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DRG Study on “Monetary Policy, Forex Markets and Feedback under Uncertainty in An Open Economy”

The Reserve Bank of India released a DRG Study entitled, “[Monetary Policy, Forex Markets and Feedback under Uncertainty in An Open Economy](#)”. The Study is co-authored by Prof. Ashima Goyal, Indira Gandhi Institute of Development Research along with staff members from the Reserve Bank (Shri Ayyappan Nair, Assistant General Manager, Financial Markets Department and Dr. Amaresh Samantaraya, Assistant Adviser, Department of Banking Supervision).

The Study attempted to examine options for monetary policy arising from its intervention in Indian foreign exchange markets. Beginning with a brief survey of current microstructure of foreign exchange markets in India and its monetary policy institutions, the study brings out policy trilemmas in dealing with large cross border flows in a rapidly growing emerging market, where fundamentals are uncertain. Major findings of the study are as follows:

- Intervention affects both the level of the exchange rate and its volatility – supporting intervention as an additional policy tool.
- Among microstructure variables, merchant net demand or order flows affect the level of exchange rate, while dealer order flow and turnover variables affect volatility.
- Although intervention increases turnover, anticipated intervention decreases it, suggesting it is optimal to reveal information about future intervention. Expectations of future exchange rates and intervention are stabilising and not perverse.
- Estimated strategic market behaviour and model derivations both indicate intervention and signaling may be a more effective influence on exchange rates in the Indian context than interest rate changes.
- Markets form expectations of intervention activity and respond strategically to it. The increase in dealer turnover with intervention may imply strategic intraday arbitrage, whereby dealers profit at the expense of merchants and the central bank.

[Note: Development Research Group (DRG) is constituted in the Reserve Bank's Department of Economic Analysis and Policy for undertaking effective policy-oriented research backed by strong analytical and empirical basis on subjects of current interests. The views expressed in these studies are those of the authors and do not reflect the views of the Reserve Bank.]