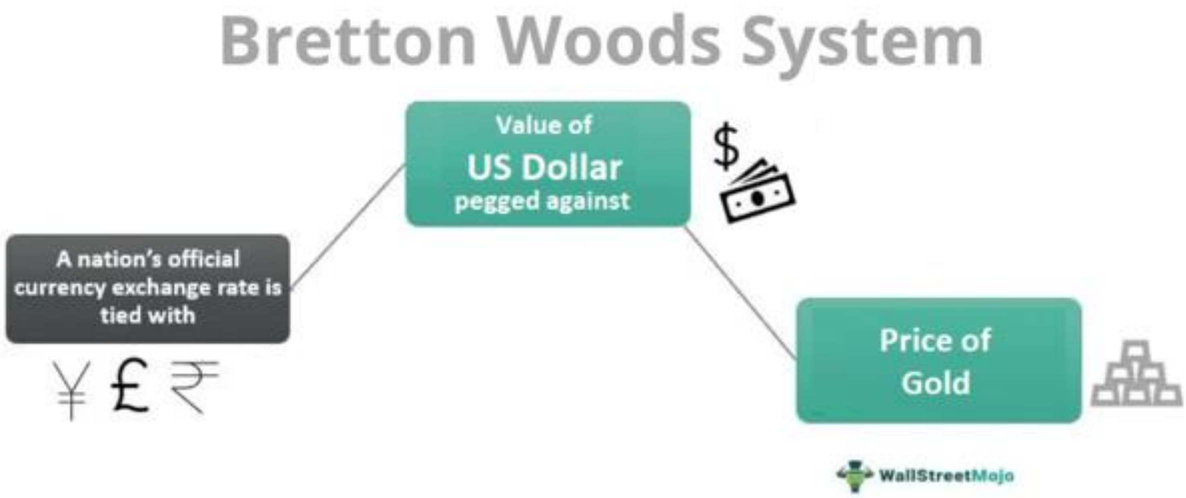
## Bretton Woods System

- The Bretton Woods system was an international monetary agreement that standardized currency exchange rates.
- Currencies belonging to various nations were pegged against the US dollar. The US dollar itself was pegged against the price of gold.
- Initially, one ounce of gold was worth $35.
- It aimed to bring uniformity to global exchange rates. It was based on the **gold standard.** This system regulated international trade between 44 countries and remained in practice from 1945 to 1973. The system collapsed because the US dollar could not hold its value.

  **"Gold standard"** - The gold standard refers to a monetary system where a nation's currency is valued according to a specific quantity of gold. Under the system, the value of paper notes was standardized in terms of gold.




## Characteristics of Bretton Woods

- Stabilizing international exchange rates was the primary objective of Bretton Woods.
- It was an attempt to help nations recover economically post-World War II.
- Bretton Woods was adopted by 44 countries—they agreed to **peg their currencies** against the USD.
- The US Dollar was considered—an international **reserve currency**.
- It provided a fixed exchange rate. However, this rate was adjustable.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- It standardized international monetary payments—by facilitating currency conversion.
- Post Bretton Woods, allied countries did not have any control over the international payment and settlement system.

## Collapse of Bretton Woods

- Between 1968 to 1973, Bretton Woods was on its way out. US President Richard M. Nixon **ceased** USD-gold convertibility. In the 1960s, the US dollar struggled to hold its value.
- Nixon noticed that the US was short on gold. US's Gold reserves could not meet the value of dollars in circulation. Economists' attempts to revitalize Bretton Woods failed. In 1973, the Bretton Woods agreement collapsed—it ceased to exist.
- The Bretton Woods arrangement failed due to **the following reasons**.
    1. The system depleted US gold reserves—as more and more US dollars were issued to meet international demand.
    2. In the 1960s post-Vietnam War, the US struggled with inflation. Its current account balance was low; thus, the government decided to call off this system.
    3. Moreover, this system lacked a proper adjustment mechanism for the balance of payments.
    4. There was a deficit balance of payment in the US. Meanwhile, there was a huge demand for the US dollar worldwide, resulting in liquidity issues.
    5. The US dollar was the international reserve currency. This caused seigniorage issues for many other nations. Other nations believed that this system provided an undue advantage to the US. USD yielded a higher rate of return when sold internationally and lesser when sold domestically.
    6. Finally, in response to inflation and the current account balance deficit, the government declared restrictions on gold-dollar conversions.
- Post Bretton Woods breakdown, countries did not need to peg currencies against USD or gold prices. The coins were free to float and fluctuated with the market demand. Central banks regulated the supply of money in their respective countries.


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- However, because of the Bretton Woods collapse, the world witnessed oil shocks. Countries absorbed expensive oil prices with flexible exchange rates.

## Exchange Rate Management in India

### Par Value System (1947-1971)

- During the period 1947 till 1971, India followed the par value system of the exchange rate whereby the rupee's external par value was fixed at 4.15 grains of fine gold.
- The RBI maintained the par value of the rupee within the permitted margin of ±1% using Pound Sterling as the intervention currency. The devaluation of the rupee in September 1949 and June 1966 in terms of gold resulted in the reduction of the par value of rupee in terms of gold to 2.88 and 1.83 grains of fine gold, respectively. Since 1966, the exchange rate of the rupee remained constant till 1971.

### Pegged Regime (1971-1992)

- With the breakdown of the Bretton Woods System, in December 1971, the Rupee was linked with Pound Sterling.
- Following the breakdown of Bretton Woods System there was a downward pressure on the Pound Sterling vis- a – vis major international currencies; being pegged to Sterling, this led to misalignment of the rupee vis- a – vis other currencies.
- To overcome the weaknesses associated with a single currency peg and to ensure stability of the exchange rate, the rupee, with effect from September 1975, was pegged to a basket of currencies.
- The currencies included in the basket as well as their relative weights were kept confidential by the Reserve Bank to discourage speculation.
- During this period – (1975-1972), the exchange rate of rupee was officially determined by the RBI within a nominal band of +/-5% of the weighted basket of currencies of India's major trading partners.

By the late 'eighties and the early 'nineties, it was recognised that both macroeconomic policy and structural factors had contributed to balance of payment difficulties. The current account deficit widened to 3.0 per cent of GDP in 1990-91 and the foreign currency assets depleted to less than a billion dollar by July 1991. It was against this backdrop that India embarked on stabilisation and structural reforms to generate impulses for growth.

## The Period Since 1991

- The Report of the High-Level Committee on Balance of Payments (Chairman Dr. C. Rangarajan) laid the framework for a credible macroeconomic, structural and stabilisation programme encompassing trade, industry, foreign investment, exchange rate and the foreign exchange reserves.
- Following the recommendations of Rangarajan Committee to move towards the market determined exchange rate, the **Liberalised Exchange Rate Management System (LERMS)** was put in place in March 1992 involving dual exchange rate system in the interim period. The dual exchange rate system was replaced by unified exchange rate system in March 1993.

## Liberalised Exchange Rate Management System (LERMS)

- LERMS was announced in the budget for 1992-1993.
- This system introduced Partial Convertibility of rupee.
- Under this system, a dual exchange rate was fixed under which **40 %** of foreign exchange earnings were to be surrendered at the official exchange rate while the remaining **60%** were to be converted at a market determined rate.
- Foreign exchange surrendered at official rate was to be used for the import of essential items (like crude oil, petroleum products, fertilisers, life saving drugs, etc.)
- Foreign exchange converted at market price was to be used to finance all other imports. Since the official exchange rate was lower than the market rate, this system meant taxing the exporters to subsidise the govt's bulk imports. The implicit export tax was between 8-12% & was highly resented by exporters.

## Market – Determined Exchange Rate Regime (1993 – Present Day)

- LERMS was essentially a transitional mechanism & provided a fair degree of stability. There was also a healthy build-up of reserves.


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- As a result, there was a smooth changeover to a regime under which the exchange rates were unified, effective from March 1, 1993. Since then, the day to day movements have largely been market-determined.
- The **objective** of exchange rate management has been to ensure that the external value of the rupee is realistic and credible as evidenced by sustainable current account deficit and manageable for any exchange situation.
- Subject to this predominant objective, the exchange rate policy is guided by the need to reduce excess volatility, prevent the emergence of destabilising activities, help maintain adequate level of reserves, and develop an orderly foreign exchange market.
- This shows that the market determined exchange rate regime being followed by India since 1993 is a **'managed float'** regime.
- Under the unified exchange rate regime adopted in the 1993 - 1994 budget, the 60: 40 ratio was extended to 100% conversion. This 100% conversion was extended for
    i. Almost the entire merchandise trade transactions (export and import of goods)
    ii. All receipts, whether on current or capital account of balance of payments, but not all payments.
- Side by side the official RBI rate also stayed on for the conversion of items not permitted under the unified market rate, i.e., more than half a dozen of invisible items of current account as well as capital account.
- In addition, various exchange control norms of the Reserve Bank remained in operation all along, with some relaxation of provisions. This shows that the 1993 - 1994 budget introduced **full convertibility on trade account**.
- In February 1994, the Reserve Bank undertook several steps towards achieving **current account convertibility** when it announced relaxations in payment restrictions for a few invisible transactions and liberalisation of exchange control regulations up to a specified limit on varied transactions.
- **Current Account Convertibility** was finally achieved in August 1994 when the Reserve Bank further liberalised payments and accepted obligations under Article VII of the IMF, under which India is committed to forsake the use of exchange restrictions on


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current international transactions as an instrument in managing the balance of payments.

- The experience with the market determined exchange rate system has been **satisfactory.** For most of the period since 1993, the foreign exchange market was characterised by orderly conditions except few episodes of volatility.

**Table 2.1 : Chronology of the Indian Exchange Rate**

| Year | The Foreign Exchange Market and Exchange Rate |
|---|---|
| 1947-1971 | Par Value system of exchange rate. Rupee's external par value was fixed in terms of gold with the pound sterling as the intervention currency. |
| 1971 | Breakdown of the Bretton-Woods system and floatation of major currencies. Rupee was linked to the pound sterling in December 1971. |
| 1975 | To ensure stability of the Rupee, and avoid the weaknesses associated with a single currency peg, the Rupee was pegged to a basket of currencies. Currency selection and weight assignment was left to the discretion of the RBI and not publicly announced. |
| 1978 | RBI allowed the domestic banks to undertake intra-day trading in foreign exchange. |
| 1978-1992 | Banks began to start quoting two-way prices against the Rupee as well as in other currencies. As trading volumes increased, the 'Guidelines for Internal Control over Foreign Exchange Business' were framed in 1981. The foreign exchange market was still highly regulated with several restrictions on external transactions, entry barriers and transactions costs. Foreign exchange transactions were controlled through the Foreign Exchange Regulations Act (FERA). These restrictions resulted in an extremely efficient unofficial parallel (hawala) market for foreign exchange. |
| 1990-1991 | Balance of Payments crisis |
| July 1991 | To stabilize the foreign exchange market, a two step downward exchange rate adjustment was done (9% and 11%). This was a decisive end to the pegged exchange rate regime. |
| March 1992 | To ease the transition to a market determined exchange rate system, the Liberalized Exchange Rate Management System (LERMS) was put in place, which used a dual exchange rate system. This was mostly a transitional system. |
| March 1993 | The dual rates converged, and the market determined exchange rate regime was introduced. All foreign exchange receipts could now be converted at market determined exchange rates. |

**Source** : Reserve Bank of India

## FERA (Foreign Exchange Regulation Act) v/s FEMA (Foreign Exchange Management Act)

| Provisions | FERA | FEMA |
|---|---|---|
| **Year of Enactment** | FERA was introduced in the year 1973. | FEMA came into force in the year 1999, replacing FERA. |
| **Objective** | The primary objective of FERA was to regulate, control, and conserve foreign exchange. | FEMA was designed to facilitate external trade and payments and promote orderly management of the foreign exchange market in India. |
| **Approach** | FERA had a preventive approach. It restricted many activities related to foreign exchange. | FEMA, on the other hand, has a liberal approach. It was introduced to enhance the flow of foreign exchange in the country. |
| **Violations** | Violations of FERA were considered criminal offenses. | Violations of FEMA are considered to be civil offences. |
| **Residential Status** | Under FERA, the residential status of a person was determined by his/her stay in India for a period of six months. | Under FEMA, the period of stay in India to determine the residential status is 182 days. |
| **Treatment for Violation** | FERA had a provision for imprisonment for violation of its provisions. | FEMA does not have a provision for imprisonment for any violation of its provisions unless it is a deliberate attempt to evade the law. |


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## Reasons for Depreciation of Indian Rupee

- The Indian Rupee depreciated by around 10% against the US dollar and the rupee was the worst-performing Asian currency in 2022.
- The US Fed aggressively raised interest rates by 425 basis point (bps) in 2022 in its fight against inflation. This led to a higher interest rate differential between the US and India, and investors pulled out money from the domestic market and started investing in the US market to take advantage of higher rates.
- Due to greater imports, India's trade deficit grew to an all-time high of over $23 billion in November 2022.
- This expanding trade gap is caused by the increase in oil costs.
- High crude prices and the slump in equities markets are both contributing to the dollar's negative outflow.
- In 2022, Foreign Portfolio Investors (FPIs) pulled out Rs 1.34 lakh crore from the Indian markets – the highest-ever yearly net outflow. (Rs 1.21 lakh crore from the stock markets and Rs 16,682 crore from the debt market)
- This decline was mainly on account of appreciation in the US currency on haven appeal amid fears of recession and inflation across many parts of the world and Russia-Ukraine war.

## Impact of Depreciation on the Indian Economy

- Weaker rupee should theoretically give a boost to India's exports, but in an environment of uncertainty and weak global demand, a fall in the external value of rupee may not translate into higher exports.
- It poses risk of imported inflation and may make it difficult for the central bank to maintain interest rates at a record low for longer.
- India meets more than two-thirds of its domestic oil requirements through imports.
- India is also one of the top importers of edible oils. A weaker currency will further escalate imported edible oil prices and lead to a higher food inflation.


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## Measure to stem the slide of Rupee.

- **Repo Rate Hike -** RBI can consider a hike in repo rate to incentivise foreign investors to invest in Indian debt securities and stop the exodus of foreign capital from the equity market. This way the demand for the dollar will come down and will provide some support to rupee.
- **Currency market intervention -** RBI can step up currency market intervention by selling of dollars from its reserves which will cater to the higher demand for the US currency.
- **Restrict outward dollar remittances -** RBI under the liberalised remittance scheme can also restrict outward remittance dollars.
- **Open Market Operations** - RBI can address the situation by improving liquidity in the system through open market purchase bonds and by reducing the cash reserve ratio CRR.

## Long term systemic changes to be ushered in.

- The government should go all out to push exports of goods and services.
- Remove all bottlenecks to exports and provide logistics support.
- Bank should be mandated to provide liberal funding for exports.
- FDI norms should be further liberalised.
- This is a rare opportunity for Indian exports as rupee has depreciated more sharply than currencies of other emerging economics clearly making Indian goods and services virtually the cheapest globally. The response from the government as well as the exporters must be quick.
- Cut red tapism and provide faster clearances wherever required to facilitate faster and quicker exports.
- Speed up investment by the government, expedite investment proposals held up in bureaucratic red tapism.
- Initiate government level reforms which are non-controversial and easy to implement it is not about 'bold reforms' but about 'quick reforms.


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- India can closely look at full convertibility of the rupee, as as it would encourage inflows. Convertibility would also allow surfacing of the underground USD into money market thereby augmenting supply of USD.

## The Impossible Trinity

- Exchange rate management is complex and a challenge for any central bank.
- There is also the 'impossible trinity' that it is impossible for Indian central bank to manage exchange rates, open current accounts, and independent monetary policy all at the same time.
- At best it can manage any two of them but not all the three. This is the biggest challenge before any central Bank of which two, to manage, when all three are imperatives, come especially in adverse circumstances.

## Nominal Effective Exchange Rate (NEER)

- The Nominal Effective Exchange Rate (NEER) is a weighted average exchange rate that represents the value of a country's currency relative to a basket of multiple foreign currencies.
- It is calculated by taking the unadjusted weighted average of the exchange rates between the domestic currency and various foreign currencies.
- The NEER is an important indicator used to assess a country's international competitiveness in the foreign exchange market and can be adjusted to account for inflation differentials through the calculation of the Real Effective Exchange Rate (REER).
- The NEER provides a comprehensive view of a country's currency value against multiple currencies simultaneously, allowing for a broader assessment of its exchange rate dynamics.

$$\mathbf{NEER = (w1 * ER1) + (w2 * ER2) + \ldots + (wn * Ern)}$$

  - NEER is the Nominal Effective Exchange Rate.
  - w1, w2, …, wn represent the weights assigned to each foreign currency in the basket.


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- ER1, ER2, …, ERn are the exchange rates of the domestic currency with each foreign currency in the basket.

- The weights assigned to each currency in the basket are typically based on trade flows or other economic factors that reflect the importance of each currency in the country's international trade.
- The exchange rates used in the calculation are usually the market exchange rates or official exchange rates, depending on the context and availability of data.

## Real Effective Exchange Rate (REER)

- The Real Effective Exchange Rate (REER) is a measure that considers the inflation differentials between a country and its trading partners when assessing the value of its currency. It provides a more accurate measure of a country's international competitiveness by adjusting the Nominal Effective Exchange Rate (NEER) for inflation.

**REER = (NEER * CPI Domestic) / (CPI Foreign)**

  - REER is the Real Effective Exchange Rate.
  - NEER is the Nominal Effective Exchange Rate.
  - CPI Domestic is the Consumer Price Index of the domestic country.
  - CPI Foreign is the Consumer Price Index of the foreign country or countries in the currency basket.
- By incorporating inflation differentials, the REER provides insights into a country's competitiveness in international trade, as it reflects not only nominal exchange rate movements but also relative price levels between the domestic and foreign economies.


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