Module - 5
Introduction to Indian Foreign Exchange Market

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Lesson - 5
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Highlights & Motivation:

Happenings in the foreign exchange market (henceforth **forex market**) form the essence of the international finance. The foreign exchange market is not limited by any geographical boundaries. It does not have any regular market timings, operates 24 hours 7 days week 365 days a year, characterized by ever-growing trading volume, exhibits great heterogeneity among market participants with big institutional investor buying and selling million of dollars at one go to individuals buying or selling less than 100 dollar.

In this module, a brief introduction to **forex market, details about trading volume, market participants, different types of forex products** are discussed. In addition, brief history and evolution for exchange market would also be discussed.

Learning Objectives:

- **Forex market in India**
- **Forex Market in India: A historical perspective**
- **FERA Vs. FEMA**
- **Pre-liberalization exchange rate regime in India and Hawala market**
- **Brief introduction to currency convertibility in current & capital account.**

5.1: Forex Market in India:

Traditionally Indian forex market has been a highly regulated one. Till about 1992-93, government exercised absolute control on the exchange rate, export-import policy, FDI (Foreign Direct Investment) policy. The **Foreign Exchange Regulation Act(FERA)** enacted in 1973, strictly controlled any activities in any remote way related to foreign exchange. FERA was introduced during 1973, when foreign exchange was a scarce commodity. Post independence, union government's socialistic way of managing business and the license raj made the Indian companies noncompetitive in the international market, leading to decline in export. Simultaneously India import bill because of capital goods, crude oil & petrol products increased the forex outgo leading to sever scarcity of foreign exchange. FERA was enacted so that all forex earnings by companies and residents have to reported and surrendered (immediately after receiving) to RBI (Reserve Bank of India) at a rate which was mandated by RBI.

FERA was given the real power by making **"any violation of FERA was a criminal offense liable to imprisonment".** It a professed a policy of **"a person is guilty of forex violations unless he proves that he has not violated any norms of FERA".** To sum up, FERA prescribed a policy – **"nothing (forex transactions) is permitted unless specifically mentioned in the act".**

Post liberalization, the Government of India, felt the necessity to liberalize the foreign exchange policy. Hence, **Foreign Exchange Management Act (FEMA) 2000** was introduced. FEMA expanded the list of activities in which a person/company can undertake forex transactions. Through FEMA, government liberalized the export-import policy, limits of FDI (Foreign Direct Investment) & FII (Foreign Institutional Investors) investments and repatriations, cross-border M&A and fund raising activities.

Prior to 1992, Government of India strictly controlled the exchange rate. After 1992, Government of India slowly started relaxing the control and exchange rate became more and more market determined. **Foreign Exchange Dealer's association of India (FEDAI),** set up in 1958, helped the government of India in framing rules and regulation to conduct
forex exchange trading and developing forex market In India.

A major step in development of Indian forex market happened in 2008, when currency futures (Indian Rupee and US Dollar) started trading at National Stock Exchange (NSE). Since the introduction, the turnover in futures has increased leaps and bound. Though banks and authorized dealers were undertaking forex derivatives contracts, but the introduction of exchange traded currency futures marked a new beginning as the retail investors were able to participate in forex derivatives trading.

RBI document titled" Foreign Exchange Market" available at **http://rbidocs.rbi.org.in/rdocs/publicationreport/pdfs/77577.pdf** is an informative document on historical development of Foreign exchange market in India. The next section, Section 5.2, the important milestone of "Historical Development in Forex Market in India" is given. The readers are advised to supplement this section with the document available at the above link.

5.2: Foreign Exchange Market in India: Historical Perspective:

Indian forex market since independence can be grouped in three distinct phases.

1947 to1977: During 1947 to 1971, India exchange rate system followed the par value system. RBI fixed rupee's external par value at 4.15 grains of fine gold. 15.432grains of gold is equivalent to 1 gram of gold. RBI allowed the par value to fluctuate within the permitted margin of ±1 percent. With the breakdown of the Bretton Woods System in 1971 and the floatation of major currencies, the rupee was linked with Pound-Sterling. Since Pound-Sterling was fixed in terms of US dollar under the Smithsonian Agreement of 1971, the rupee also remained stable against dollar.

1978-1992: During this period, exchange rate of the rupee was officially determined in terms of a weighted basket of currencies of India's major trading partners. During this period, RBI set the rate by daily announcing the buying and selling rates to authorized dealers. In other words, RBI instructed authorized dealers to buy and sell foreign currency at the rate given by the RBI on daily basis. Hence exchange rate fluctuated but within a certain range. RBI managed the exchange rate in such a manner so that it primarily facilitates imports to India. As mentioned in Section 5.1, the FERA Act was part of the exchange rate regulation practices followed by RBI.

India's perennial trade deficit widened during this period. By the beginning of 1991, Indian foreign exchange reserve had dwindled down to such a level that it could barely be sufficient for three-week's worth of imports. During June 1991, India airlifted 67 tonnes of gold, pledged these with Union Bank of Switzerland and Bank of England, and raised US$ 605 millions to shore up its precarious forex reserve. At the height of the crisis, between 2nd and 4th June 1991, rupee was officially **devalued** by 19.5% from 20.5 to 24.5 to 1 US$. This crisis paved the path to the famed "liberalization program" of government of India to make rules and regulations pertaining to foreign trade, investment, public finance and exchange rate encompassing a broad gamut of economic activities more market oriented.

1992 onwards: 1992 marked a watershed in India's economic condition. During this period, it was felt that India needs to have an integrated policy combining various aspects of trade, industry, foreign investment, exchange rate, public finance and the financial sector to create a market-oriented environment. Many policy changes were brought in covering different aspects of import-export, FDI, Foreign Portfolio Investment etc.

One important policy changes pertinent to India's forex exchange system was brought in -- rupees was made convertible in current account. This paved to the path of foreign exchange payments/receipts to be converted at market-determined exchange rate. However, it is worthwhile to mention here that changes brought in by government of India to make the exchange rate market oriented have not happened in one big bang. This process has been gradual.

Convertibility in current account means that individuals and companies have the freedom to buy or sell foreign currency on specific activities like foreign travel, medical expenses, college fees, as well as for payment/receipt related to export-import, interest payment/receipt, investment in foreign securities, business expenses etc. An related concept to this is the "convertibility in capital account". **Convertibility in capital account** indicates that Indian people and business houses can freely convert rupee to any other currency to any extent and can invest in foreign assets like shares, real estate in foreign countries. Most importantly Indian banks can accept deposit in any currency.

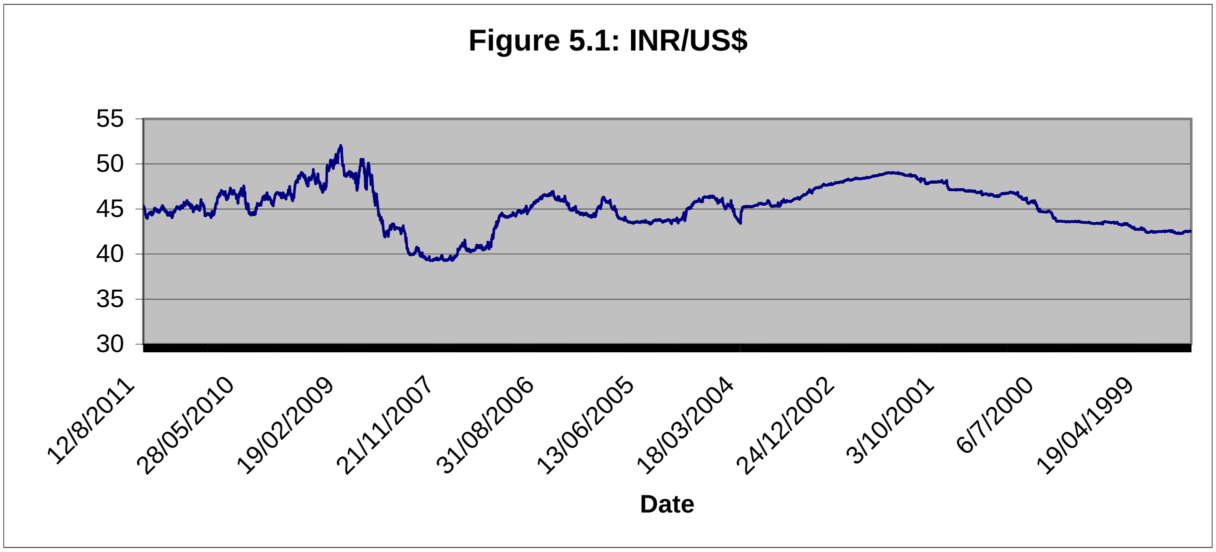
Even though the exchange rate has been market determined, from time to time RBI intervenes in spot and forward market, if it feels exchange rate has deviated too much.

Table 5.1: RBI Intervention in Indian Forex Market

Source: http://rbidocs.rbi.org.in/rdocs/publicationreport/pdfs/77577.pdf

Year	Purchase (In US$ billion)	Sell	Net
1995-96	3.6	3.9	-0.3
1996-97	11.2	3.4	7.8
1997-98	15.1	11.2	3.9
1998-99	28.7	26.9	1.8
1999-00	24.1	20.8	3.3
2000-01	28.2	25.8	2.4
2001-02	22.8	15.8	7.0
2002-03	30.6	14.9	15.7
2003-04	55.4	24.9	30.5
2004-05	31.4	10.6	20.8
2005-06	15.2	7.1	8.1
2006-07	24.5	0	24.5

It would have in interesting to chart the exchange rate of India per-1992 period. However, due to lack of data, **Figure 5.1** shows the Rupee exchange rate from August 1998 till August 2011.



It can be clearly seen from the **Table 5.1** and **Figure 5.1** that during 2007 rupee appreciated significantly. To stem the rupee appreciation, RBI purchased US$ to the tune of 24.5 billion.

5.3 Forex Exchange Turnover

According to the **RBI report (September 2009) by Goyal, Nair & Samataray titled "Monetary Policy, Forex Markets, and Feedback under Uncertainty in an Opening Economy",**

The extract from the report highlights the foreign exchange turnover in India

" Indian FX market has grown many times over the last several years. The average daily turnover, which was in the vicinity of US $ 3.0 billion in 1998-99 grew to US $ 18 billion during 2005-06. The turnover rose considerably to US $ 48 billion during 2007-08 with the monthly turnover crossing US $ 65 billion in February 2007.

The inter-bank to merchant turnover ratio halved from 5.2 during 1997-98 to 2.3 during 2007-08 reflecting the growing participation in the merchant segment of the foreign exchange market.

The spot market remains the most important FX market segment accounting for 51 per cent of the total turnover. Its share has declined marginally in recent years due to a pick up in the turnover in derivative segment. Even so, Indian derivative

trading remains a small fraction of that in other developing countries such as Mexico or South Korea. Short-term instruments with maturities of less than one year dominate, and activity is concentrated among a few banks (IMF 2008)".

Box 5.1: Interesting facts about Indian Rupee
http://www.lonympics.co.uk/new/rupee.htm

India has been one of the earliest issuers of coins in the world (6th Century BC). The origin of the word "rupee" is found in the word rup or rupa, which means "silver" in many Indo-Aryan languages such as Hindi. The Sanskrit word rupyakam means coin of silver. The derivative word Rupaya was used to denote the coin introduced by Sher Shah Suri during his reign from 1540 to 1545 CE. The original Rupaya was a silver coin weighing 175 grains troy (about 11.34 grams) . The coin has been used since then, even during the times of British India. Formerly the rupee was divided into 16 annas, 64 paise, or 192 pies. In India decimalization occurred India in 1957.

5.4: Pre-Liberalization exchange rate regime in India and Hawala Market:

At this juncture, it is pertinent to discuss **"Hawala market"** operating in India before liberalization. Before 1992, RBI was strictly controlling the exchange rate. This created a parallel foreign exchange market – a black market in foreign exchange popularly known as "Hawala Market".

Hawala market is nothing but illegal foreign exchange market where forex trading happen at rates different than the rate mandated by the RBI. When the official rate "overvalues" the home currency, Hawala market starts operating.

Example of a Hawala Transaction: a NRI working in USA wants to send 20,000 US$ to his family member. If he send this money through bank, he receives rupees at prevailing exchange rate of INR 35/US$. But in the black market, the exchange rate is INR 40/US$.

In other words, RBI puts a value of INR.35 per US$, when it should have been Rs.40/US$. Hence INR is overvalued at the official rate.

The NRI contacts a hawala operator in USA and gives $20,000 to him. The USA hawala operators counterparty in India, pays Rs. 40/US$ to the family members of NRI here in India. The transaction between hawala dealer in USA and his counterparty India are done through smugglers.

During the heyday of hawala transactions in 1990's, it was a common knowledge that exporters **under invoice** their export earnings and importers **over invoice** their imports goods (so as to increase the cost of import denominated in foreign currency) and the differences are kept abroad and later repatriated back through Hawala route.

Even after 17 years of liberalization and even though exchange rate is market determined by supply & demand forces, Hawala market still operates, though at a smaller scale. According to a news report in Hindu (March 2005), many people working in the Gulf countries opt for the `pipe' or 'Hawala' transactions for obvious reasons of convenience and speedy transactions. No bank can beat these operators in delivering the money so fast, and that too at the receiver's doorstep!

The ramifications of Hawala market operations are manifold. In fact, through Hawala market, the money laundering is undertaken. A very informative article on Hawala Transactions are available at Interpol website (**http://www.interpol.int/Public/FinancialCrime/MoneyLaundering/Hawala/default.asp**).

It is probably one of the most comprehensive pieces of document on Hawala market.

Short Questions:

1. Briefly explain, "What are the significant changes in FEMA compared to FERA".
2. What is FEDAI and what role it plays in Indian forex market?
3. What is difference between currency depreciation and devaluation?
4. What could be the motive behind "under invoicing of imports" and "over invoicing of exports".
5. What is difference between a currency being convertible in "current account" vs. currency being convertible in "capital account".

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3. FERA & FEMA Guidelines: **http://www.femaonline.com/**
4. Balakrishnan S., Forex speculation drives corporate losses, Business Line, February 14th 2009.