IMAGING: AJAY MOHANTY

Has the exchange rate regime changed for the worse?

JOSH FELMAN & ARVIND SUBRAMANIAN

Over the past few years, the Reserve Bank of India (RBI) has radically altered the nation's exchange rate policy, shifting from a relatively flexible regime to an inflexible one. This change has been noted by a few commentators, including K P Krishnan and Sajjid Chinoy. But by and large it has not received the attention it merits.

This is unfortunate, since the shift has had important implications for the nation's competitiveness, its export performance, economic growth, and external resilience. Consider how.

To understand the radical nature of the current regime, we first need to grasp the policy that long preceded it. Ever since the liberalisation in 1991, the RBI has pursued a flexible exchange rate policy.

It never allowed the rate to float completely freely. But it did allow the rate to move as needed.

Essentially, the RBI pursued a three-pronged strategy: (i) Allowing depreciation when capital outflows put downward pressures on the rupee; (ii) allowing appreciation when particularly rapid export and productivity growth created upwards pressure; and (iii) building up reserves during episodes of strong capital inflows.

This policy had two important advantages. First, it allowed the exchange rate to respond to cyclical market forces. This is apparent from *Figure 1*, which shows developments in the real effective exchange rate, that is, the rate adjusted for differences in inflation between India and its trading partners. One can see that the rate appreciated by 16 per cent during the boom from 2002 to 2011, thereby dampening the excess demand and inflation that emerged during this period.

In contrast, the real exchange rate depreciated during the three episodes of large capital outflows: The Global Financial Crisis (2008), the Taper Tantrum (2012-2013), and the Emerging Market (EM) mini-crisis, when financial anxiety increased, initially out of fears that Turkey might default (2018), then because the Indian financial conglomerate ILFS collapsed.

Second, the policy ensured that over the long run, India maintained its external competitiveness.

Figure 1 shows that from 1994 to 2019 the real effective exchange rate oscillated around a stable level (*blue line*), helping the country's export sector to thrive and compete in foreign markets.

Figure 2 gives further insight into the workings of the RBI's exchange rate policy. Most obviously, the strategy has allowed India to build up its foreign exchange reserves over the longer-term (*black line*). From June 2002 to September 2018, reserves swelled from $59 billion to over $400 billion as the RBI absorbed large capital inflows, the inevitable result of India's growth being stronger than elsewhere in the world.

Figure 2 also shows that during the three cyclical episodes of rupee pressure mentioned above — the Global Financial Crisis, the Taper Tantrum, and the EM panic — the RBI largely aimed to smooth the adjustment, rather than deplete its reserves trying to fight depreciation.

Despite the success of this policy, it was abandoned after 2019. Figure 2 shows that while the RBI continued to buy reserves during episodes of capital inflows, the central bank embarked on a policy of selling reserves aggressively during periods of downward pressure, to limit the depreciation of the rupee.

This new policy was especially marked in the period from February to October 2022, when the RBI lost a whopping $105 billion in reserves to prevent depreciation after the US Federal Reserve started to raise interest rates aggressively to fight inflation. Admittedly, a portion of this loss was due to valuation effects. But the fact remains: A reserve depletion of this magnitude has never previously occurred in India's history.

In some ways, the new determination to fight depreciation seems to have intensified recently. One can see this from the solid red line in *Figure 2*, which shows a marked break — a pronounced flattening — in the exchange rate line starting in 2022. Simplifying somewhat, one could characterise the current policy as one of trying to peg the rupee-dollar exchange rate. To reinforce this newfound urge for stability, the RBI sold about $25 billion in reserves between July and October 2023.

The consequences of this new approach have been significant. As *Figure 1* shows, the average level of the real exchange rate has been 10 per cent stronger since 2019 than it was during the 1994-2018 period. This loss of competitiveness could not have come at a worse time — when exporters were already struggling with weak demand from overseas markets.

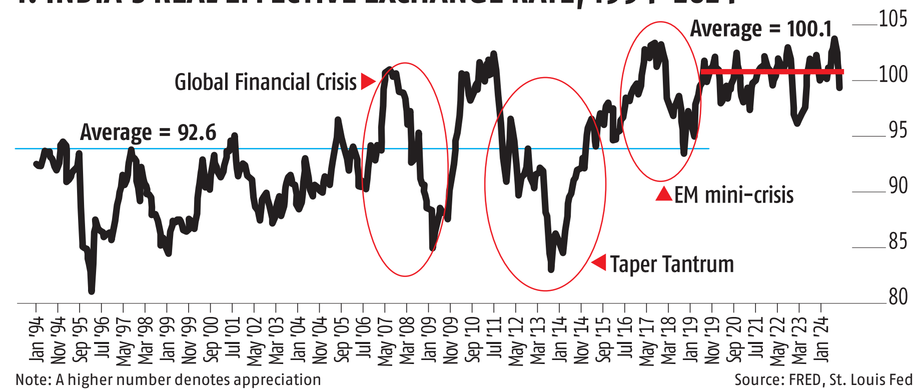
As a result, non-oil export growth has been quite subdued, averaging just 4½ per cent a year in dollar terms between 2018-19 and 2023-24 — and even less over the last two years. This is a far cry from the 10½ per cent annual average growth between 1994 and 2018. It is difficult to quantify how much of this slowdown has been due to the appreciation, but assuming a fairly conventional elasticity, the 10 per cent real appreciation might have reduced exports by about 5 percentage points over the past two years.

Conversely, under an alternative scenario, where competitiveness had been maintained, exports and GDP growth would have been stronger. And under the old intervention strategy the reserve sales of $130 billion in 2022 and 2023 would not have occurred. In other words, the new strategy produced a double whammy: Reduced growth and some loss of macroeconomic resilience that higher reserves provide.

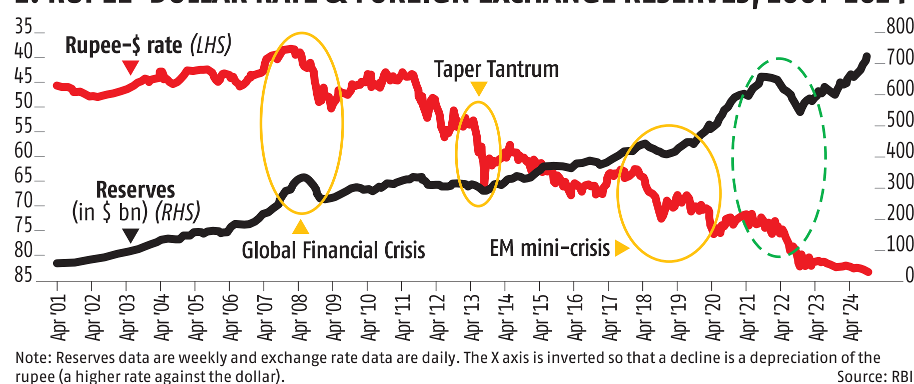
So why has the RBI moved away from its long-standing strategy? Perhaps it had valid, maybe even important reasons for doing so. But we will never know — and cannot rule out alternative explanations — until the RBI sets out its current strategy and explains why it has adopted the new approach.

Until it does so, speculation will be rife.

1. INDIA'S REAL EFFECTIVE EXCHANGE RATE, 1994-2024



2. RUPEE-DOLLAR RATE & FOREIGN EXCHANGE RESERVES, 2001-2024



Josh Felman is Principal, JH Consulting. Arvind Subramanian is Senior Fellow, Peterson Institute for International Economics and former Chief Economic Adviser, Government of India