Development and Management of Forex Markets: A Central Banking Perspective *

BIMAL JALAN

I am thankful to the Forex Association of India for inviting me to this Session of the Twenty-First Asia Pacific Forex Congress. I would like to add a special word of welcome to the delegates from Asia and the Pacific regions to Delhi to participate in this Congress. For us, this is a very special occasion as India, I believe, has a lot to learn from the experience of countries in our region in the proper development and management of foreign exchange markets. I am particularly glad that organisers have also invited experts from various parts of the world to deliberate on contemporary trends in forex markets, the impact of new technology as well as regulatory and organisational issues. I am sure your deliberations here will be fruitful. We in the Reserve Bank of India, very much look forward to the conclusions of your discussions.

In this gathering of specialists, forex dealers and experts, I do not have much to contribute by way of market insights or new information. You are much more familiar with all the issues connected with the working of forex markets than I am. Perhaps the best way in which I can help your discussions is to give you a central banking perspective on the development and management of forex markets in the light of recent trends in the world economy. As you know, policy issues relating to the management of the external sector, particularly the appropriate exchange rate systems, the appropriate intervention policy and appropriate foreign exchange reserve policy figure very prominently in the on going discussions on International Financial Architecture in various fora, such as IMF, the World Bank, G20, Financial Stability Forum and the Bank for International Settlements. India has been participating in all these discussions along with Central Bank Governors, Finance Ministers of industrial and other developing countries, including many of the countries represented here. Last few years have also given us a fair amount of experience on behavioural and regulatory aspects of forex markets. Both in theory and in practice, the state of debate is still somewhat unsettled. There are a number of issues on which worldwide consensus is still evolving. Let me briefly share with you the current thinking on some of the important issues which affect forex markets.

First, an important issue which has been extensively discussed in the literature as well as in different international fora is that of an **appropriate exchange rate regime**, particularly for emerging markets. You are all perhaps familiar with the so called impossible trinity, namely, full Capital Account Convertibility (CAC), Monetary Independence (for inflation control), and a Stable Currency.

If CAC is accepted, according to accepted theory, you either have the choice of giving up monetary independence and setting up a Currency Board or give up the stable currency objective and let the exchange rate float freely so that monetary policy can then be directed to the objectives of inflation control. In this scenario, exchange rate should matter only it affects domestic inflation. In theory, the recommended approach is either free float or a currency board.

In reality, however, the actual policy adopted by most Central Banks is different than the theoritical optimum. A recent study by the IMF, for example, shows that by far, the most common exchange rate regime adopted by countries, including industrial countries, is neither a

currency board nor a free float. Most of the countries have adopted intermediate regimes of various types including fixed pegs, crawling pegs, fixed rates within bands, managed floats with no pre-announced path, and independent floats with foreign exchange intervention moderating the rate of change and preventing undue fluctuations. By and large, barring a few, countries have "managed" floats or Central Banks intervene periodically. This is also true of European Central Bank (ECB) recently and Japan traditionally. The US has also intervened with ECB or Bank of Japan (BOJ) in favour of moderating the movements of Euro or Yen.

It is thus a matter of fact that irrespective of the pure theoretical position of a currency board or a free float, the external value of the currency continues to be a matter of concern to most countries, and most Central Banks.

Part of the reason why countries are concerned about exchange rates is psychological, and part real. Psychological -because of headline effect of a depreciating currency - "all time low", "weak", "tumbling" creates a negative impact about the soundness of a country's currency. For an ordinary man or woman on the street and the political leaders who represent them, it becomes a matter of concern as nobody wants his country's economy or currency to be weak or tumbling. However, irrational it may be, it is a fact which has to be reckoned with by all Central Banks. It would be nice if there was a new terminology to describe movements in exchange rates which is less emotive and less sensational.

Part of the reason for concern with exchange rates is also real, as seen in East Asia, Russia and elsewhere. The contagion effect is quick and a sharp change in the currency value can affect the real economy. Exporters may suffer if there is unanticipated sharp appreciation and debtors or other corporates may be affected badly if there is a sharp depreciation, which can also lead to bank failures and bankruptcies.

A fundamental change that has taken place in recent years is the importance of capital flows in determining exchange rate movements as against trade deficits and economic growth, which were important in the old days. The latter do matter, but only over a period of time. Capital flows, on the one hand, are primary determinants of exchange rate movements on a day to day basis. For example, the US with the largest trade deficit in the world today has the strongest currency. Europe, with a massive trade surplus, on the other hand (until lately) has one of the weakest currencies. This result is explained by movements in capital flows, which is a relatively a new phenomenon. The same is happening the world over - East Asia, New Zealand, South Africa and Australia.

Capital flows in "gross" terms which affect exchange rate can be several times higher than "net" flows on any day - and these are also much more sensitive to what everybody else is saying or doing than is the case with foreign trade or economic growth. Therefore, herding becomes unavoidable. I am sure you will agree that all dealers prefer to be wrong with everyone else rather than being wrong alone! Daily Risk minimisation guarantees "herd" behaviour. In this situation, as recent experience shows, the Central Banks have to intervene in some form or other - including the mightiest and not so mighty. While the degree of intervention and management varies from Central Bank to Central Bank, concern about exchange rates is a fact that you and I have to live with - at least for some time.

India, as you know, has "managed" floating with no fixed rate target. Daily movements are watched by the Reserve Bank very closely. Our markets are relatively thin, and the declared policy of the Reserve Bank is to meet temporary demand-supply imbalances which arise from time to time. For example, in the current period, because of extra-ordinary rise in oil prices, the RBI has been meeting the oil import requirements of Indian Oil Corporation (IOC) directly as also debt service requirements. Our objective is to keep market movements orderly and ensure that there is no liquidity problem or rumour or panic- induced volatility.

Interestingly, in view of the actual experience about the behaviour of exchange market, there has also been a shift in the theoretical position in regard to the "unholy" trinity of CAC, Monetary Independence and Exchange Rate Stability. Some well known economists are now in favour of temporarily or permanently giving up the CAC. Others seem to favour intermediate regimes. A recent theoretical study by Calvo and Reinhart of NBER in the U.S. interestingly concludes that "all that we can say is that, when it comes to exchange rate policy, discretion rules the day." Similar is the conclusion reached by Frankel.

A **Second issue** that has figured in the literature is that if some management of the exchange rate is required, what is it that we should be monitoring - nominal or Real Effective Exchange Rate (REER)? From a competitive point of view and also in the medium term perspective, it is the REER which should be monitored as it reflects changes in the external value of a currency in relation to its trading partners in real terms. However, it is no good for monitoring short-term and day-to-day movements as "nominal" rates are the ones which are most sensitive of capital flows and also attract the most headlines. (For example, in respect of the behaviour of US dollar - Euro or US dollar -Yen hardly, anybody talks about the real rates of exchange of these currency!). Thus, in the short-run, there is no option but to monitor nominal rate.

Interestingly, while every one agrees that the value of a currency should be monitored against all major currencies, all the headlines and comments by dealers are concentrated on the US dollar. One hardly hears Pound hitting "all time high" against Euro or Yen or vice versa. All we would hear is Euro, Yen, or Pound against the US dollar. There is certainly a reason for it as the US dollar is the currency that is mostly used in trade. However, what it means is that Central Banks have to pay maximum attention to US dollar whether they like it or not.

Another interesting issue is "stability" versus "volatility" in exchange markets. In principle, it would be desirable if exchange rates appreciate when capital flows are strong, and depreciates when they are weak. Unfortunately, in practice this option is not always available to Central Banks during periods of uncertainty or turbulence, because the market behaviour is not symmetrical in both directions. There is a greater tendency to hold long positions in foreign currencies and hold back sales when news is bad and currencies are depreciating, then the other way round when news is good and currencies are appreciating. It is also a fact that corporates, investors, and FIIs prefer relative stability to volatility as hedging costs less when conditions are stable.

Another issue which has figured prominently in the current debate on forex management is the question of appropriate policy for management of foreign exchange reserves. In a regime of free float, it can be argued that there is really no need for reserves. Some countries, where monetary policy is directed towards the single objective of inflation control, in fact maintain no reserves,

except for operational purposes. However, in the light of volatility induced by capital flows and the self-fulfilling expectations that this can generate, there is a now growing consensus for emerging market countries to maintain “adequate” reserves. How adequacy is to be defined is still an open question. Earlier, the rule was in terms of months of imports. Now increasingly it is felt that reserves should also be adequate to cover likely variations in capital flows. “Guidotti rule”, which has also been mentioned by Alan Greenspan, has argued that reserves should be adequate to cover one year’s import and capital flow requirements.

In India, we are taking into account liquidity as well as import requirements and unforeseen contingencies in the management of reserves. For this reason, we added US $ 10 billion to our reserves in the last couple of years and have recently taken action to further augment our reserves to meet the cost of high oil prices. Reserves are now more than adequate to meet the oil burden as well as any other likely variations in capital flows for a fairly long period. We have followed a very careful policy to reduce our short-term debt, which is lower than 7/8 years ago, and also to ensure that relatively short-term deposits from NRIs, which are kept in FCNR(B) accounts, are matched by foreign assets of deposit-taking banks.

There is also a consensus on the need to make available information by Central Bank on reserves, including forward liabilities, as well as market operations and turn-over, so that lenders and the markets have full information about a country’s external liabilities as well as Central Bank’s assets and forward liabilities. We in the Reserve Bank are also following international practice in this regard and are regularly publishing information on all our transactions as well as reserve, liquidity and forward liabilities.

Let me stop here. I have tried to give you a bird’s eye view of the dilemmas the Central Banks face as well as the issues that are currently being debated internationally at the level of Finance Ministers, Central Bank Governors and Heads of International Institutions. It may be useful to remember that floating exchange rate system, and volatility associated with capital flows, are relatively new phenomena. Until the 90s, we lived in a world of fixed exchange rates with par values or, fixed but adjustable exchange rates, in response to changes in fundamentals. Floating rates, Capital volatility, massive changes i n technology and integration of world wide markets across different time zones are relatively new phenomena. So, we are still on the learning curve. There are also some major structural changes taking place in the organisation of markets, for example, as a result of emergence of common European currency, whose full impact is not yet evident.

Recent changes have brought tremendous benefits to the developing world, including India. Capital constraints and technological constraints to developments are fast disappearing. As the new horizons open, we are also faced with some new challenges. With your help, support and guidance, I am sure, India and other countries represented here will be able to take maximum advantage from new technological and other advances while minimising risks.

*** Excerpts from inaugural remarks made by Shri Bimal Jalan, Governor, Reserve Bank of India, at the Twenty-First Asia Pacific Congress held in New Delhi on December 1, 2000.**