics of RBI Intervention

India has adopted 'managed' or 'dirty' float regime since a long time, though it was only in 2004 that the policy statement declared officially that India had a managed float. Adoption of this exchange rate regime has caused a rise in the frequency and scale of intervention by the RBI in the foreign exchange market. The RBI uses foreign exchange to manage reserves and intervenes to ensure stability in rupee value and to smoothen any jerky movements in its rate caused by demand-supply mismatch vis-à-vis other currencies.

A perusal of the central bank's annual reports reveals that it uses both direct and indirect intervention to manage the exchange rate. The direct intervention in the form of purchases and sales in the intervention currency (i.e. US dollars) in both spot and forward markets is supplemented with indirect intervention, viz. quantitative restrictions, reserve requirements and interest rate changes. Intervention can also be made through statements (to the press or otherwise) in times of exchange rate crisis, or in extreme circumstances, through a slew of monetary and other measures.

In effect, the RBI regulates the forex market intermittently. RBI has two intervention strategies – leaning against the wind and minimization of deviations from a target level for the exchange rate. There has been a significant effort by the Reserve Bank to lean against the wind and maintain the spot rate in alignment with a moving relative Indo-US prices' target. However, such intervention is generally not governed by any predetermined target or band around the exchange rate.

The details of exactly how the intervention is carried out are not public information. However, the fundamental ideology and modus operandi can be perceived by reading publicly available documents. The RBI usually stays behind the scene and asks a public-sector bank to buy or sell dollars in the market.

Trends in Rupee Movement

When India became independent in 1947, there were no external borrowings on India's balance sheet and the exchange rate as on 15 August 1947 was 1 US$ = 1 INR. It depreciated subsequently. In early controlled exchange rate regime, the rupee exchange rate hovered around Rs 4.00 in the 1950s, Rs 5.00 in the 60s, Rs 7.00 in the 70s, and Rs 8.00 in the 80s. In the liberalized era of 90s, the rupee moved to Rs 20 and Rs 40 in the next decade of 2000 and to nearly Rs.60 in 2013.

After the double depreciation of 1991, the next major turning point in the history of rupee came in the year 2003 when it reversed the trend of depreciation in its value that had persisted through the nineties. This was followed by a sharp appreciation in 2007 and then came great fall in 2008 as a result of global financial crisis. Thereafter, rupee has been in a zone of volatility.

Between 2000 to 2007 period, the rupee was relative stable, hovering in the range of 44-48 per US dollar. In late 2007, it reached a 10-year high of 39 per US dollar on sustained foreign investment inflows. However, the story ended badly with the onset of the global economic crisis when foreign investors pulled out their funds rapidly. During this period, the rupee recorded lows of 50.27 in October 2008, 52.04 in March 2009, 54.30 in December 2011 and 57.30 in June 2012, prior to the latest slump breaching the unprecedented level of 60.

Overall it can be seen from the **Figure I, II & III** that the intrinsic volatility of the rupee has increased from the very low levels in the fixed exchange rate

regime till 1991. In the period after reforms, high volatility has been associated with external shocks such as the East Asian crisis (1995-98), the dot com bust and dollar depreciation in the new century post Y2K, and the global economic crisis since 2008. Rupee staged a recovery after 2008 before entering a period of volatility again in 2012.

The Story of RBI Intervention so Far

The RBI's forex management policy in the 1980s was limited to pegging the rupee rate in the morning and changing its reference dollar rates in response to volatility in the market during the day, every time the market threatened to break out of the controlled range. It also changed the rupee rate in case undue movements were discerned.

Intervention is mainly unidirectional between 1993-95; i.e. an appreciation is offset through purchases by the Reserve Bank. During 1993-95, extensive intervention by the central bank kept the nominal exchange rate (spot) almost constant between 31.23 – 31.81 rupees per US dollar resulting in a period of relative calm in terms of exchange rate movements. **Table I**

This is confirmed by the central bank's own account of this period when it describes its intervention strategy (1993-95) to be directed at "...protecting the export competitiveness and consolidating the foreign exchange reserves." Clearly, a strong defense of the exchange rate led to very large interventions during these two years.

There was another major bout of dollar sales in October 1995 in the spot and forward exchange markets to "...prevent further depreciation and to guide the rupee along a course consistent with macroeconomic fundamentals".

The Reserve Bank's intervention activity rose again in Oct.-Dec. 1997 and Jan-July 1998 in response to volatility in the foreign exchange market. In the post-Asian crisis period, particularly after 2002-03, capital flows into India multiplied manifold and increased speculation on Indian rupee. The RBI had to intervene actively to reduce the volatility in the market. During this period, it made direct interventions in the market through purchases and sales of the US Dollars and sterilized its impact on monetary base.

Next major bout of intervention came in 2008-09 in the wake of the global financial meltdown. On account of heavy selling by foreign institutional investors and appreciation of the US dollar against most currencies, RBI had to repeatedly intervene to prop the depreciating rupee in 2008.

At that time, RBI sold $35 billion (net) to bolster it the plunging rupee. It sold a record $20.63 billion foreign currency during October alone to check the steep depreciation of the rupee. With net sales estimated at $18.67 billion in the month, the cumulative sales of foreign currency between April and October 2008 was $28.32 billion. In rupee terms, on a net basis, RBI sold foreign currency worth nearly Rs 93,000 crore during October 2008.

The RBI was in a position to defend rupee in 2008-09 because it had a Forex Reserves to Total External Debt ratio (total forex reserve as a percentage of total debt) of 138. Such excess reserve helped RBI to deflect the impact on the rupee during the 2008 crisis and it depreciated to the maximum of 52.17/ dollar that was quite acceptable. In its bid to support the falling rupee, the RBI spent more than $20 billion in spot-market intervention between September 2011 and March 2012.

Despite many instances of intervention, it is pertinent to note that Reserve Bank's intervention has been relatively small in terms of volume (less than 1 per cent during last few years), except during 2008-09. Its gross market intervention as a percent of turnover in the foreign exchange market was the highest in 2003-04 though in absolute terms the highest intervention was US$ 84 billion in 2008-09. During October 2008 alone, the RBI sold US$ 20.6 billion in the foreign exchange market. This was the highest intervention till date during any particular month.

And the Saga Continues...

The rupee has been in a free fall since May 2013 catalyzed by the dollar's strength overseas after the US Federal Reserve stated obliquely that its $85 billion per month bond buying programme could end in near future. The rupee plunged to record low of 61.21 on July 8, 2013 registering a new low in a series of record lows seen over the past few weeks. It breached a previous all-time low of 60.76 on June 26, 2013. On an aggregate, it has weakened 9.3

percent since the beginning of 2013, the worst fall in emerging Asia. **Figure IV & V.**

This time around, things are a little different from the previous phases of volatility in rupee. Unlike the strong intervention in 2008-09, in 2013 RBI has been cautious in direct intervention in propping rupee and has instead undertaken a number of indirect measures to defend the rupee. It has shown a more disciplined adherence to a hands-off forex policy.

Recently, RBI governor reaffirmed that the central bank does not target any exchange rate level but only intervenes to smoothen volatility. "We let our exchange rate be largely market-determined, but intervene in the market to smooth excess volatility and/or to prevent disruptions to macroeconomic stability." "India has been following the 'middle solution' to deal with the exchange rate problems. Middle solution implies giving up on some flexibility to maximize overall macro economic advantage."

The Steps taken by RBI to Support the Rupee Since June 2013:

- The RBI has been seen intervening on more than one occasion during June-July, 2013 to stem the fall of rupee by selling dollars via state-run banks. As per data from RBI, it has sold $107 million in the spot market in order to mitigate the rupee's fall in May 2013. It also sold $5.80 billion in the forwards market in May 2013 to temper future expectations on the rupee.
- RBI has raised the Marginal Standing Facility (MSF) rate and its Bank Rate by 200 basis points each, to 10.25 percent to raise the cost of borrowing by banks, with an intention to curb rupee volatility by reigning in liquidity.
- It has also raised the daily balance requirement for lenders' cash-reserve ratios to 99 percent from 70 percent effective July 27 2013.
- It has announced sale of bonds worth Rs. 12,000 crore through open market operations to suck liquidity in its bid to defend the sliding rupee.
- In July 2013, RBI has announced an auction of 60 billion rupees ($1 billion) of cash-management bills.
- The RBI has capped the amount lenders can borrow in daily repurchase auctions at 0.5 percent of their deposits.
- It has ordered State-owned oil companies to purchase their dollar requirement from a single public sector bank for daily transactions so as to curb volatility in the currency.
- It has brought down the period of realization and repatriation for exporters of goods and software to nine months from earlier 12 months, a move to shore up foreign exchange inflows.
- It has introduced a slew of measures to curb gold import including:

- Hike in gold import duty to 8 percent.
- Tightening of gold imports by making them dependent on export volumes
- Further it has stipulated that if any importer of gold fails to export 20% of the gold from the arrived consignment, he would be barred from importing any more gold. This could reduce imports, as only a very small portion of gold is exported now.
- To enhance flow of foreign funds and increase rupee demand, RBI has enhanced the existing limit for investment by SEBI registered foreign institutional investors (FIIs) in Government securities (G-Secs) by a further amount of $5 billion. This will take the overall limit for FII investment in G-Secs from $15 billion to $20 billion.

- The RBI has allowed long term investors like Sovereign Wealth Funds (SWFs), multilateral agencies, endowment funds, insurance funds, pension funds and foreign

central banks to be registered with SEBI, to invest in G-Secs for the entire limit of $20 billion.

- The RBI has granted permission to Indian companies in manufacturing and infrastructure sector and having foreign exchange earnings to raise external commercial borrowing (ECB) for repayment of outstanding rupee loans towards capital expenditure and/or fresh rupee capital expenditure under the approval route. The overall ceiling for such ECBs will be $10 billion.
- After stepping up its monitoring, the RBI has now mandated foreign banks to limit themselves to placing hedging-related trades on onshore forward markets on behalf of overseas clients and not use existing client positions to make other trades, such as for proprietary trading. In a notification, the RBI has ordered Authorized Dealer-1 category banks to immediately stop trading on their prop accounts in the exchange traded futures market.
- Further, in consultation with RBI, SEBI has decided to curtail position limits and doubled margin requirements on exchange traded USD-INR futures with immediate effect.
- Meanwhile, in a bid to bring foreign money to India and push the rupee, the government has decided to open up several sectors for foreign direct investment.

RBI intervention gained effectiveness from these measures as can be seen in dipping in Rupee movement in July, 2013 but currency expectations aren't quite anchored. There is a set of analysts who believe that rupee is still undervalued at the current rate and a rate of 70 has been predicted. Almost equal number of analysts are of an opposite view. They believe all the negatives in terms of weakening macroeconomic fundamentals, fiscal deficit, current account deficit, falling import cover, rising import bill and persistent depreciation have already been factored-in in the current rupee valuations and things are set to improve from here on with rupee settling at around 58.

Discussion: Is Intermittent, Sporadic Intervention the Right Way?

Case for Intervention

India's exchange rate regime has evolved from an extremely controlled and fixed rate system to a middle position of managed float. In a large part of its history since 1991, the volatility of the rupee has remained low against the dollar, as the RBI has intervened through both direct measure of purchases/sales of the US dollar and indirect monetary measures. It has managed periods of instability in a flexible and pragmatic manner by reacting promptly and swiftly to rupee movements through direct and indirect interventions and has withdrawn from the market as soon as orderly conditions have been restored. The success of RBI's approach can be witnessed in the fact that despite several unexpected external and domestic challenges, India's exchange rate performance has been quite satisfactory and most analysts believe that the rupee is moving along with the economic fundamentals in the post-reform era.

The South Asian and the sub-prime crisis have demonstrated the susceptibility of rupee to global factors and capital flows in response to external events. So managed float with sporadic intervention suits the domestic cycle better than a system of full float with free capital flows that makes rupee vulnerable to perverse movements. Leaving the currency to the mercy of volatile capital flows can endanger the entire economy.

However, the approach to intervention has to evolve further has India moves towards full capital account convertibility and becomes more integrated with global economy. The impossible trinity of independent monetary policy, open capital account and exchange rate management poses bigger challenge in managing periods of rupee volatility in the changed economic milieu. Going forward, the RBI will need to exhibit more flexibility, adaptability and innovations in liquidity as well as exchange rate management to maintain order and stability in forex market.

Case Against Intervention

The supporters of no intervention have attacked the claims of the proponents of the RBI's current midway

intervention policy who argue that if the rupee were left free to the market, it would worsen the import bill and hamper economic growth. They aver that it is not essential that rupee would only depreciate and never appreciate if left to market forces. Further, even if it depreciates, it will eventually lead to long run structural benefits in terms of growth of import substitutive industries and a move towards harnessing natural energy sources such as solar, wind, and thermal power domestically to reduce dependence on expensive, imported oil. Efficiency in consumption of oil can also be increased by cutting heavy subsidy in crude oil prices and passing the burden to people. This would help stem current account deficit, one of the biggest factors behind current rupee depreciation.

The proponents of rupee driven solely by market forces argue that no intervention would mean that various players in economy would adjust their investment, consumption and borrowing level according to the flow of foreign capital and import costs. This will automatically ease off the CAD pressure by causing the quantum of imports to reduce and exports to rise. From long-term perspective, macroeconomic fundamentals, economic environment and market forces should determine the value of a currency. As the situation prevails, until India continues to have a widening deficit and the global economy deteriorates continuously, intervention will be futile as no amount of intervention will be successful stemming the slide in the rupee, as witnessed in past few months.

The dynamics of rupee depreciation is changing rapidly and the factors contributing to rupee slide in the current period such as deficits, dollar strengthening, tightening of external liquidity, Euro-zone crisis and other non India-related factors are beyond RBI's control and cannot be reversed or neutralized by it. RBI has no control over external liquidity or even the size of the current account deficit.

Finally, a move away from intervention may be defended on grounds that in changing world realities, RBI has limited ability to prop the rupee. India's forex reserves, which stand at $260 billion approximately, may not be sufficient to defend rupee eternally. What is even more critical is that much of the reserves are liabilities than assets. Though it may seem that India has amassed large foreign exchange reserves, a closer examination shows that it is not enough to prop up the Rupee if it comes under sustained hammering. India's imports in 2011-12 were USD 488 billion. Thus, at current levels the reserves are only slightly more than six months worth of imports, which is considered a comfortable level. This remaining USD 40 billion are enough to fund the gap between current account deficit (about USD 5 billion a month) and capital inflows (about USD 2-3 billion a month) for a year and half. So there are hardly any reserves in RBI's kitty to defend rupee strongly or even fund a sudden or increased flight of capital.

To Intervene or not?

All central banks, be it the RBI, the Fed in the U.S., the Bank of England or the People's Bank of China, keep a watch on the exchange rate of their currency, and when the rates become volatile, these central banks try to intervene directly or indirectly in order to make necessary 'corrections'. Some exchange rate flexibility deepens market and encourages hedging, but there should be limits to exchange rate flexibility so that it does not hurt the real sector. The exchange rate system in India is quite flexible and has worked well so far. The RBI has intervened in both spot and forward forex market with a view to restore order in the market and control excessive volatility in rupee. It has always withdrawn from the market once the situation is in control or when factors indicate that intervention is futile at this stage.

There is enough empirical evidence to prove that intervention has served as a potent mechanism in controlling the magnitude of exchange rate volatility and it has not target a certain level of rupee. It is an indubitable fact that Indian economy is in dire straits. GDP is at its lowest in a decade, growth rate of industrial production is non-existent, fiscal deficit is high and faces threat in the form of food security bill, import cover is eroding while import bill is escalating, CAD is at an unsustainable level and inflation has persisted for too long. The author believes that in the given set of circumstances, continuation of managed float regime is the best alternative as the Indian economy is too fragile to absorb the adjustments required in the wake of leaving rupee completely to the market.

The Way Ahead

While intervention by RBI is desirable way ahead, the approach needs to be refined.The RBI cannot be expected to fight on the front of the impossible trinity (exchange rate, external situation and liquidity) at the same time.The RBI's intervention should be seen as a reprieve and a recourse to tide over periods of uncertainty with rupee value sustaining itself in the long run on the back of structural reforms, administrative steps, proactive management of CAD risks and macroeconomic stability. It is not so much the RBI as the government that can make a decisive impact on rupee value through its policies.

Going forward, in the face of further liberalization and fuller CAC, the wiser way ahead is RBI intervention is through the monetary policy. Any quantitative intervention should serve to smoothen the path of the rupee's movement on either side, not to stop or reverse it.

Though it is not the RBI's goal to manipulate the exchange rate and hold it at any artificial level, as a guide to intervention, the RBI should work out a band for the exchange rate that it need not share with the market. Such a band would serve as a guide for intervention. Most importantly, the band should be dynamic and adjusted according to changing realities. The author accepts the difficulties in determination of such a band but there are models to forecast the exchange rate that can be further expanded to determine the above-referred band. Discussion of these models is beyond the purview of the current study.

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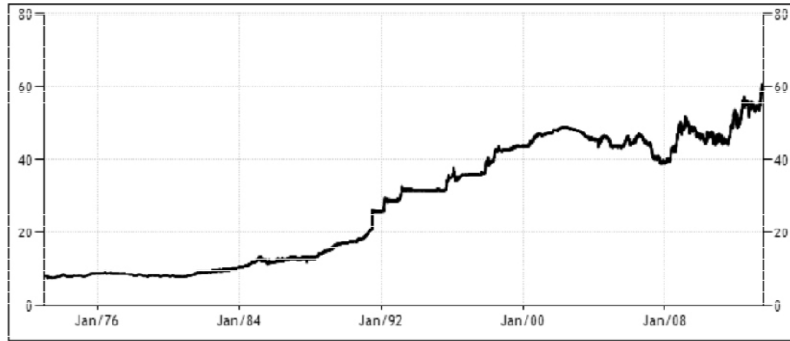
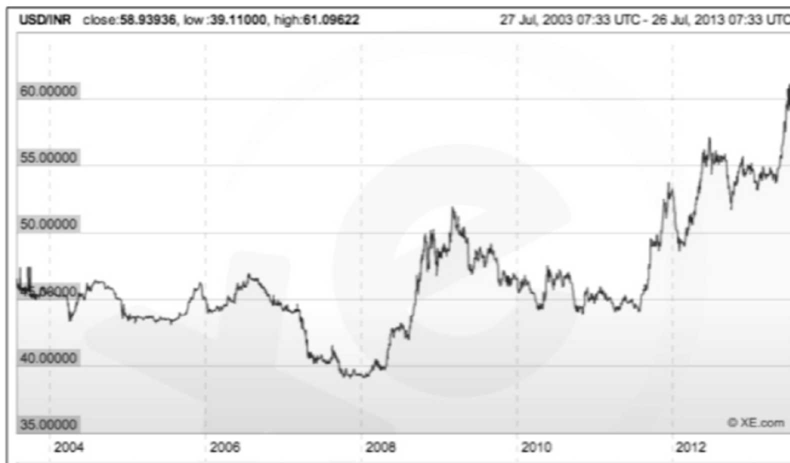


Source: http://www.tradingeconomics.com/india/currency

Figure I : Trends in Rupee Movement since 1973

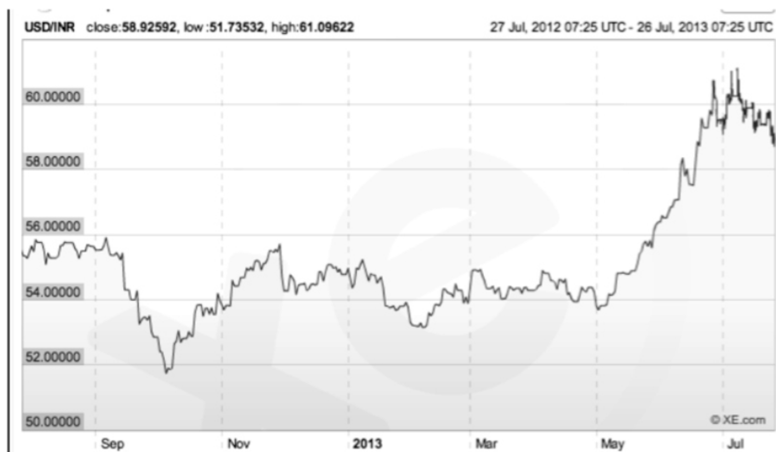


Source: http://www.xe.com/currencycharts/?from=USD&to=INR&view=10Y

Figure II : Rupee Trend in Past Ten Years

Data Source: RBI Reports

Figure III : Depreciation (-) or Appreciation (+) in Ruppe (1993-2010)



Source: http://www.xe.com/currencycharts/?from=USD&to=INR&view=1Y

Figure IV : Trend in Rupee Exchange Rate (2012-13)

Source: http://www.xe.com/currencycharts/?from=USD&to=INR&view=1M

Figure V : Trend in Rupee Exchange Rate (June - July 2013)

Table I : Interventions by RBI during 1993-98 (USD Million)

	Purchases	Sales	Gross Intervention	Net Intervention
1993	11287	4021	15508	7266
1994	15238	1	15239	15237
1995	1987.6	4799.5	6787.1	-2811
1996	10058.5	5837	15895.5	4221.5
1997	13182.5	6671	19853.5	6511.5
1998	28180	27903	56.83	277
1999	19910	17439.5	47349.5	2470.5

Source: RBI Bulletins (Gross intervention is the sum of purchases and sales, irrespective of sign. (Net intervention is the same, except that the sum takes account of the signs)