
Exchange Rate Conundrums

The 1970s ushered in a period of great uncertainty for the global economy. The breakdown of the Bretton Woods system of stable exchange rates and the emergence of floating regimes presented serious problems for exchange rate management, and created balance of payments difficulties for many countries. The oil shock of 1973–74 amplified these trends. The speed and magnitude of all these developments resulted in destabilizing the global monetary system, leaving the authorities generally unprepared to cope with the evolving pressures within the system. Established mechanisms of liquidity creation were unequal to the task of absorbing the massive capital flows and propelled the need for reform of the monetary system. The backlash of these developments had to be borne by the developing countries, too, although they were on the periphery of the debate.

This chapter seeks to evaluate the response of the Reserve Bank and the Indian government to the global events and to the efforts at attaining exchange rate stability. It highlights the Bank's thinking on the initiatives launched for future reform of the monetary system.

A word of caution might be in order here. The documentation and official records available for a comprehensive evaluation of India's exchange rate management policy are woefully inadequate, and the methods of storage and retrieval of archival material rather poor. What is more, the Indian bureaucracy, as a rule, does not maintain diaries and personal jottings. The Reserve Bank's records of this period show little evidence of commitment to paper of sensitive policy issues. Perhaps the rigid laws regarding disclosure of classified material prevented senior officials from baring their thoughts on paper. Despite this infirmity, the chapter attempts to narrate the happenings of the tumultuous decade of the 1970s and the response and reactions of the Bank and the government in the formulation of major policy decisions.

The narrative begins with the rupee devaluation of 1966. The historic

alteration in the exchange rate through the devaluation of the rupee in June 1966 was a greatly controversial event in the monetary history of India's economy, and it sparked interest for years afterwards. The vigorous, even acrimonious debates that preceded the devaluation—whether or not it was needed, and whether or not would be effective in reducing the large and rising trade deficits—gave high motivation to the central Bank and the Ministry of Finance officials, as well as the academic community, to analyse and measure its effectiveness and repercussions in the second half of the sixties.

Although the devaluation itself was covered in Volume 2 of the history of the Reserve Bank of India in great detail, its effectiveness and repercussions need to be restated here in order to better appreciate the developments that influenced the value of the rupee in the 1970s. The early plan periods, beginning with the Second Plan, were marked by a very difficult balance of payments situation brought on by the policy of heavy industrialization and reliance on import substitution, and the tragic failure to recognize the potential of foreign trade as an engine of growth for the economy. Not only was the option of export earnings ignored but, while eschewing commercial borrowing, heavy reliance was placed on foreign external assistance to finance current account deficits. No doubt, adverse external factors, like the three wars (in 1962 with China, and in 1965 and 1971 with Pakistan) interspersed with droughts compounded the problem. However, in retrospect, it is abundantly clear that policy-makers underestimated not only the export potential but, more importantly, the import intensity of the import substitution process. Austerity was enjoined on a population that was gradually being strangled by permits, physical rationing, and currency restrictions on foreign travel and foreign investment. Short supply and import licensing marched hand in hand with the shortage of foreign exchange reserves. In 1956–62, intense use was made of QRs to control the unsustainable deficit; in the years 1962–66 use was made of the price mechanism by tampering with export tariffs and surcharges, and export subsidies and tax rebate; 1966–68 was a period in which exchange rate change was effected to improve the external payments position and, although reliance on QRs continued, export subsidies and tax rebates were withdrawn. From the point of view of allocative efficiency and its impact on growth, trade policies were not complementary to the exchange rate policy being pursued. In the long run, the commitment to a strategy of import substitution proved to be high-cost one as inefficiencies crept into the system and problems stemming from the overvalued exchange rate became more apparent.

It is pertinent to note that the Reserve Bank, although historically the administrator of monetary and exchange rate policy, was able, in the mid-sixties, to exert little direct and effective resistance to influence the course of exchange rate policy. But it would be wrong to infer, on that account, that the RBI had no role to play. Although in guarded terms, the senior hierarchy of the Bank, ever since 1963, had favoured a move towards a more realistic exchange rate policy. Several staff notes and memoranda prepared in 1965 and 1966 bear evidence of the need felt for a greater emphasis on export promotion policies and appropriate exchange rate adjustment. Governor Bhattacharyya, while giving a patient hearing, failed to share his views or information candidly with his deputies although he himself was privy to Delhi's views and agreed with the group that favoured devaluation. This was because he knew that there were hard opponents like T.T. Krishnamachari, who believed that multilateral agencies were forcing the country on to the suicidal path of devaluation. But, following the devaluation in June 1966, the Governor was the chief spokesperson of the view that devaluation by itself was not a solution. In one of his addresses he said that 'it was a challenge to stand on our feet' and went on to state: 'The success with which we are able to contain inflation, increase exports and reduce dependence on others for imports will determine how soon we could make a turnaround in our balance of payments.' These thoughts were indicative of the fact that the Governor was aware of the conditions in which the country could hope to maintain the devalued rupee rate. Inflation had to be kept firmly in check if the maintenance of any export advantage derived from devaluation had to be translated into a gain in reserves.

So, in crafting a package of supportive measures, Governor Bhattacharyya took extra special care to see that there was no general relaxation of the credit policy; in fact, there was overall tightening of credit expansion in the interest of monetary stability, even while ensuring its flow to various sectors according to their priorities. Exports were accorded high priority in the credit policy, and tools like moral suasion and concessional unlimited refinancing through the Reserve Bank for short-term finance, at pre and post-shipment stages, as well as by the Industrial Development Bank of India (IDBI) for longer-term finance, were employed to render exports profitable. The policy was kept under constant review and fine-tuned to meet emerging developments. Bhattacharyya went so far as to give an assurance to the export community that adequate refinance would be available at the Bank rate to all categories of export bills purchased by the banking system. Likewise, in framing the structure of rates at which commercial banks bought sterling export bills and in fixing the rates at which the

Reserve Bank bought sterling from banks, the interests of the export community were safeguarded.

Devaluation was accompanied by some changes in import policy as well. Imports were liberalized and tariffs reduced. Devaluation had also narrowed the disparity between the rupee prices of indigenous products and imported products. Apprehending freer availability of imported products, the RBI Governor urged the business community to encourage the use of local products and not to make a beeline for imports except where essential, warning of the dangers of unemployment and consequent recession. In the closely related field of foreign collaboration, Bhattacharyya cautioned against the reckless entry of foreign collaboration arrangements, which, according to him, would be a burden on the balance of payments and a set-back to the development of Indian industry. In short, the challenge of devaluation was the ability of the nation to stand on its feet by containing inflation, increasing exports and reducing dependence on imports.

Introduction of the devaluation package represented a major policy reversal entailing exchange rate adjustment, import liberalization, elimination of export subsidies and greater fiscal discipline. The earlier inward-looking policy of industrialization coupled with export pessimism was the root cause of the deterioration in the terms of trade and the external payments position. Devaluation, however, failed to correct the external payments situation immediately: the financial year 1966–67 witnessed a draft on reserves excluding International Monetary Fund (IMF) transactions of \$170.5 million. The main factors responsible for the deterioration in reserves were the sharp drought-induced decline in exports, and an increase in debt service payments accompanied by a sharp reduction in external aid inflows. The exceedingly difficult foreign exchange situation was relieved in 1967–68 as a result of debt relief, larger utilization of foreign aid, improved exports and reduced foodgrains imports following better availability of domestic supplies. The unsettled export conditions following devaluation of the rupee continued for the greater part of 1967–68 with the reserves recording a further loss of \$61 million and coming down to \$577 million. Despite this loss of reserves, the external accounts in 1967–68 were, surprisingly, in better shape. The pick-up in reserves from December 1967 to March 1968 was due in part to CFF drawing and the sharp improvement in exports.

By December 1967, there were distinct signs that post-devaluation clouds were lifting. The clearest indication was a revival in the growth of exports. A major international development occurred at around the same time, viz. the devaluation of the pound sterling. The 1960s were a period of growing

shortage of international liquidity in relation to the volume of world trade, with both the United States and the United Kingdom experiencing chronic balance of payments problems and both reserve currencies—the pound sterling and the US dollar—under heavy selling pressure. Payments crises of varying degrees of intensity had plagued the British economy at two-year intervals. In mid-1967 there was once again a sharp deterioration in the British current account and, despite a rise in Britain's Bank rate to a high of 6 per cent and the announcement of a new line of IMF credit, confidence evaporated; Britain was forced to act in the face of a heavy speculative outgo of sterling. On 18 November 1967, the pound sterling was devalued by 14.5 per cent, from \$2.80 to \$2.40.

India, in unison with the major world currencies, retained its existing gold parity. Having devalued the rupee just eighteen months back by 37.5 per cent, and bearing in mind the political fall-out and criticism which accompanied that move, Indian authorities, on the basis of the central Bank's advice, decided that since the measure of devaluation of the sterling was not all that large, the correct course of action would be to refrain from making an immediate adjustment, even though several countries like Ceylon, Hongkong, New Zealand, Spain, and Israel had done so. Pakistan, too, had revised its bonus voucher scheme. In a memorandum submitted to the Reserve Bank's Central Board on 8 December 1967, it was explained that the decision was based on the reasoning that there was no need for yet another change. It was pointed out that Indian exports in terms of sterling would be costlier in the British market but, as Indian exports like tea and tobacco did not compete with UK manufactures in the domestic market, the danger of earnings from these exports declining was minimal. What, however, was of significance was the impact on Indian exports—such as jute goods and tea—in the British and other markets, of Ceylon's devaluation and Pakistan's adjustment in its multiple exchange rate system; these would adversely affect the competitiveness of India's exports of jute manufactures and tea. While proffering advice that the trend of sterling would have to be watched, the Bank cautioned the government against rushing in to adjust the level of export duties; it said that corrective measures of this type should not worsen the terms of trade for the exporting country to the benefit only of the importing country. On the import front, discounting any price rise in the UK on account of the devaluation of that currency, imports would be cheaper in rupees. Admitting that India had suffered a loss in its sterling holdings as a result of the UK devaluation, it stood to gain, in rupee terms, so far as repayments were concerned. In retrospect, it would appear that the decision was a wise one.

There was, however, a change in the actual maximum and minimum rates at which the Reserve Bank would buy and sell sterling from authorized dealers—the Bank's buying rate was adjusted from \$4.7619 to \$5.5556 per Rs 100, and its selling rate for ready delivery from \$4.7467 to \$5.5360 per Rs 100. It may be recalled that forward sales by the Bank were discontinued following its bad experience during the devaluation of the rupee in June 1966, when some authorized dealers in foreign exchange took advantage of the facility to make speculative gains by effecting purchases of foreign currencies that were not backed by genuine trade transactions.

Indicating the impact of the devaluation of the sterling on the Reserve Bank's balance sheet, the Governor placed the total loss at around Rs 10 crore, amounting to 4 per cent of the total assets excluding gold. In his view, this was not large for a country which was an important member of the sterling area. The loss, to some extent, was minimized as a result of the timely diversification of holdings of foreign assets undertaken by the Bank a few months earlier. The increase in the UK Bank rate, too, was expected to improve the investment income on India's sterling holdings. To the extent that British prices moved up—in the Bank of England's reckoning a 4 per cent price rise was anticipated as a result of the devaluation—some real loss was inevitable.

The Governor, in discussions with financial interests abroad, sought their views on ensuring the safety of India's international reserves. His impression was that both the UK and the US authorities were determined to avoid a devaluation of their currencies; moreover, the existence of mutual support operations amongst central banks suggested that runs on reserve currencies would be adequately met. Besides, the UK no longer objected to 'outer sterling area' countries keeping their reserves in currencies other than sterling. The likelihood of the UK providing any guarantee at that point of time against any change in the par value of the reserve currencies appeared remote.

But, within a year, the UK was pressed by several of the sterling area countries into offering specific proposals for guaranteeing their official sterling holdings. When the details were received officially from the Chancellor early in July 1968, the Indian reaction was one of surprise. Each of the thirty-eight members of the overseas sterling area was urged to maintain an agreed percentage of its reserves in sterling for seven years. The agreed percentage was expected to be 'not lower than the present level'. In turn, the British government offered to provide a guarantee in terms of dollars for all the sterling holdings of sterling area countries if these holdings exceeded 20 per cent of their total gold and foreign exchange reserves. The offer

of a guarantee, for which a small charge was proposed, was a measure of the extent to which the sterling had fallen from grace and an indication of the UK government's desire to retain a key role for the sterling in the international payments system. As a result of negotiations, these proposals were amended and the final form in which the agreement took shape was as follows. All sterling holdings in excess of 10 per cent of India's gold and foreign exchange reserve would qualify for the guarantee. Deputy Governor Anjaria, when apprising the Board of the amended proposal, pointed out that India's sterling holding formed 13 per cent of its total reserve holdings, and the intention of the authorities was to raise this proportion to 15 per cent as it was to India's advantage to earn the higher rate of interest that could be obtained on investments in sterling. The proposal for levying a charge was also dropped. Regarding the period of guarantee, the UK authorities were persuaded to make the agreement effective for three years instead of seven years, as the Indian authorities considered seven years too long a period. As part of the operations to provide stand-by credit to the sterling, the BIS was anxious to increase its own resources. India accepted that there was some value in the arrangement and for the purpose of assisting stability in the international system, it transferred 5 million to a dollar account with BIS and a further DM mark 140 million to two deutsche mark accounts with it. These balances with BIS were denominated in their original currencies. The DM balances with the BIS earned a higher rate of interest compared with what was obtained from the Deutsche Bundesbank; however, the BIS was hesitant to undertake a further switch from dollars to DM as it could involve a substantial loss of income on the investment. In arriving at decisions regarding the future disposition of foreign exchange balances, officials like Seshadri, who were responsible for taking the decisions, were wary of pursuing this path in haste.

Overall, the negotiations on the guarantee arrangements that were concluded on 21 September 1968 were cordial and smooth, and it was conceded that there was a benefit in the guarantee despite the weakness of the dollar. Wisely, the authorities recognized that if India was to continue to play a responsible role, it had no option other than to negotiate within the ambit of the draft Basle agreement.

Liquidity management and inflation control were the centrepiece of Bhattacharyya's governorship of RBI in the post-devaluation period. Inflationary trends were discernible in 1966–67 and 1967–68. The wholesale price index rose by 13.9 per cent in the former year and by another 11.6 per cent in 1967–68. It was difficult to insulate the economy from the drought-induced inflationary pressures caused by the large fall in foodgrains

production necessitating heavy reliance on foodgrains imports. The key to controlling inflation lay in improving the supply position of foodgrains and raw materials production, for it was the serious imbalance in the demand/supply situation and not devaluation per se that was the root cause of the inflation. On the import side, though devaluation was accompanied by liberalization measures, imports failed to pick up because of higher prices; in fact, the capital goods industry tail-spinned into a recession because of the subdued public investment demand, which the Reserve Bank attributed to the substitution of cheaper, domestically produced substitutes.

In the difficult post-devaluation transition phase (1966 to 1968), for those in charge of macroeconomic policy at the central Bank, there was always a dilemma of not allowing inflation and inflationary expectations to get out of hand while, at the same time, not aggravating recession by adopting an overly restrictive credit policy stance. Management of credit in those difficult years called for a delicate balance between demand/supply forces. With deft strokes the Reserve Bank's management struggled to create that balance by placing an accent on credit liberalization measures, but on a very selective basis, for productive sectors like agriculture, exports and small-scale industry, while keeping the rest of the economy on a short leash so far as cost and availability of credit were concerned.

By the second half of 1968–69, overall industrial recovery was in evidence with a rise in exports and a steady strengthening of agricultural production through the application of new technology. The economy appeared on surer grounds for the resumption of growth. It was steered away from the path of drought-induced recession on to a path of stability. But, to sustain the latter, as rightly underlined in the Bank's *Annual Report* for 1968–69, further success in the growth of exports depended crucially on the maintenance of competitiveness of comparative costs, for any resurgence of inflationary pressures could not but affect adversely the 7 per cent export growth target envisaged in the Fourth Plan.

While some change in attitude towards exports became evident with the Export Policy Resolution of 30 July 1970, which contained measures aimed at identifying thrust areas with long-term export potential and the setting up, soon thereafter, of the Trade Development Authority to build up exports through a package of personalized services in the field of trade, information, research and analyses, import substitution over a wide area continued to remain the basic premise of the development strategy.

At this point, we need to retrace our steps to discuss external monetary developments and the sterling area arrangements. Since India was a member of the sterling area, the bulk of her reserves were held in sterling. In

1966 India was required to devalue for domestic considerations. Till then, the exchange rate was not an issue. Occasionally there was some discussion in the Reserve Bank whether it was worthwhile to remain in the sterling area or to diversify from the sterling into dollar and deutsche mark. But these were modest initiatives and at the beginning of the 1970s, the sterling still represented a sizeable proportion of India's foreign exchange reserves. In the two decades after World War II, being a member of the sterling area meant there was no practical alternative to holding the bulk of external reserves in the traditional form of sterling balances, as an overwhelming proportion of Indian exports were invoiced in sterling. True, the 1966 devaluation of the rupee was guided wholly by domestic considerations but, nonetheless, with an eye on the sterling and closely aligning with whatever moves the UK made in its exchange control system. As the seventies approached and the international monetary system came under growing pressure from 1967 onwards, there were a series of currency crises that culminated in the May 1971 upheaval, in which the par values of the deutsche mark and Dutch guilder were suspended, and those of the Austrian schilling and Swiss franc raised, and Belgium transferred all capital transactions to the free market. Though these changes in the parity of the deutsche mark/French franc came on top of the 1969 changes in their parities, they were unable to meet the needs of the situation, and the entire Bretton Woods system was thrown into disarray with the suspension of convertibility of the US dollar on 15 August 1971.

Following the 1971 annual IMF-World Bank meeting, an air of uncertainty gripped the global exchange rate scenario. The mild euphoria exhibited earlier evaporated, for it was felt that it was without justification. The battles within the G-10 seemed as insoluble as ever, and moods and attitudes were, if anything, becoming more firmly entrenched. The fact of the matter was, the Americans did not want to be seen retreating and they allowed the situation to run into October and November hoping for an early solution to the whole crisis.

In mid-November, Prasad, the then Executive Director at the IMF, wrote to I.G. Patel and narrated the frank exchange of ideas that the developing country directors had had with the Assistant Secretary of the US Treasury, Volcker. It was apparent to Prasad that Volcker, who always spoke with self-assurance, was doubtful about the ability of the US to push through its own formula at the forthcoming G-10 meeting. Things were certainly not going according to the US book—in fact, answering a question from Prasad whether the European countries, having embraced floating exchange rates, were adopting a leisurely approach to the solution of these problems,

Volcker confirmed that he shared Prasad's apprehension; he added that there seemed to be an increasing tendency in Europe of working towards regional monetary integration. With the major European industrial countries having picked up another US\$1.2 billion in reserves, Prasad's reading was that it would cut into the US leverage to bargain with the European Economic Community (EEC). As spokesperson for the developing countries, Prasad then queried Volcker on the universal European demand for a gesture on the gold price issue and devaluation of the dollar in terms of gold, and whether the US would concede to the European demand. In categorical terms the US Treasury Secretary thundered: 'No—the US was not willing to make any compromise, no matter what pressures the Europeans may bring and how long it may take to stave off agreements on other issues.' Reacting to Volcker's response and realizing that there was no easy road to salvation, Prasad merely added that the third world countries were not exercised by the 'gold price of the dollar' and were unlikely to pressure the US on this issue. However, he took the opportunity to tell the US authorities to come up with positive suggestions, to either accept a formula of fixing currency values in terms of a 'numeraire' of a selected group of currencies, or quickly work out an agreement to set up the SDR of a stated value as a symbol for the measurement of currency values. While stating that the US had no objection to devaluation, Volcker admitted he had no real suggestion to offer to get round the impasse.

The upshot of the uncertainty about the value of the dollar was that several countries, large and small, were reluctant to put through their transactions with the IMF and were holding back, in the hope that they would get a better package and that the Fund management was undoubtedly concerned about the flagging of its operational status.

SEARCH FOR STABILITY

The year 1971 stands out for special attention in the annals of the history of international finance, for it saw the breakdown of the par value system, so carefully crafted in 1944. The system crumbled because of the unprecedented growth of the global economy in the 1960s, the inadequate supply of gold and massive US current account deficits, indicative of the overvaluation of the US dollar in terms of leading world currencies. Accentuating the weakness of the dollar were massive short-term capital outflows to the rich industrialized nations, which facilitated the build-up of huge dollar holdings outside the USA. The underlying problem was a large and growing external payments deficit by the US, which touched a high of US\$30

billion per month in 1971, amidst widespread speculation that a currency realignment was inevitable. The outflow of funds from the US was a response to the widening interest differentials in favour of Europe, following the tight monetary conditions prevalent in Europe. Added to this was the speculative element, as portfolios were adjusted to take advantage of the appreciation of currencies against the US dollar. Borrowers sought to increase their exposure to the US dollar, while holders of assets increased their holdings of instruments denominated in the deutsche mark, Swiss franc and other stronger currencies. Touched off initially by interest rate considerations, the short-term capital movements fed on speculation regarding parity changes. Their volume and frequency were aided by the return to convertibility of major currencies, the emergence of important currencies of equal strength for the first time since 1944, and the existence of the largely restriction-free Euro-dollar market.

By 1970, the view was steadily gaining ground that the international monetary boat had been rocked by massive short-term capital flows that had culminated in a series of costly crises in the international monetary sphere, and that there was need for orienting the par value system in the direction of greater flexibility.

The Indian approach towards the new flexibility was not one of enthusiasm but of open-minded willingness to consider suggestions that might improve the working of the monetary system in the direction of more orderly and effective adjustment without changing the essential features, for too wide a margin in their perception could tantamount to abandonment of the par value.

The flotation of the mark and the Dutch guilder in May 1971, and the readjustment of several European exchange rates offered a brief respite. But the continuing large deterioration in the US payments position undermined fundamentally the viability of the US dollar at the parity established since December 1946, and threatened the Bretton Woods system which the dollar parity and gold convertibility of the US dollar had underpinned. Substantial leads and lags developed in US external transactions despite the strong reflationary stance of the US monetary and fiscal policy, and further eroded the confidence of the US dollar. Speculative pressures on the US dollar were also provided by the continued refusal of Japan to consider revaluation of the yen.

The figure, for the first half of 1971, of US balance of payments deficit on official settlements basis, was US\$2 billion; it moved up to US\$2.5 billion for July alone, and bounded up to \$7 billion for the first fortnight of August—a number that removed the last vestige of confidence in the

stability of the US dollar. Although swap credit lines were hurriedly put together, the US was forced to introduce a major economic package on 15 August 1971, which, among other measures, included the slapping of a 10 per cent import surcharge and suspension of convertibility into gold and other reserve assets of dollars held by foreign treasuries and central banks. US President Nixon also called for international consultations to secure a viable realignment of exchange parities of the US dollar in relation to world currencies, and for negotiations by the G-10 industrial nations leading to a reform of the monetary system.

Following the US announcement, the UK declared that the parity of the sterling would remain unchanged at US\$2.40 a pound but dealings would not be confined within the existing limits; when the rate tended to rise above US\$2.42 to the pound, the US dollar would be allowed to float upwards without a ceiling at \$2.40 to \$2.42 per pound. The developing countries were not quite in on these decisions. So, when the US decided to suspend the gold convertibility of the US dollar, understandably, the significance of the departure from Bretton Woods was difficult to comprehend. It became apparent that with the breakdown of the Bretton Woods system, an interim floating arrangement had emerged for the major currencies. In view of this, the Finance Ministry, in consultation with the Reserve Bank of India, announced on 22 August 1971 that while there would be no change in the gold parity and consequently the rupee-dollar parity of Rs 7.50 to the dollar, the Reserve Bank would buy and sell pound sterling for ready delivery at rates that would be determined daily, and with regard to the par value of the sterling.¹ In order to take advantage of the depreciating dollar, the rupee peg was shifted from pound sterling to the dollar. A wait and watch approach to the breakdown of the Bretton Woods system, in the circumstances, was perhaps the most pragmatic way of addressing the problem.

Reporting to the weekly Committee of the Central Board of the Reserve Bank on President Nixon's shock measures of 15 August 1971, Executive Director Pendharkar explained that the external aspect of the measures was to reduce speculative pressures against the dollar through the suspension

¹ Between August and December 1971, while the gold parity as well as the US dollar parity of the rupee as fixed in June 1966 remained unchanged, the rupee-sterling rate was allowed to fluctuate with reference to the par value of the rupee in terms of US dollars and the exchange value of pound sterling daily in the London foreign exchange market, where it was allowed to float freely upward against the dollar. The margin retained by the Reserve Bank over the London cross rates for arriving at its rates for buying and selling spot sterling, which was fixed at £0.0175 from 23 August 1971, was reduced to £0.125 with effect from 8 September 1971, on representations that the earlier margin was too steep.

of dollar convertibility into gold and the imposition of an import surcharge. Internally, the measures were intended to lift stagflation in the economy through cuts in government expenditure on foreign aid and a wage price freeze. The Reserve Bank's initial assessment was: if Japan and Germany revalued their currencies by 10 per cent or thereabouts, India's exports to these countries would not be affected as they were not that large, but imports from these countries would become costlier and India's foreign assets, which were in dollars and sterling, would be reduced. However, in the judgement of the Bank, the likelihood of revaluation of the yen and deutsche mark was remote, particularly in the case of the former as Japanese exports to the US were sizeable. On the other hand, the impact of the US measures on Indian exports to the US would be contained in view of Secretary Conally's assurance that the surcharge would not affect developing countries. The proposed measures on foreign aid would impact on the quantum of aid, particularly as the International Development Agency (IDA) replenishment would suffer. The August measures were described by Pendharkar as preparation for a dollar devaluation; if that happened, Indian jute and tea exports would be affected.

Adding to the comments, Governor Jagannathan stated that India had an obvious stake in a healthy US economy which would signify orderly trade and aid prospects. Mafatlal, a member of the Committee, raised the issue of how the Bank would react if both the US dollar and the British pound were devalued. The Governor responded, if that happened, India would have to seriously rethink its position, but added, it would depend on the extent of the devaluation. Mafatlal was also curious to know the implications of pegging the rupee parity to the dollar while allowing the rupee–sterling rate to float, and how the Bank proposed to deal in other currencies such as the mark and the yen. The Governor clarified that India obviously had to peg the rupee to some currency. Having decided that the rupee's parity with gold would not be disturbed, this meant keeping the parity with the dollar unchanged. It could not therefore be construed that if the value of the dollar in relation to gold were changed, it would *ipso facto* follow that the Indian rupee's value to gold would also change. The Governor emphasized that the Indian decision was clear—not to change the par value in terms of gold. In the case of the sterling, he explained that the Reserve Bank was obliged to sell sterling and the rate at which the deals in sterling would be concluded would depend upon the sterling/dollar rate. As for the other currencies, the rate would depend on the float rate.

These events were of momentous significance, for they marked the demise of the fixed exchange rate system established under the Bretton

Woods arrangements. The inflexibility of the gold exchange standard had revealed the difficulty of making appropriate and timely exchange rate adjustments, but, despite that, it had imposed a certain measure of discipline on countries that were members of the system, except for the US. The drawback of the fixed exchange rate system stemmed from the way in which reserves were created, for it relied heavily on the US balance of payments deficits to provide the needed global liquidity. The upshot of this was that the US was the only member to escape discipline, as it was the country issuing the reserve currency; and, as the world economy expanded, demand for international liquidity greatly exceeded the supply of monetary gold and this gap was filled by the issue of central bank liabilities of the reserve currency. This was generally perceived to be unsatisfactory.

In the debates that ensued to rehabilitate the international monetary situation on an enduring basis, the developing countries, initially on the periphery of this debate, strongly opposed the system of floating rates. The Reserve Bank of India's official view, as elaborated by Executive Director Pendharkar in a memorandum to the Central Board, was to develop a neutral reserve asset, which would not be subject, as would any national currency, to the changing fortunes of an individual economy or, as gold was, to the natural and other irrational and unique limitations to its production and use. Such a neutral asset would enable countries to hold their reserves profitably and only by reference to such an asset could international reserves, assistance and obligations be determined, without making the monetary system overly dependent on the predilections or policies of individual reserve currency economies. The move to a high level of flexibility in the exchange system removed most of the discipline and blunted the adjustment process. A widening of the margins, Pendharkar argued, would necessarily require general resort to forward cover in all external payments transactions and the costs of forward cover would rise with the width of the margins within which the currencies were allowed to fluctuate. This would prove a serious handicap for the exports of many developing countries, particularly for their new exports, while their imports would be generally more expensive due to the resultant adverse impact on their terms of trade. All in all, the new arrangement was viewed with considerable suspicion. Economists like Madan, Pendharkar and Bhatt within the RBI maintained that an alternative to devaluing the US dollar would be to retain the dollar price of gold, and to raise the gold value of SDRs and express all currency parities in SDRs. This, in their view, would mark signal progress in gold demonetization and in the development of a neutral reserve standard. However, easing out the dollar and making the SDR the centrepiece of the

international monetary system was nowhere on the agenda of the reform exercise.

The foregoing makes it clear that a lasting solution to the problems confronting the international community after the 15 August 1971 package of measures announced by the US, called for a fundamental reform of the monetary system. From the viewpoint of the Reserve Bank, the elements of such a reform were a resolution of issues relating to the choice of a stable and appropriate reserve asset or a mix of assets with a diminishing role for gold and national currencies; provision for adequate addition to liquidity for the orderly growth of trade and economic development; establishment of acceptable criteria for exchange rate adjustment; control of short-term capital flows; and an overhaul of the structure of the IMF to correct the lopsided weight that the rich industrialized countries enjoyed in the decision-making process on the basis of the then existing quotas. It was, however, realized that, with major currencies floating, reform of the monetary system could not be considered till after a realistic realignment of currencies.

After four months of intense negotiations, the Finance Ministers and Central Bank Governors of the Group of Ten (G-10) met in an executive session under the chairmanship of Mr Connally at the Smithsonian Institute in Washington on 18 December 1971, and hammered out an agreement on a new pattern of exchange rates.² The crux of the realignment was a proposed devaluation of the US dollar against gold of 7.89 per cent, fixing the new parity at US\$38. Simultaneously, the US removed the 10 per cent surcharge imposed earlier. But the suspension of gold convertibility of the dollar was not revoked. It was understood that, pending legislative approval of the 7.89 per cent devaluation of the dollar against gold, formal action establishing a new par value of the US dollar would take some time.

Meanwhile, the agreed changes in the exchange rates of other currencies were given effect to by the adoption of appropriate central rates. The adoption of central rates with wider median entailed a medium appreciation of major currencies against the US dollar of about 11 per cent. The Canadian dollar continued to float. While adopting the central rates, most countries indicated that they would avail the margin of 2.25 per cent permitted by the IMF. The significance of the Smithsonian agreement was that, after months of disagreement, there was agreement on a realignment of major currencies, the first such multilateral determination of exchange rates in history.³

² Schweitzer, Managing Director of the IMF, took part in the meeting and reported on the views of the Executive Directors of non-G-10 developing countries.

³ *IMF History: 1972–78*, Vol. I, p. 263.

The Smithsonian agreement partially shored up the par value system but failed to provide a lasting solution. It called for some major decisions by India. Averse to floating the rupee and wedded to the fixed exchange rate system, India was required to decide on the choice of the reserve currency on which it would peg the rupee and on the exchange rate for the Indian rupee. The devaluation of the dollar by 7.9 per cent had changed the dollar–sterling parity from \$2.40 to \$2.60. The choice of reserve currency was not all that difficult as the pound sterling continued to have its adherents within the Reserve Bank who held the view of steady depreciation of the rupee. There was every indication that the centre of financial gravity had moved towards the dollar and a substantial part of the speculative funds that had resulted in massive outflows prior to the realignment were expected to return across the Atlantic, firming the US dollar on the exchanges. In this situation, the desirability of discontinuing with the dollar peg became evident; so, the Indian government decided to delink from the dollar and establish a central rate in terms of sterling, equivalent to the average of the buying and selling rate of sterling, based on the London quotations for dollars on 17 December 1971, before the realignment. Recognizing that establishing an appropriate exchange rate was a vexatious issue, highly sensitive politically, Government of India decided to keep unchanged the rupee–sterling rate prevailing at the end of the preceding week and resumed forward purchases of sterling which had been temporarily suspended. The new rupee–sterling rate was fixed at Rs 18.9677 as against the old rate of Rs 18, entailing a devaluation of the rupee against pound sterling by 5.38 per cent. Further, the rupee–dollar rate was also altered from Rs 7.50 to the dollar to Rs 7.27—a modest revaluation of the rupee of 2.95 per cent against the dollar. Through Prasad, the Indian Executive Director, the IMF was accordingly informed of the change and the Fund took note of the Indian proposal without expressing any difficulty.

Like many other countries, India also took advantage of the wider band of 2.25 per cent on either side of the central rate. The main consideration influencing the Indian decision appears to have been the anxiety of not wanting to hurt exports and invisible earnings. Overall, it was a modest adjustment; the weighted depreciation of the rupee vis-à-vis the new rouble parities and agreed central rates, according to the Reserve Bank's calculations, was around 4.5 per cent against the major currencies in relation to the April 1971 parities.

As part of the Smithsonian accord, it was agreed that negotiations would be promptly undertaken for a fundamental reform of the international monetary system. Not to be left out of the discussions and following the

mandate given by the Group of 77 at Lima on 7 November 1971, a twenty-four-member Inter-Governmental Group on International Monetary Reform (G-24) was set up to ensure full participation of the developing countries in the reform exercise and to safeguard their interests. At its inaugural Ministerial Meeting in Caracas on 6–7 April 1972, G-24 decided to support the creation of a Committee of the Board of Governors of the IMF (C-20) on issues related to the reform. The United Nations Conference on Trade and Development (UNCTAD), at its third Santiago session in April 1972, supported the effective participation of developing countries in the decision-making process, and endorsed the view that the nine developing countries should be represented on the Board of Governors Committee.

In the months that followed world exchange markets were relatively calm, but, in the third week of June, a sudden burst of speculation against the pound sterling disturbed the calm. In the preceding two months there had been growing uneasiness about the prospects of the UK balance of payments in the context of industrial unrest, and continuing inflation set off rumours of a possible devaluation of the sterling. This triggered concerted intervention by the Bank of England and the Central Banks of European countries in the exchange markets in London. Despite the efforts to save the sterling, 22 June witnessed the biggest outflow of short-term capital in a single day, forcing the UK authorities to take an expeditious unilateral decision to let the pound sterling float and impose exchange control measures as a precaution against speculative outflow through sterling area currencies. These measures effectively circumscribed the sterling area to the UK, Ireland and Gibraltar. India was also subject to controls but nevertheless it allowed the rupee to float with the sterling.

The pound sterling slumped from the Smithsonian rate of \$2.6057 to \$2.4430. With considerable uncertainty prevailing in the market and difficulties in predetermining the 'correct rate', Indian authorities decided to make no change in the exchange rate system, except for a small upward adjustment in the Reserve Bank's rates for spot purchases and sales of sterling from authorized dealers. The adjustment was effected in two stages—a minor one on 26 June, followed by a slightly larger one on 4 July, involving an appreciation of 0.87 per cent in the sterling value of the rupee over the position obtaining before the sterling float. This was all done in the hope and expectation that the float would be temporary. Although a number of countries, including Pakistan, had chosen the US dollar, Reserve Bank officials debated the policy alternatives and decided against establishing a formal link with the dollar; they concluded that in the long run a hard currency would not be suitable from the Indian standpoint.

The difficulties of the sterling could not but cast a shadow on the viability of the Smithsonian realignment. Following the sterling float, speculative attention turned to the US dollar and massive intervention by European Central Banks was required to hold up the dollar to its support point. It was only after the US intervened and displayed its readiness to do so, that the suspended swap network was restored and the US dollar strengthened above its support point.

These developments provoked the IMF's Board to study the UK experience and see what lessons could be drawn from it for a reformed monetary system. It was evident that a reformed system should be able to reduce the disturbing effects on exchange rates of short-term capital flows. Another lesson, to which Prasad, a former Economic Adviser of the Reserve Bank and a second-time nominee of Government of India on the Executive Board of the IMF, drew attention, was the disadvantages for the developing countries of a monetary system that relied primarily on national currencies for reserves. He graphically pointed out that on twelve of the fourteen occasions on which India had changed its exchange rate since 1918, India, as a member of the sterling area, had responded to changes in the rate for the pound sterling, rather than to its own needs and requirements. This, he said, pointed to the limitations of a monetary system based on reserve currencies; no matter how small the change, it introduced complicating factors in the trade and payments arrangements of these countries. Prasad advocated the need for a uniform international standard, like the SDR, to which world currencies could be linked to obviate the problem.

Reporting the debate in the IMF, Prasad, in a secret letter to I.G. Patel, hinted at the possibility of avoiding disturbance of the rupee by continuing to maintain quotations for the rupee in terms of all currencies other than the pound sterling within the 2.25 per cent margins, but allowing the sterling rate to go past 2.25 per cent. This would tantamount to transgression of the wider margin decision but it could be defended on the ground that it helped reduce disturbance to trade and payments. But the Reserve Bank would need to examine if, in practice, there would be operational problems.

These developments on the international monetary front had led to the setting up of the Committee of the Board of Governors on 'Reform of the International Monetary System'—the C-20. Unrest and upheavals in the foreign exchange markets, punctuated by closures, had highlighted the urgency for restructuring the framework of international monetary arrangements. And this was of particular importance to the less developed countries because the environment of greater exchange rate flexibility that

had emerged from recurring currency crises posed for them the problem of greater uncertainties to cope with, for which they had no institutional arrangements. At the C-20 deliberations, the Indian delegate advocated adoption of a more efficient and equitable adjustment mechanism with stability of exchange rates, international creation of and control over liquidity with the SDR as the principal reserve asset, and establishment of a link between international creation of liquidity and development finance as an instrument for the transfer of real resources.

While the deliberations on the Reform of the Monetary System were underway, the position regarding the dollar turned adverse, so much so that it was worse than that of the pound sterling. The weakness of the dollar stemmed from the continued growth in the US trade deficit and misgivings about the US administration's ability to deal with the situation; this forced the dollar to devalue despite the massive support to it by the major Central Banks. Against this background, Volcker, the US Treasury Secretary, rushed to meet the financial heads of Europe; these consultations paved the way for further devaluation of the dollar. On 13 February 1973, the US administration proposed to the Congress a reduction in the par value of the dollar of 10 per cent in terms of the SDR, setting the new rate at $\text{SDR } 0.828948 = \$1$. With the currencies of six countries—Germany, France, Denmark, Belgium, Luxembourg and the Netherlands—agreeing, on 12 March, to make no change and to float jointly, and the rest of the currencies including the yen floating independently, a new structure of exchange rates came into being: the invincible dollar was devalued for a second time in fourteen months. The new realignment of currencies was seen as a 'solution' that had been reached with remarkable speed. The Governor of the Bank of England, in a message to RBI Governor Jagannathan, described the move as 'bold and constructive'; he reassured him that the sterling agreements would remain in force and that consultations about the implementation of the guarantee would continue in the period in which sterling continued to float. But the new floating arrangements had unhinged the par value system and, despite the efforts of the IMF and the developing countries to prevent it, a new era of widespread floating had dawned.

In view of the uncertain conditions prevailing in the international foreign exchange markets, on the advice of the Reserve Bank, no change was made in the existing parity of the rupee, which was maintained at Rs 18.9677 per pound sterling, and foreign balances continued to be held at the existing central rates. As a precautionary measure, the Bank thought it fit to stop purchases of both spot and forward dollars as also purchases of forward sterling, while continuing to abide by the statutory obligation un-

der the Reserve Bank of India Act of purchase and sale of spot sterling. The press and some political critics, racked by doubts, purported that the authorities were unaware and caught by surprise. Justifying the Bank's stand, Governor Jagannathan explained to representatives of the press that the sterling had not been officially devalued and that sterling had not depreciated either in terms of the dollar or in terms of the rupee; but, because of its float, it had depreciated vis-à-vis strong currencies like the yen and western European currencies. India, like many others, was not master of the situation; in fact, no country was. The Reserve Bank had rearranged its dollar portfolio by reducing the holdings of dollars to a comparatively small amount, but the high degree of loyalty to the sterling because of the sterling area arrangements, coupled with the high rate of interest earned on sterling holdings (around 9 per cent, as against barely half that amount on the deutsche mark and yen), had prevented diversification out of sterling. Hence the Bank's preference for holding money in sterling in the UK.

Floating rates, however, failed to dampen speculative flows of funds from one currency to another, and the exchanges lacked an undertone of stability. It is pertinent to note that the Federal Reserve Bank of New York, in September 1973, expressed strong reservations about 'an international monetary system based on freely floating exchange rates ... as having failed to meet its real life test'. Even after the June 1973 revaluation, the currencies of the EEC joint float appreciated noticeably against the US dollar. With the deteriorating trade position of the UK, pound sterling continued its downward float despite the raising of the minimum lending rate, necessitating reactivation of the swap arrangements. The approach of the expiry date of 24 September 1973, of the UK Sterling Guarantee Agreements, was an additional factor undermining the sterling on the exchanges. Not to worsen an already volatile situation, the UK government unilaterally extended the guarantee arrangements by a further period of six months and offered to protect the value of sterling reserves in terms of the US dollar at a guarantee point of \$2.4213, provided the holders maintained the stipulated minimum proportion throughout the six-month period. For India this was 11 per cent of the total reserves including gold. This decision, along with the Bank of England's intervention in the exchange markets, eased the pressure on the sterling but put exactly the opposite type of pressure on currencies like the Australian dollar, the New Zealand dollar and the Netherlands guilder, threatening the joint float arrangement, which moved to the top of the snake by mid-August and pierced the ceiling by the middle of September.

Meanwhile, the Committee on the Reform of the International Mon-

etary System and Related Issues (C-20) was vigorously debating the central issues of adjustment and convertibility but conflicting views strongly held by the major countries posed great difficulty in arriving at a common position. Nor were the issues relating to gold or the valuation of SDR anywhere near resolution. As for the link between SDR creation and development finance, its consideration was seen to be receding. Lack of political will in the exercise of reform of the monetary system was seen by the developing countries as an effort on the part of the developed countries to drag on the current floating arrangement, in the hope that it would stabilize and weaken support for a return to a fixed exchange rate regime. The developing countries feared the emergence of a polycentric world monetary system and creation of ad hoc currency areas in which the IMF would play the more distant role of arbitrator between them. Restating the views India held on basic aspects of the reform, at the annual meeting in Nairobi, the Finance Minister expressed India's dismay at the tardy progress, and the absence of political will and vision it implied, emphasized the lack of attention being paid to provide a link between international creation of liquidity and development finance, and warned the international community that any agenda that failed to transfer real resources to the less developed countries would not be acceptable to them.

INDIAN RESPONSE TO WIDESPREAD FLOATING

Reverting to the Indian scene, the parity of the Indian rupee was taken up at the Cabinet level. In preparation for a full-scale discussion in the Cabinet, Governor Jagannathan wrote a lengthy letter to P.N. Dhar that provided cogent answers to aspects of the Reserve Bank's policy that were a cause of concern to the government—viz. the disposition of India's monetary reserves, why the Indian rupee had to be linked to the sterling and not the US dollar, and were the authorities caught by surprise. On diversification, it explained that the Reserve Bank had pursued a policy of a blend of tradition and a cautious stance towards diversification. It had reduced to the lowest its official holdings of dollars (4.8 per cent) and acquired German and Japanese currencies at the cost of depleting sterling and dollar holdings. This was no accident. Sensing revaluation of the yen and the deutsche mark, a conscious decision was made to acquire these currencies, but there was no escape from holding dollars and sterling as these were reserve currencies used as intervention currencies even by powerful and rich nations like Germany and Japan. This, then, was the constricting factor in the diversification of the currency portfolio. The interest factor

too had played a role in the Reserve Bank's decision to acquire hard currency; it meant lower earnings on the investment in these currencies for it entailed complex guesswork to know how far appreciation would compensate for the loss of interest. Despite this, the RBI had taken the risk and had profited. The Governor wrote:

The rupee was not linked to sterling, in the sense that we were not bound to move the same way as sterling. We had the freedom to choose, but for good reason we had chosen sterling as it was the intervention currency and designated our central rate in terms of sterling.

Refuting that the Bank was caught unawares, the Governor asserted that in a complex situation India had not taken longer time than reasonable nor longer than other countries similarly affected.

Based on the material provided by the Reserve Bank, the Finance Minister, in a statement in the Rajya Sabha, defended the government stand. He stated that the course of action taken was the best in the interest of the country. Maintaining continuity with the past and without a detrimental effect on trade, the rupee–sterling rate remained unchanged; the extent of the fluctuation in the exchange value of the rupee vis-à-vis other currencies was not large and the effects on exports, imports, budgetary receipts and service payments were likely to be of a marginal nature. The Finance Minister assured the House that in the ongoing discussions on international monetary reform, every endeavour would be made to secure arrangements that reflected the needs of the developing countries for adequate liquidity, and stability of trade and exchange rates.

In the aftermath of the dollar devaluation, the Exchange Control Department was flooded with queries from the East European countries on the official parity of the rupee. The Reserve Bank confirmed that the gold clause was still applicable to the agreements as there was no change in the gold parity of the Indian rupee.

Volatility in foreign exchange markets also posed accounting issues, which were examined by the Chief Accountant's office. Based on the guidelines suggested by the Department, Executive Director Seshadri ruled that so long as the sterling and other currencies floated, revaluation of holdings should be carried out each calendar quarter with reference to market rates and not to central rates, as was earlier the case, and revaluation gains transferred to the Exchange Fluctuation Account. But, on reconsidering the issue, Governor Jagannathan felt that revaluation gains may best be booked as unrealized appreciation in the Issue Department for the time being, in

effect treating the gain as a sort of secret reserve. The Governor's preference to understate the rupee value of the reserves was to avoid creating a perception that reserves had increased, which could lead to increase in demand by spending ministries for larger allocations of foreign exchange. But, unclear about the advantages of revaluation gains being treated as hidden reserves, the Finance Ministry pointed to the discrepancies such a procedure would give rise to, between the published reserves and the reserve figures as reflected in the Bank's balance sheet. The Reserve Bank, realizing the practical limitations of indefinitely deferring the gains by transferring them to a secret reserve, later rescinded the instructions and ruled that the entire revaluation gain of Rs 26.4 crore should be transferred to the Exchange Fluctuation Reserves, which would be included in the published figures of other liabilities, while, on the asset side, the value of the assets would be written up. The Central Board of the Bank was informally apprised of the change.⁴

Meanwhile, anticipating a steady rise in the deutsche mark in terms of sterling and a further weakening of the dollar accompanied by a sympathetic weakening of the sterling, the Reserve Bank, for the first time, moved to acquire deutsche mark and French franc deposits with the BIS and diverted their holdings away from investment with central banks. Adopting a policy of turning over, at short intervals, deposits with leading commercial banks in Europe and with the BIS to gain the benefit of rising interest was seen as a remunerative strategy for diversifying the disposition of the country's reserves. For the first time, the RBI's foreign exchange reserves outside sterling and dollars were in excess of its reserves in sterling and dollars. Having made an appreciation of Rs 43.4 crore, the Bank realized the limits of any further diversification and adopted a cautious stance as it realized that there was no lender of last resort in the Euro-currency market. The first foray into the Euro-market was successful; however, a judicious management policy of reserves demanded slow travel on this route.

The government was appreciative of the manner in which the Reserve Bank had managed its foreign exchange portfolio. However, in view of the very large liabilities in US dollars, the Economic Secretary, M.G. Kaul, advised the RBI Governor not to diversify out of dollars—a suggestion that was not well received by the Governor who remained of the view that switching from other currencies to the US dollar would have to be done cautiously. It must be conceded that, despite the limitations of the difficulty in

⁴ Minutes of the meeting of 7 July 1973.

anticipating exactly the prevailing trend and when it was likely to be reversed, operating from Bombay with no direct or intimate links with the leading global foreign exchange markets, and having no advance information about the operations of multinationals and interventions by central banks, the Reserve Bank management, maximized the income on the country's foreign exchange assets. The switches it had made were at fairly good rates and had yielded overall profits.

Between June and September 1973, despite the clarifications provided by the Bank's representatives to the Joint Select Committee on the Foreign Exchange Regulation Bill, a tirade of criticism was levelled against the Bank by Jyotirmoy Bosu, that the RBI and the government had devalued the rupee thrice without saying so. The Bank management reiterated that technically there had been no change in the par value of the rupee in terms of gold, and that operationally too, the central rate of the rupee had continued to be £1=Rs 18.7677 since end-1971. The Bank had, within the permissible margin of 2.25 per cent of this rate, varied its spot buying and selling rates for the sterling. This, in effect, meant that the rupee's cross rates had varied in accordance with the market value of the sterling for all those currencies that were not specifically linked to the pound sterling.

The complexity of policy-making was highlighted by the perverse movement of exchange rates in a period of major currency readjustments. Following the dollar devaluation of February 1973, the dollar remained generally weak; between April and July, it fell, in part because of the Watergate scandal. But after November 1973 there was a distinct hardening of the dollar. Linkage of the rupee to the sterling had resulted in the appreciation of the rupee to Rs 8.20 to the dollar, while the sterling had dipped below \$2.29—an all-time low, and a development whose ramifications Economic Secretary M.G. Kaul urged the Reserve Bank to consider, in view of its low holdings of dollars. The Bank forthwith made a detailed currency-wise presentation in which, while accepting that the dollar had hardened and all other currencies were much weaker, it attributed the hardening to the oil crisis. But it sought to correct New Delhi's perception that the Bank's holdings were abnormally low and needed replenishment: in the latter half of 1973, as the dollar strengthened, the process of converting sterling into dollars had been resumed and to avoid losses resulting from adverse rates for conversions, dollar purchases had been made directly from the market.

TOWARDS AN OUTLINE OF REFORM

Following the quadrupling of oil prices in January 1974 and the submission by the Committee of the Board of Governors (C-20) of the outline of Monetary Reform, discussions were stepped up in the Interim Committee—successor to the C-20. Substantial agreement emerged regarding improvements in the characteristics of the SDR and amendments of the Articles of Agreement of the IMF, but differing views continued to be held on vital issues regarding gold and exchange rates. There was general agreement on abolishing the official price of gold between member countries and the IMF. In principle, support was also forthcoming for the use of profits from the sale of part of the Fund's gold holdings for the benefit of the developing countries, although agreement on specific arrangements remained to be evolved. Some headway was discernible on the arrangements between Central Banks on the use of gold reserves but uncertainty continued to dog the gold market. The emerging strength of the US dollar and the Rambouillet agreement between the French and the US Presidents to allow Central Banks and the monetary authorities to revalue their gold holdings at market-related prices, coupled with South Africa's decision not to sell on the market its entire gold output, prevented gold prices from escalating further. No consensus, however, could be reached on exchange rate arrangements or their stabilization.

India's reaction to these developments was one of great disappointment, for the continued floating of major currencies with exchange rates moving both ways by fairly large margins, left the developing countries open to the vagaries of the key currencies. Clearly, the size of the reserves of developing countries was inadequate to bear this type of buffeting. Although the majority of the Fund's membership had favoured a return to a system of par values with provisions for the establishment of central rates, this remained a distant pipe-dream. The pound sterling remained the weakest of the major currencies and, by July 1974, the trade-weighted depreciation of the pound sterling amounted to 17 per cent from its Smithsonian parity. In anticipation of possible further weakness of the sterling, the Reserve Bank of India set about examining the various options and implications of the steady depreciation of the pound and the rupee along with it, but came up with no conclusive solution. Hopeful of a return, sooner rather than later, of the par value system, its early judgement was that India might be worse off experimenting with a new exchange rate than under the existing sterling exchange system.

A major breakthrough came at the Kingston Jamaica meeting on 6 Janu-

ary 1976, when the Interim Committee settled arrangements relating to gold and exchange rates by endorsing the Sixth Quota increase by 32.5 per cent to SDR 39 billion—allowing a doubling of the present share of the oil-exporting developing countries as a group without a change in the collective share of the other developing countries—and adopted the amendments to the Fund's Articles. Legalizing floating exchange rates, whether they floated independently or collectively, the Jamaica agreement conferred the seal of approval by the international community on a system of floating rates, putting to rest the hybrid system in existence since the breakdown of the Bretton Woods par value system. Introduction of stable but adjustable par values was contemplated, but at a future date, when underlying stability of the world economy was in evidence. The Jamaica accord reiterated the right of members to have exchange arrangements of their choice but emphasized collaboration with the Fund to ensure orderly exchange arrangements for fostering growth with stability, and avoiding manipulation of exchange rates and the international monetary system to gain unfair competitive advantage. To assist the balance of payments adjustment process, the Fund's armoury for providing assistance for balance of payments deficits and covering members' reserve needs was enhanced through an increase in quotas; each drawing tranche was temporarily increased from between 25 per cent to 36.25 per cent of the existing quotas. Disposal of 50 million of the gold held by the Fund—25 million ounces by restitution and 25 million by sale at market-related prices—constituted another element of the Jamaica package to help tide over the adverse impact of the oil price increase on the adjustment process. Profits from the gold sale were earmarked for the creation of the Trust Fund for extending concessionary assistance to low per capita income countries. The Jamaica agreement thus brought down the curtain on the reform exercise that was embarked upon after the breakdown of the Bretton Woods system.

The Reserve Bank's evaluation of the Jamaica agreement was negative. Its principal objections, as stated in a Board memorandum of 2 February 1976, were the abandonment of stable but adjustable par values and the enshrining of the right of members to have exchange rate arrangements of their own choice. In the view of the Bank, by legitimizing floating, the system had been made flexible but unpredictable. A disappointing feature of the new arrangement was that it had enhanced the reserve role of key currencies, detracting from the international control of liquidity through SDR creation. Arrangements in regard to gold were seen as seriously undermining the monetary role of gold; in fact, the clock had been set back for an SDR-controlled system. The decisions pertaining to gold would help mobi-

lize the immobilized official gold, resulting in uneven additions to international liquidity and postponement of possible SDR allocations. The objective of promoting a real transfer of resources to developing countries through a link between the creation of SDR and development finance had received scant attention—in fact, the link debate was shoved on to the back-burner of the reform agenda. In short, all that the Jamaica agreement had achieved was to make the international monetary system more US dollar-centred than the gold-based Bretton Woods system.

THE BANK'S EXAMINATION OF THE RUPEE–STERLING LINK

Although the Reserve Bank provided the argumentation for discussions on the international monetary reform debate to the government and the Indian Executive Director at the IMF, it was not involved in the various rounds of the discussions. However in 1975, the Bank's Executive Director, Seshadri, along with Janakiraman, in light of the international developments, assumed greater responsibility for examining the implications of the steady depreciation of the pound sterling and, along with it, that of the rupee.

Among the major European currencies, the pound sterling remained the weakest. With the UK economy slipping into severe recession, OPEC investment tapering off, and the rate of inflation and current account balance of payments deficits assuming unmanageable proportions, the pound sterling faced its most strenuous period through the greater part of 1975 and the first half of 1976. The market remained bearish, notwithstanding the government's anti-inflationary programme and the hike in the interest rate structure. By end-December, the sterling's trade-weighted depreciation from its Smithsonian parity widened to about 30 per cent. The turbulence in the European exchanges in early 1976, following the selling run on the lira and strong pressure on the French franc, depressed the sterling further. Despite massive intervention by the Bank of England, foreign exchange reserves declined by nearly \$3 billion in March and April of 1976, and the trade-weighted depreciation remained at a high of 38.8 per cent at end-June 1976.

Against the backdrop of these developments, Seshadri, in a note, examined the pros and cons of the Indian rupee's link with the sterling. He showed that a conjuncture of powerful forces had dramatically altered the official financial environment between 1968 and 1976. The end of the Bretton Woods system of stable but adjustable par values and the decline in the status of the sterling as a reserve currency had resulted, over the nine-year period since 1966, in a substantial and cumulative depreciation of the

rupee. The note seriously questioned the view that the sterling link had been convenient and beneficial to India's exports, in light of the developments in the exchange markets in the early and mid-seventies. It argued that continuance of the link was justified so long as the sterling was relatively stable, but the rate of inflation in the UK, the liquidity crises, the secondary banking crisis and the diversification out of sterling by oil-producing countries precluded even official intervention to support the sterling. The oil shock of 1973–74 had greatly amplified these trends. To avoid a vicarious and unintended depreciation of the rupee, in the future, Seshadri made a strong plea for fixing the value of the rupee independently. 'The logic for severing the ties with sterling', he said, 'was compelling.' First, there was a decline in the status of the sterling as a reserve currency. Second, the proportion of trade invoiced in sterling had declined considerably. Third, a number of sterling area countries had switched to the US dollar or other currencies or adopted a currency basket, and only six countries, besides India, were floating with the sterling. On the other hand, exporters' rupee export earnings were protected through a massive forward exchange cover, the implications of which for the government's budget and for the Indian importer and industry could not be overlooked. In short, importing British inflation via the link with the sterling was no longer justified.

Seshadri's note sparked off further examination by the Reserve Bank, of the mechanics for determining the value of the rupee. It had been urged by some quarters that the Indian rupee should be allowed to float independently. The Bank categorically advised against floating, stating that Indian conditions ruled out this option. First, the inter-bank market was not broadbased, and the Reserve Bank was statutorily required to buy and sell foreign exchange within limits specified by the central government. Second, the value of the rupee was not market-determined, and tight exchange controls and the inability of commercial banks to keep open positions in foreign currencies militated against the creation of a broadbased inter-bank market in India. Although a number of countries, including Pakistan, had chosen to follow the dollar, a formal link with the dollar from the Indian viewpoint was considered unsuitable. Bank officials eagerly looked at other options and studied the experience of other countries, in order to introduce a measure of relative stability into the Indian exchange rate regime. Ruling out independent floating, currency cocktails and trade-weighted index, the Bank suggested linking the rupee to the SDR as the most advantageous and operationally least difficult option. Operationally, it would mean declaring a base rate for the rupee, in terms of the SDR determined

via sterling, at the notional rupee–sterling parity of Rs 18.80 to the £, with the policy objective of ensuring that the actual rate for the rupee in terms of the SDR did not deviate beyond 2.25 per cent of the base on either side. If a variation of more than 2.25 per cent continued beyond five working days, a correction would be made for the rupee prospectively. However, as a ground rule, whenever a rate adjustment went beyond 2.25 per cent, every effort would be made to bring the rate back to the base rate to ensure stability in the value of the rupee. The Bank sought authority from the government to determine the exchange rate on the basis of this formula without any interference or prior consultation with the government, but this was not conceded.

While the Finance Ministry mulled over the policy alternatives and the mechanics of the change, the pound sterling steadily lost ground on the exchange markets. The US dollar/pound sterling declined from \$2.4430 in June 1972 to around \$2.20 in September 1975. Consequently, the rupee depreciated vis-à-vis the US dollar to the same extent. From June 1971 through June 1975, the rupee depreciated against the French franc by 53 per cent and against the Japanese yen by 35 per cent. The effective depreciation of the Indian rupee during this period amounted to 23 per cent. The vulnerable international exchange rate scenario ultimately forced the Finance Ministry to take a historic decision on 24 September 1975. The rupee's peg to the pound sterling since 1931, except for a brief interlude of three months in September 1971, was abandoned, and the rupee was pegged to a basket of currencies. The rupee was delinked from the sterling and a new arrangement was adopted under which the exchange value of the rupee was determined with reference to the daily movements of a selected number of currencies of countries which were major trading partners. Initially, it was a five-currency basket, of which one currency was variable and that depended on the pattern of payments falling due. In designing the basket and working out the modalities for its operation, Oxford-returned Dr Vijay Joshi, who was appointed special adviser in the Ministry of Finance, assisted the government. Taking a leaf out of the Australian experience, the currencies included in the basket and the weights assigned to them were not disclosed but left to the discretion of the authorities operating the basket. It was a tightly guarded secret. The available Bank records throw no light on how the multi-currency basket adopted for determining the value of the rupee was settled, nor are there any records or documents that reveal the composition of the basket. Presumably, the basket included the US dollar, the pound sterling, the deutsche mark, the French franc and the Japanese yen, and the weights assigned to these were on the basis of

these countries' shares in India's trade. Although the peg was shifted to a secret multi-currency basket, the pound sterling continued to remain as the intervention currency, which meant that the Bank was required to buy and sell spot sterling in order to keep the exchange rate vis-à-vis that currency stable. The RBI's rates for spot sterling were revised so as to yield a middle rate of Rs 18.3084 per pound. Thus the central rate of Rs 100 = £5.2721 was no longer valid.

The government issued a press release to describe the contours of the multi-currency peg and the delinking from the sterling. It emphasized that the new arrangement was designed to meet a transitional situation, and that the IMF was engaged in devising a durable system of exchange rate relations. Defending the government's move before the Consultative Committee of Parliament, C. Subramaniam, Finance Minister, said 'the new link to a basket of currencies should provide greater stability and less uncertainty in the minds of businessmen'. He went on to note that the decision to switch to the new arrangement was prompted by the need to insulate the imports of food and oil, which were becoming expensive in the face of the decline of the sterling. With political support coming from members of all the leading political parties, the Finance Minister assured that the government would remain 'wide awake' to safeguard the country's interests in the matter of the rupee's exchange rate, while hinting that the rupee must become stronger at home to be strong abroad.

The secrecy surrounding the decision was patently clear. Using the sterling as the intervention currency would have presented no problem had the pound been steady in international markets. That not being so, moving to a basket system of valuation on grounds of stability, between June 1975 and June 1976, resulted in the Bank being required to revalue the rupee with reference to the pound six times, to the extent of 12.6 per cent in the aggregate. These revaluations were carried out to keep the value of the rupee stable vis-à-vis other currencies. The dollar rate throughout was kept more or less stable at Rs 9. Although the official announcement was that the rupee was linked to a currency basket, the IMF, in its classification of exchange rate arrangements of member countries, categorized the Indian exchange rate arrangement as under 'managed float'. This meant, in practice, that the authorities had the flexibility to operate a multi-currency peg in a discretionary manner and not be guided or driven by mechanical parity adjustments of the rate for the rupee against its intervention currency, viz. the pound sterling.

In operating the basket, the Reserve Bank was initially faced with the problem of announcing the rates on time. The perception of the govern-

ment was that the Bank would not be in a position to manage and operate the mechanism without technical expertise. The government was therefore reluctant to give unrestricted freedom to the Bank to set the daily rupee rate without prior clearance from it, even when the change in the rate was within the band of 2.25 per cent. Logistically, such consultations entailed delays, sometimes of a couple of days, by which time events had overtaken the new rate. On one occasion (some months after the introduction of the basket), in view of the urgency involved, Janakiraman, a senior Bank official in charge of DEIO, was forced to take a late-night flight to Delhi to meet the economic adviser, Manmohan Singh, to obtain the Finance Ministry's clearance. To expedite matters, both of them then rushed to the Finance Minister, H.M. Patel. On learning that the existing procedure of seeking prior clearance from the Finance Minister before announcing the exchange rate change precluded the Reserve Bank from making timely adjustments in the rate, Patel ruled that the Bank be authorized to effect the change provided the adjustment was within the permitted band, and to notify the government daily regarding the change. This decision provided the needed flexibility to the Bank to operate the new exchange rate mechanism more effectively.

As mentioned, the sterling continued to remain the intervention currency but its continuous weakening between September 1975 and July 1976 compelled the Reserve Bank to revalue the rupee six times, to the extent of 12.6 per cent, in a brief span of nine months. This made the Bank re-examine the justification for continuing with the pound as the intervention currency, and whether to change over to the use of the dollar. Two officials, Janakiraman and Seshadri, who shared similar approaches and worked well together, examined the issue. In a cogent, well-argued note, later forwarded to the government, the Bank reasoned that it would not be advantageous to change over to the use of the dollar as the intervention unit. After all, purchases of both the sterling and the US dollar by the Bank had to continue and only one of the rates could be kept constant, and it was not material which of the two was chosen to be kept constant. The Bank's preference clearly was for the sterling, mainly on the ground that the London and European markets were broadbased, and offered finer rates and better facilities for trading and investment. Similar facilities could not be accessed from the New York market.

There were other constraints, too, in using dollar as the intervention currency. The Reserve Bank bought forward currencies through six of its offices, whereas the Federal Reserve Bank of New York insisted that it would act only on instructions from the Central Office. The matter was discussed

at great length and after the visit of Paul Volcker, the Fed agreed to deal with branches of the RBI as well. The Bank started buying dollars directly from authorized dealers from October 1972. Purchases of deutsche marks and Japanese yen were started from May 1974. However, the Bank sold only pound sterling. The Bank of England offered facilities for investment of surplus funds, and the costs of conversion from sterling into dollars was negligible. At that point in time, therefore, the Bank saw no particular financial advantage in changing over to the US dollar as the intervention currency, but hedged its conclusion with a caveat that should the pound's international value turn erratic, necessitating frequent alterations in the rupee–sterling rate, use of dollar could then be considered.

As it turned out, continuous fluctuations in the exchange rates of the currencies called for several revisions in the pound–rupee rate. It was found difficult to maintain the rupee value of the basket of currencies within a band of 2.25 per cent on either side of the base value of Rs 18.3084 that was adopted when the basket was introduced. So, effective 30 January 1979, it was decided that the exchange rate would be maintained within a wider band of 5 per cent on either side, providing the authorities manoeuvrability to fix a more appropriate rate for the rupee.

At this point, a word about the behaviour of the inter-bank market might be in order. The Reserve Bank had laid down the maximum margin that commercial banks could load on their spot and forward buying rates and spot selling rate for currencies while quoting rates to their customers. Since the Bank did not sell these currencies for forward deliveries, the authorized dealers (ADs) were free to quote forward selling rates for them. With a strengthening of the sterling against the US dollar in the third week of July 1979 in London, the inter-bank exchange market in India suddenly became disorderly. The Bank's senior management in charge of foreign exchange management responded with alacrity. They examined the circumstances in which this had happened, the need for avoiding a recurrence and the remedial steps that could be taken. The Bank attributed the inter-bank market turning erratic to the sudden absence of confidence in the US dollar rate against the sterling in London, as a consequence of which there was widespread expectation that the rupee would be devalued against the sterling. Exporters decided to keep off the market whereas importers scrambled to cover their foreign exchange requirements, giving rise to a lead and lag phenomenon, and banks falling short of foreign exchange. To add to the shortage of availability of funds, overseas banks were seen to be withholding funding remittances to India and maintaining minimum balances to meet immediate needs. The drying up of this source of liquidity

resulted in the sterling rate touching rock-bottom level (400 points below the floor). Interestingly, a number of banks made enquiries whether the Reserve Bank would allow 'ready' against 'spot' swaps with overseas banks against the rupee. The Bank firmly replied in the negative, as it saw that the intention of the banks was to postpone funding remittances to India in the hope of securing a better rate later.

The sudden and abrupt drop in the rate below the RBI floor destabilized the market and created a deep depreciation psychosis. In fixing the two upper and lower limits, the Bank's intention was to ensure that the rupee, internally as well as externally, did not move beyond these limits. Clearly, the situation warranted swift action on the part of the Bank to arrest the unhealthy competition in foreign currencies that had developed, whereby the inter-bank market had turned lopsided with demand exceeding supply, driving down the rate for the Indian rupee to levels unwarranted by its external value. Moreover, the offer of the banks to sell rupees against foreign currencies had resulted in depreciating the rupee in foreign markets to an undesirable extent. The inter-bank rate for the pound sterling was driven down below the rate at which the RBI was prepared to sell sterling.

Through an AD circular on inter-bank dealings, the Bank sought to stem the speculative tendencies. The circular framed fairly stringent regulations governing inter-bank dealings with a view to ensure that the facilities provided by the Bank were availed of for legitimate transactions, and warned that a serious view would be taken if ADs were found flouting the regulations. This entailed micro-monitoring through snap checks of ADs' foreign exchange transactions. ADs were required to be vigilant to see that rupee funds acquired by overseas banks were not utilized in swap operations by their overseas units, as these were perceived to be of a speculative nature. Furthermore, ADs were called upon to keep a watchful eye on the relaxation afforded in the limit for overdrafts in the rupee accounts of overseas banks, to ensure that the relaxation was not abused to postpone funding in anticipation of rate changes or to convert rupees into foreign currency.

The circular was an interim response to regulate the market, pending a view being taken on the broader issues of narrowing the rate spread and, eventually, active intervention in the market. The logical course would have been for the Reserve Bank to actively intervene in the market. But active intervention presupposed adequate communication links, trained dealers, delegation of powers from the government to the Bank to take spot decisions to intervene or abstain from the market, internal control on the functioning of ADs on a continuous basis, and assessing the profit or loss

arising from day-to-day intervention. Realizing the inadequacy of infrastructure and the need to build capacity for taking on such a task, there was a tendency on the Bank's part towards crises management through circulars. Administration by rule, a powerful tendency of the Bank, had not yet given way to direct intervention even when events foreshadowed the need for quick consideration of substantive issues.

By mid-1979, the managers of the Indian exchange rate system started feeling that the stability in the exchange value of the rupee sought to be achieved through adoption of the basket peg was eluding them. The new dynamic flexible floating rates perplexed the monetary authorities and they found that it had given speculative advantage to larger commercial and overseas banks for funding the latter's rupee accounts in India. In order to reduce the speculative advantage, as a first step, procedural and regulatory tightening measures were instituted. With effect from 28 March 1980, sale of Japanese yen to the RBI for funding the rupee accounts of overseas banks was prohibited,⁵ and, with effect from 2 June 1980, a revised procedure of working out the dollar, deutsche mark and yen rates was adopted. Although hailed by the market as a step in the right direction, as it considerably helped to reduce the speculative advantage overseas banks enjoyed in a regime of floating rates, the Bank realized that these measures required to be supplemented through further policy initiatives. The situation called for a shift from the current policy of keeping the rate structure static to one of realignment of the rates.

The policy of keeping the exchange rate structure static had given speculative advantage to the larger commercial and overseas banks. There were some in the senior policy-makers' group, like the Controller of Exchange and Janakiraman, who saw that scope for such advantage could be reduced by 'moving with the market' rather than remaining static in the formulation of the structure of exchange rates of currencies that the Bank dealt in. They admitted that in a regime of floating rates, it was well-nigh impossible to eliminate speculative tendencies, and that it was just not possible for the Bank to be 'right' all the time. The aim of the authorities was to reduce speculative advantages: for this reason, the weights and currency composition of the basket were kept secret. Even when the IMF desired to know the weights accorded to the foreign currencies in the basket, the Bank did not disclose the details. In course of time, the market and the IMF succeeded in making a fairly accurate guess of the components of the bas-

⁵ Purchase of yen—both spot and forward—in cover of actual merchant transactions entered into by Indian exporters was continued.

ket and the weightage given to the currency. The Reserve Bank responded by revising the rate not to the previous base rate but by refixing another base rate within the band, thus precluding the possibility of applying statistical tools to unravel the composition of the basket. The basket itself was reconstituted more than once to reflect the changes in trade flows.

In July 1980, at Deputy Governor Krishnaswami's prodding, A.P. Aiyer undertook an in-depth examination of the issues relating to the structure of exchange rates. The suggestion was made that the spread between the spot buying and selling rates for the intervention currency be narrowed or widened as the situation demanded, to reduce the scope for speculative operations. Advantages were also cited for reviewing the forward margins on sterling periodically. The market's belief that forward margins on sterling would be kept unchanged had facilitated speculation. Spot and forward rates for other currencies, like the dollar, yen and deutsche mark, could be loaded on to Reuter rates structure and varied daily in such a manner that the rates structure which evolved would serve as a base for the market, even as it kept the market guessing and prevented speculation.

The practice of giving extension of forward contracts in sterling at a uniform rate, just for the asking, should also be discontinued. And, finally, the oft-debated policy issue of change in the intervention currency from the sterling to the dollar was taken up. The experience of the last couple of years had revealed that sterling as the intervention currency had not only favoured speculative forces but, with the bulk of the country's external transactions now being conducted in dollars, distortions in the sterling-dollar rate and weakening of the dollar had encouraged heavy sales of sterling and their conversion into dollars. As the US dollar was the transaction currency of the future and given India's heavy import bill for oil, the note indicated that the country's requirement of dollars was likely to grow. It pressed for a decision to switch over to the US dollar as the intervention currency, or to adopt both the US dollar and the sterling as intervention currencies, through an amendment of Section 40 of the RBI Act.

The second part of the examination was devoted to restructuring the administrative set-up, creating the infrastructure of a proper dealing room, improving communication links, and building a proper information and database to regulate the market which, currently, was being regulated on hunches. The changes suggested to streamline the foreign exchange market were indeed radical, and received the Joint Chief Accountant's and Accountant's informal blessings, but Deputy Governor Krishnaswamy was sufficiently cautious. Keeping aside policy matters for a while, he ruled that

the Bank must get on with the job of equipping itself with the facilities for active dealing. He ordered the Foreign Section to prepare a plan outlining the timeframe within which the arrangements for communications, staff and information could be put in place, to coincide with the proposal to move into the new Central Office buildings. Although regulatory philosophy held sway, the suggestions were indicative that the Bank's thinking was to create an environment in which authorized dealers would be seen more as market participants and less as clients of the Bank.

By 1981, there was general agreement on the need to switch to the dollar as the intervention currency, but political considerations came in the way of its adoption. Apprehending criticism of toeing the American line, the government shied away from taking the plunge. The upshot was between January 1981 and March 1982, as a matter of policy, the Bank allowed the US dollar to appreciate from Rs 7.90 for 1 US dollar to Rs 9.30 for 1 US dollar. This necessitated changing the pound–rupee middle rate 94 times during the fifteen-month period. An internal note of the Bank showed that the same objective could have been achieved, at best with five changes, if the intervention currency had been the dollar. In other words, the same basket with the same weights would have worked with the dollar as the intervention currency.

Despite the Reserve Bank buying large quantities of dollars to accommodate the preference of exporters to invoice their bills in dollars, it continued to maintain the sterling as the intervention currency for a very long time. In the process, it had to unnecessarily convert dollars into sterling. On behalf of the Reserve Bank, SBI was asked to buy dollars from the market, which was kept a well-guarded secret until SBI began to purchase even odd lots. Moreover, the market became suspicious when SBI, which was a regular supplier of dollars to the foreign exchange market, turned into a voracious buyer. An unguarded slip on the part of a Deputy Governor that the Reserve Bank had asked the SBI to buy the dollars resulted in termination of this arrangement.

The Reserve Bank then officially started buying and selling dollars from and to authorized dealers at rates determined by it, which practically amounted to giving the dollar the *de facto* status of an intervention currency. The Bank fixed the rate for dollars in the morning and bought dollars in the evening when the rates changed. This encouraged a reputed AD to take undue advantage of the Bank's intervention in the foreign exchange market, by buying dollars from RBI's Bombay office at about 2 o'clock at rates fixed in the morning, and, whenever the sterling weakened

against the dollar, selling the dollars and buying sterling. Prompt punitive action against the authorized dealer for indulging in such speculative activities nipped such transactions in the bud.

There is no easy explanation for why the Reserve Bank persisted with using the sterling as the intervention currency although alternative possibilities were actively explored in the late 1970s and early 1980s, but political considerations appear to have precluded decisive action till 1992. This serves as a reminder that the philosophical shift to market-based decision-making was still heavily circumscribed. In retrospect, it can be said that, in the unsettled and disturbed market environment of the seventies, the basic exchange rate regime adopted by India, an adjustable nominal exchange rate (NER) peg, a managed float arrangement, was highly desirable, and some depreciation was also appropriate to eliminate the overvaluation. However, it leaves open the question of how well the authorities operated the framework. Two distinct phases were discernable. The 1971–75 phase which called for adjustment to the first oil shock required a depreciation of the real exchange rate (RER). This was skilfully achieved through nominal depreciation by maintaining the sterling peg, which provided the cover for depreciation. Similarly, the period 1975–76 to 1978–79, when the RER depreciated 20 per cent, also witnessed strong export volume growth and low inflation—in fact, those few years were described as the ‘golden years’ of India’s balance of payments. The move to a fixed NER was made only after the inflation monster had been tamed. For a year or so, low inflation brought about depreciation of the RER.

The exchange rate scenario changed following the second oil shock. Inflation reared its head again and the decision to keep the RER fixed resulted in its appreciation. The years 1979–83 witnessed erosion of the competitive advantage for exports and export volume growth was stagnant; at the same time, foreign debt grew rapidly resulting in widening of the current account deficit. Clearly, the macroeconomic fundamentals were not strong enough to withstand the appreciation of the RER after the second oil shock. Depreciation was necessary to restore parity with the key currency—the dollar. In retrospect, again, the inactive exchange rate policy of the late 1970s and early 1980s raises the question whether the valuable instrument of balance of payments adjustment had been sacrificed on the altar of stability. The reluctance to vary the nominal exchange rate actively in the first instance and, thereafter, to devalue insufficiently, led to stagnation of exports. With no tightening of imports, this resulted in recurring deficits that had to be financed through commercial and concessional borrowings, which sowed the seeds of later trouble. Clearly, the phase of appreciation of

NER was 'undesirable' and the decision to keep it fixed was a grave mistake. To what extent the Bank played a major part in the decision is difficult to say, in view of the absence of commitment on paper of the vital decisions pertaining to exchange rate management.

ATTEMPTS AT DIVERSIFICATION OF RESERVES

The breakdown of the Bretton Woods system in 1971 set in train disintegration of the exchange system based on fixed gold parities. At that time there was little official support to jettison a system that had served well. The emphasis, therefore, was on technical improvements within the existing structure (wider margins around official parities). The creation of the SDR in 1970 as an additional form of international liquidity was expected to introduce an element of stability into the exchange markets. But the uncertainty surrounding the key currencies—the dollar and the pound—failed to reassure markets about the stability of the reserve currencies.

From 1971, the Reserve Bank started gradually and cautiously rearranging its portfolio. Following the termination of the Indo-UK sterling agreement in December 1974, under which India received compensation on two occasions, the process of diversification of foreign exchange reserves was speeded up. In the early 1970s the Bank was empowered to purchase securities issued by foreign governments to be payable in foreign currencies, and to deposit balances in accounts opened with foreign central banks or any international bank (supranational institutions). Subsequently, with the growth in reserves triggered by the second oil shock and drawals from the IMF, in July 1978, the statutory provisions were amended and enlarged to cover investment in Eurobonds and commercial bank deposits, as well as open gold accounts abroad with central banks. The main advantage of the diversification was that the Bank could utilize and invest more effectively the foreign exchange reserves that had been rising continuously since 1975.

In 1979 and after, the Reserve Bank was seen placing a number of special deposits through the Indian commercial banks. However, the level of reserves held in different currencies was a very sensitive issue and switches from one currency to another was a tightly guarded secret. Earlier, because of the lack of infrastructure, such conversions were blindly effected through the Bank of England or the Federal Reserve of New York or the Bank of International Settlements (BIS) but, in the late 1970s, it was the Joint Foreign Exchange Committee of the government and the RBI who laid down the broad guidelines for the deployment of foreign balances. On one occasion, the government indicated to the Bank that its deposit exposure with

the BIS and its deposits with commercial banks were on the high side in the context of safety of funds. However, with the fall in the level of foreign balances in 1981, the level of BIS deposits to the total level of reserves came down appreciably.

With the advantage of hindsight it can now be said that the sterling guarantee agreement delayed the diversification of official reserves but it did provide some protection of their value at a time of high risk in holding any other currency. For the global system as a whole, sterling agreements facilitated an orderly retreat from the sterling without aggravating the disruption in global currency markets, and ensured the smooth disintegration of the sterling area.