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THE IMPACT OF MONETARY POLICIES ON THE EXCHANGE RATE IN INDIA

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ABSTRACT

This paper investigates the impact of monetary policies on the exchange rate of India.Theoretical explanations and statistical readings have been used. Exports of goods and services, and inflation all have statistically significantly positive and negative effects on the exchange rate.

INTRODUCTION

Exchange Rate

The exchange rate refers to the rate at which the currencies of different countries are traded or exchanged.

The exchange rate can be defined in the following ways:

1- The number of units of domestic currency that exchanges for one unit of foreign currency. Example: $1 = 82.22 Indian Rupees

2- The number of units of foreign currency that exchanges for one unit of the domestic currency. Example: 1 Indian Rupee = $0.012

Table - Foreign Exchange Rates Of the Indian Rupee (Market Rate in Rupee Per Unit of foreign currency)

Foreign Currency	Exchange Rate - 2020	2021	2022
US dollar	74.132 INR	75.31 INR	82.30 INR
British Pound	99.62 INR	100.54 INR	91.09 INR
Canadian Dollar	55.2969 INR	58.95 INR	59.66 INR

Euro	84.64 INR	87.44 INR	79.92 INR
UAE (Dhiram)	20.19 INR	20.14 INR	22.41 INR
Swiss francs	79.06 INR	80.88 INR	82.41 INR
Singapore Dollar	53.75 INR	55.017 INR	57.25 INR
Japanese Yen	0.70 INR	0.67 INR	0.56 INR
Thai Baht	2.37 INR	2.31 INR	2.16 INR
Hong Kong dollar	9.55 INR	9.51 INR	10.48 INR

Exchange Rate System In India

India has been operating on a managed floating or dirty floating exchange rate regime since March 1993, commencing a period in which the rupee's currency rate is set by the market with a mechanism for timely central bank intervention.

Under managed floating or dirty floating, the central bank intervenes, to buy and sell foreign currencies in an attempt to influence the exchange rate.

Monetary Policy

It is the policy of the central bank to control and regulate the availability and flow of credit with the public as well as the cost and use of money for achieving certain predetermined objectives of economic policy. It is also known as credit policy since a major portion of the money supply in an economy consists of bank money and control of the money supply is possible only through control over the supply of bank credit.

In order to achieve the overarching goal of economic policy, monetary policy refers to the employment of monetary instruments under the supervision of the central bank to control variables like interest rates, the money supply, and the availability of credit.

The central bank in India is the Reserve Bank of India. It is the apex monetary and banking authority in India.

It should be emphasised that, since 1998, when the monetary targeting paradigm was abandoned, the interest rate has been used as the primary instrument for communicating monetary policy in India under the liquidity adjustment facility. However, it may be argued that changes in the money supply, whether planned or unplanned, anticipated or unanticipated, could have a considerable influence on the real economy given the cash-intensive character of the Indian economy. In reality, the Reserve Bank of India's monetary aggregates in its monetary policy review demonstrates its continued relevance in terms of policy considerations.

Monetary Policy - Tools

The Reserve Bank of India must reduce the supply of money or raise the cost of money in order to keep the demand for goods and services under control and prevent inflation.

Quantitative tools: The tools used in policy that have an impact on the money supply across the entire economy, including industries like manufacturing, agriculture, the auto industry, real estate, etc.

Reserve Ratio: Banks are required to hold aside a predetermined amount of cash reserves or other assets that the RBI has approved. There are two types of the reserve ratio

Cash Reserve Ration (CRR) - Banks are required to deposit this amount in cash with the RBI. The bank is not permitted to lend it to anyone or to benefit from CRR in any way.

Statutory Liquidity Ratio (SLR): Banks must reserve this amount in liquid assets like gold or RBI-approved instruments like government securities. Although banks are permitted to earn interest on these assets, it is relatively little.

Open Market Operations (OMO): The RBI buys and sells government assets in the open market to regulate the amount of money in circulation. Open Market Operations refer to these transactions made by the Central Bank in the open market.

The RBI drains market liquidity when it sells government securities, and does the exact opposite when it purchases securities. The latter action is taken to limit inflation. OMOs' main goal is to prevent short-term liquidity imbalances in the market caused by foreign capital flow

Qualitative tools: Unlike quantitative tools, which have an immediate impact on the money supply of the entire economy, qualitative tools are targeted instruments that have an impact on the money supply of a particular industry.

Margin requirements: The RBI sets a specific margin against collateral, which affects how often consumers borrow. Customers will be able to borrow less if the RBI increases the margin requirements.

Moral persuasion - The RBI persuades banks to keep money in government securities instead of specific industries.

Controlling credit by avoiding lending to certain sectors of the economy or speculative enterprises is known as selective credit control.

Policy Rates for the Market Stabilization Scheme (MSS):

The bank rate is the interest rate that the RBI charges banks for long-term loans of capital. However, at the moment, RBI does not fully regulate the money supply through the bank rate. In order to create control over the money supply, it makes use of the Liquidity Adjustment Facility (LAF) - repo rate as one of the key mechanisms. If the bank does to maintain the required SLR or CRR, it will be subject to a penalty determined by the bank rate. RBI employs the Liquidity Adjustment Facility (LAF) as a tool to modify the money supply and liquidity. LAFs come in the following varieties:

Rate of repo the repo rate is the price at which banks short-term borrow money from the RBI in exchange for repurchase agreements.

In accordance with this policy, banks must offer government securities as collateral and then afterwards purchase them back after a specified period of time.

The rate for Reverse Repo: The rate that the RBI pays to banks in order to hold more money in the RBI is the opposite of the repo rate. The following is how it relates to the repo rate:

Repo Rate - 1 is the reverse repo rate.

Marginal Standing Facility (MSF) Rate: The MSF Rate is the penalty rate above the rate permitted by the monetary policy at which the Central Bank loans money to banks. Banks that employ the MSF Rate are only allowed to use 1% of the SLR securities.

Repo Rate + 1 time MSF Rate

Studying the variables influencing the exchange rate is vital given the significance of this figure in the economic growth of India.

LITERATURE REVIEW

Exchange Rate Channel

While the rupee is convertible for foreigners and non-resident Indians (NRIs) on their capital accounts, similar changes are made for domestic citizens. For capital outflows in the form of direct and portfolio investment, non-resident deposits, and the repatriation of assets and cash held abroad, significant relaxations have been permitted. Indian citizens can now open accounts with Indian banks in foreign currencies.

The following are the main steps done to enlarge and deepen the Indian forex market and connect it to the global financial system:

1- Flexibility for banks to establish a gap and net overnight position limitations, start trading in foreign markets, and use derivative products for asset-liability management

As a precautionary measure, 2- authorised dealers (ADs) in foreign exchange are permitted to borrow abroad up to restrictions based on their capital basis; 3- corporations are free to cancel and rebook forward contracts as well as to hedge projected exposures.

The capacity to move money around more freely has been made possible by the flexibility of exchange rates and the gradual abolition of capital regulations. Foreign exchange inflows may increase if monetary policy action results in interest rate arbitrage until exchange rate changes bring the interest rate parity back. In turn, an increasing exchange rate would reduce aggregate demand, reducing inflationary pressures. However, the possibility of exchange rate adjustments might not be present, either fully or partially, if significant portions of economic agents lack sufficient resilience to endure volatility in currency and money markets.

Therefore, in order to stabilise the market, the central bank may need to conduct foreign exchange operations.

The central bank's decision to inject money into the economy would conflict with its stated policy objectives and undermine monetary transmission. As a result, managing money becomes difficult, and the monetary authority may need to engage in offsetting sterilisation activities to protect the intended transmission of money.

Relationship between monetary policy and exchange rate

1. The impact of monetary policy according to the type of currency system

India is in the floating exchange rate regime, and the currency system is the floating exchange rate regime. Therefore, by increasing the exchange rates, the central bank does not intervene in the market. With an increasing exchange rate, exports increase and imports decrease.

2. The impact of monetary policy with respect to the price level

The general price levels rise if the RBI adopts an expansionary monetary policy, which raises the money supply. Domestic goods become more expensive than foreign goods as a result of rising domestic pricing, which also reduces their export competitiveness in international markets. Exports decline and imports rise as the competitive power is diminished. Importers' demands for foreign currency rise as a result of falling exports and rising imports, while the availability of currencies declines. From two channels, it increases the exchange rate.

3. The impact of monetary policies with regard to portfolio

When the RBI adopts an expansionary monetary policy, the money supply rises, which lowers the interest rate. As interest rates decline, consumers remove their money from banks and invest it in other markets, such as the foreign exchange market, making bank deposits less appealing. The returns of some assets, such as currencies, rise and their demand rise when interest rates are low and other assumptions remain the same. The exchange rate will rise as demand for them rises.

Trilemma

External developments have occasionally had an impact on Indian monetary policy, particularly the use of policy interest rates, which are also intended to moderate currency rate swings The well-known trilemma constraint—the trade-offs between an independent interest rate (monetary) policy, exchange rate stability, and financial openness (deregulation of capital controls)—is clearly present in India. When policymakers pursue more capital market openness (financial liberalisation) or adopt an interest rate policy that differs from the rest of the world, exchange rate stability is endangered (given a certain external environment). This is where the trilemma configuration comes into play (monetary independence).

The RBI is in charge of making sure that there are no excessive fluctuations in the value of the rupee. There is no set exchange rate for the rupee. Therefore, the RBI cannot 'set' the exchange rate by intervening too much. The best it can do to prevent sharp variations in the exchange rate is to sell or acquire dollars.

India continues to struggle with this problem, just like every other economy. Like many western nations, it chose to have an independent monetary policy. It often permits a free exchange rate. It occasionally manages capital flows. The sharp depreciation of the rupee in 2013 is a prime illustration. The RBI implemented stringent capital controls to stabilise the currency. The rupee is, however, remarkably stable right now. According to a State Bank of India research, it could be time to take another look at capital flows, particularly those coming from China. "Policymakers should be extremely concerned about India's trade balance with China, which increased from $36.2 billion in FY14 to $51.2 billion in FY17 (47.3% of the overall trade deficit) as evidence of import substitution through Chinese imports are indeed threatening the balance," the report said.

Internationalisation of the Indian Rupee - RBI's major move to settle worldwide transactions in the Indian Rupee

In 2019, The Reserve Bank of India (RBI) put in place an additional arrangement for invoicing, payment, and settlement of exports and imports in INR in order to promote the growth of international trade with a focus on exports from India and to support the growing interest of the international trading community in INR. As a result, all exports and imports were to be priced in rupees. This action was anticipated to lower the demand for dollars and lessen the risks associated with foreign exchange and exchange rate changes.

Reducing exchange rate risk would reduce the transaction costs of cross-border trade and investment operations. However, unless supported by substantial and deep domestic financial markets that are capable of effectively absorbing external shocks, it makes it more difficult to pursue both exchange rate stability and a domestically oriented monetary policy at the same time.

Following is a general outline of how the Foreign Exchange Management Act of 1999 (FEMA) governs international commerce transactions in Indian Rupees:

Invoicing: All exports and imports made pursuant to this Agreement may be valued at and invoiced in (INR).

Exchange Rate: The market may decide the exchange rate between the two trading partners' currencies.

Settlement: In accordance with the established protocol, the settlement of trade transactions under this agreement shall be made in Indian Rupees.

The usage of rupees as a means of exchange would significantly lessen the risk and burden connected with the dollar in recent times, as many countries are experiencing a shortage of foreign currency. It would increase exports and decrease the costs of transacting in international trade. For instance, due to payment issues, trade has nearly ceased as a result of the sanctions against Russia. The RBI's trade facilitation system is causing an improvement in Russia's payment problems.

The RBI will need to exercise caution when monitoring the stability of the money supply and interest rates during the phased implementation of the same, especially given the Indian economy's surging inflation despite the RBI's inflation targeting measures. Since inflation can still shift by 10–13% as a result of an exchange rate change, the RBI uses exchange rates as a crucial information variable when determining how to formulate monetary policy. With the currency rate now entirely controlled by the market and the capital account gradually becoming totally convertible, a strong and efficient domestic financial system will also aid in absorbing external shocks.

CONCLUSION

There is a need for developing market economies like India to provide greater exchange rate flexibility, but the government can also gain from having the ability to interfere in foreign exchange markets in light of the volatility seen in global capital flows. Therefore, it is necessary to maintain a sufficient amount of foreign exchange reserves, which in turn both facilitates and limits the implementation of monetary policy. One important lesson is that managing the currency rate and monetary policy in emerging nations requires flexibility and practicality rather than strict adherence to theoretical norms.

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