# International Finance

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## Lecture - 14
## Development of Foreign Exchange Market in India

Good morning, in session fourteen we will be discussing about the development of Indian foreign exchange market. And already we have discussed different phases of foreign exchange market. How foreign exchange market all over the world developed. How the currency standard established? How the economy or the world economy migrated from barter system to what is called a metallic system, then migrated to inconvertible paper currency standard.

We have discussed about the inconvertible paper currency standard the conversion rate and thus required an establishment of foreign exchange market. Foreign exchange market is very important particularly for international trades. When international trade take place in different currency standard, and that currency standard them self inconvertible paper currency, it requires the development of foreign exchange market.

Foreign exchange market, particularly develop in developed country and the newly established colonial country particularly when they got their independence. They establish their own economic format, and in this process they developed different phases of the foreign exchange market. When you consider about India; India got it independence in 1947. After that at the part of the colonial regime it was part of the great Britain pounds, and great Britain pound that is the pound sterling continued to be one of the major currency for India. And over the period Indian financial market developed, the foreign exchange market developed and we have migrated from what is called the pound sterling regime to a US dollar regime. And also we have established what is called what is called the different parts of the foreign exchange market particularly the foreign exchange spot, foreign exchange forward, foreign exchange future options these are the requirement for efficient foreign exchange market.

And in this session we will be discussing about the development of Indian foreign exchange market over the years. We will be we will be discussing about the policy reasons. We will be discussing about the policy framework which leads to establishment

of a, what is called a more efficient foreign exchange market in the Indian context. In this in this session we will be discussing about the different committee reports and how the committee reports have been implemented over the years to establish the Indian foreign exchange market.

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Let us start with the India. If you see in the India had India had followed a strict exchange control from the time of second world war; the second world war starting from early of second world war particularly 1940 onwards India followed a strict exchange rate regime. The regime requires that without the permission of the government you cannot convert the currency into either gold that time or the paper currency standard and the strict exchange rate exchange regime was implemented was adopted all need to preserve the current currency.

After the second world war when India got independence; the reserve bank of India that is India central bank took over the management of foreign currency. And RBI particularly looked at the conserving foreign currency which is precious which was precious that time. The foreign currency resources were preserved and the foreign currency was used particularly for the development of the country for the import requirements. The import requirements here the at the first 5 year plan during this 1952 to 57 58; that time we requires capital intensive industry and this import requirement was fulfilled for preserving the foreign currency.

The exporter had to surrender the foreign currency to the authorised dealers. Authorised dealers primarily were banks, commercial banks. And they get the authorised dealer provided the rupee as decided by the currency exchange rate by the RBI. The purchase and sell of purchase and sell of foreign exchange or foreign security by Indian's were strictly controlled. As a Indian you cannot purchase foreign currency assets. You cannot purchase transfer the foreign currency from India to other country without the permission of reserve bank of India. And the and the conversion or the requirement of foreign currency decided by the RBI for which purpose we need the foreign currency one what will be the rate decided by the RBI.

In 1978, the RBI allowed banks to undertake intraday trading in foreign exchange and this perhaps marked the development of or the beginning of the Indian foreign currency market. The 1978 RBI allowed banks for intraday trading. Intraday trading means within the day there will be minute level of fluctuation of exchange rate will be there and this band of exchange rate fluctuation the authorised dealer can buy and sell foreign currency and this this step lead to the development of or beginning of the Indian foreign currency market.

As a opportunity to make profit through arbitrage major banks started quoting foreign currency in two way pricing system. The two way pricing as we discussed earlier class, earlier sessions the buying rate and selling rate. And buying rate selling rate provide the difference of buying and selling rate provide some kind of transaction profit. And transaction profit when whenever there is a cross currency requires spot; it provides some kind of arbitrage opportunity, arbitrage profit for banks and banks since 1978 they started quoting foreign currency for intraday trading purpose.

During 1975 or 78 to 91 92 the exchange rate regime India is characterised by what is called daily announcement of exchange rate by the RBI for buying rate and selling rate. And at that buying and selling rate authorised dealer provide exchange rate exchange rate buying and selling quote to the merchant. And merchant transaction or the export import transaction depends upon the what rate the RBI is announcing the exchange rate and what transaction profit or transaction exchange or transaction what is called transaction fee the banks are charging.

So, 1978 till 1992 it was daily announcement of foreign exchange rate by the RBI on that rate banks or authorised dealer provide different kind of exchange rate or quote to merchant export import for other transaction purpose and this was a strict regime followed by RBI for the preservation of foreign currency.

However, the exchange rate market was not developed exchange rate market itself was not there. The authorised dealer, among themselves create a spot exchange rate and the spot exchange rate governed by the RBI daily announcement of exchange rate for different currency. If you see in a pragmatic way there was there was no exchange rate market till 19 1992 in India. The foreign exchange market developed after foreign exchange market developed after 1992 when the liberalisation measures were initiated by the RBI.

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## Rangarajan Committee

- Provided the basic framework for policy changes in external sector, encompassing exchange rate management, current and capital account liberalisation.
- As per advised the Liberalised Exchange Rate Management System involving dual exchange rate system was instituted in March 1992, which ultimately led to convergence of the dual rates, unification of exchange rates and market determined exchange rate regime of rupee.
- Process adopted towards current account convertibility, which was finally achieved in August 1994 by accepting Article VIII of the Articles of Agreement of the International Monetary Fund.

In 1992, R Rangarajan committee they provided the exchange rate, exchange rate system or the foreign exchange development in Indian context. The foreign exchange market development process was initiated by the Rangarajan committee report. Rangarajan committee had given a phase manner how to develop the foreign exchange market in Indian context. They started with what is called a liberalised exchange rate management system which primarily provide a dual exchange rate. See dual exchange rate for export, for import and for the conversion of foreign exchange into different currency.

This continue the dual exchange rate system continue till 1992 which was ultimately lead to conversion convergence of the dual rate to a unification unified rate or the market determined exchange rate regime. The dual exchange rate primarily for exporter importer. On the dual exchange rate, on the dual exchange rate when the exporter surrender their foreign currency they will get a part of the foreign currency at the prevailing market rate. That is independent for them to convert into a prevailing market rate.

A part will be converted into a what is called a rate decided by the RBI. And there was a dual exchange rate in this process dual exchange rate create some kind of uncertainty some kind of arbitrage opportunity. And this dual exchange rate actually was a stepping stone for the conversion of Indian rupee to a market determined exchange rate regime. And market determined exchange rate regime was initiated in 1992; march 1992 onwards.

On the market determined exchange rate the current account of the balance of payment was liberalised and the current account. At present, the current account all items of the current account primarily the export, import, inward and outward remittances, the familiar being expenses for the all other day to day transaction of a exchange rate except the capital mobility was (( )) was forced to convert at the market rate.

So, there was no requirement on the part of the exporter importer look at the any RBI rates. RBI stopped announcing the daily rates and the rates were market determined and authorised dealer were given the permission to quote exchange rate as per their own demand and supply. At present, we have current account convertibility and significant part of the capital account has been liberalised. And if you see the exchange rate at present the there are many authorised dealer. Each dealer quoting different rate and why different rates are there because each dealer on the basis of their demand and supply on the basis of their requirement they quote exchange rate. And exchange rate in exchange rate of different currency particularly rupee against pound, sterling rupee against euro, rupee against yen, rupee against US dollar, Canadian dollar, Australian dollar are now market determined rate.

These rate particularly market determined the sense that there is no requirement on the part of the on the part of the authorised dealer to look at the rate of a provided by the RBI

and at present also RBI not depending any particular rate and RBI is not declaring any daily market rate or any kind of exchange any kind of foreign currency. The process of current account convertibility allowed Indian banks, Indian foreign exchange market or the central bank to sign the agreement with the RBI IMF what is called the articles 8. Article 8 of international monetary fund; the article 8 or article v triple I. By accepting this article India declared that the current account current account convertibility of their Indian rupee.

The Indian rupee is the INR 100 percent convertibility on current account transaction. As I mention earlier current account transaction is the significant part of foreign currency movements. Current account indicate the export import or international transaction of international trade side and invisible import invisible foreign currency foreign exchange rate particularly the invisible items what is called services payment, interest rate payment, for day to day family living expenses through which the travel tourism all at the current account convertibility.

The current account indicates what is called the day to day transaction of foreign currency, and day this day to day transaction of the foreign currency at present. By accepting the article 8 of the IMF India now it is market determined in case of India. Among a few country India at present among one of the few one of the few country India at present is market determined exchange rate for current account and this indicate the significant step in the development of Indian foreign currency market.

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## Sodhani Committee

- Freedom to initiate trading position in the overseas markets
- Freedom to borrow or invest funds in the overseas markets
- Freedom to determine the interest rates on Foreign Currency Non- Resident (FCNR) deposits
- Freedom to use derivative products for asset-liability management.
- Corporates also have been given freedom to hedge anticipated exposures.
- Banks can offer cross-currency options on back-to- back basis to corporates.
- Framing comprehensive risk management guidelines for banks;
- Adopting Basle Committee norms for computing foreign exchange position limits and recommending capital backing for open positions.

After accepting the Rangarajan report and converting the Indian rupee particularly the particularly for current account convertibility India tried Indian government or the RBI tried to adopt different phases of in foreign exchange market. The different phases here the spot market development, the forward market development, the future market development of foreign currency when the exchange rate is market determined it create risk. Because the fluctuation of currency it is a risk for the international transaction process. And realising this, the RBI wanted to establish the foreign exchange forward market to prevent to prevent this kind of fluctuation of foreign currency and provide some kind of hedging product risk management product for the exporter and importer.

In this process RBI established a committee what is called Sodhani committee to provide a path for the liberalised further liberalisation of foreign currency market in India and for the establishment of hedging market of foreign currency forward market in case of India. The freedom here Sodhani committee provided some kind of interesting report to government of India and RBI. And they provided what is called a path a clear cut path for the establishment of the foreign currency market in India.

In this process, the Sodhani committee recommended that freedom to initiate trading position in the overseas market. Though what does it what does it mean? It provide a they advocated that Indian authorised dealer should be allowed for trading in foreign currency market in overseas market particularly international market. They also

mentioned that freedom to borrow or invest bond in the overseas market. Banks bank and corporate should be allowed to invest allow to borrow or invest in foreign currency in abroad market, freedom to determine the interest rate on foreign currency non resident deposit. What is called FCNR deposits? Banks provide bank accept foreign currency deposit. Then thus foreign currency deposits interest rate earlier it was remained by the RBI and Sodhani committee advocated that this interest rate on foreign currency deposit that is called FCNR deposit should be deregulated and let the authorised dealer or the bank decide the decide the interest rate on foreign currency deposit.

And similarly, freedom to use derivative product for asset liability management bank should be allow to use derivative product for asset liability management. Bank accept deposit for short run and short deposit that is 1 or 2 years 3 year deposit what create loan for longer period; more than 5 years 7 years loan create in this process there is asset and liability mismatches. Thus mismatches can be addressed. If its mismatches are in the form of foreign currency this can be addressed through derivative transaction and in this process the Sodhani committee recommended for the establishment of derivative market or the forward foreign currency forward market, future market for in case of India. And bank should be allowed to use the derivative product for the asset liability management side.

Corporate also have given the freedom to hedge anticipated exposures. Corporate those are big corporate having presence all over the world, having transaction in export import related item. Generally they face what is called problems of foreign currency fluctuation. And this process in this process create uncertainty in their balance sheet, in their transaction process and Sodhani committee recommended that for corporate having a underlying exposure in foreign currency should be allowed in using the derivative for the risk management purposes. Banks can offer cross currency option to back to back basis to corporate. Bank should be allowed to allow to provide cross currency exchange foreign cross currency options for the two corporate for risk management purpose. And in this case the Sodhani committee recommended that cross currency option, that is options having if you are underlying risk in dollar you can go for a go for buying a options product in e n. And this process you can you can minimise your exchange, minimise your risk and bank should be allowed to offer cross currency options to bank corporate having underlying exposure.

The banks, Sodhani committee also recommended that RBI should develop a policy framework for framing what is a comprehensive risk management guideline for bank. Banks are having transaction banks having transaction significant transaction in foreign currency. And there should be proper risk management practices guideline for bank and Sodhani committee recommended that bank should adopt banks RBI should provide what is called a comprehensive guideline comprehensive guideline for risk management for the banking sector. Bank also Sodhani committee recommended that bank should RBI should allow should create a policy framework for the implementation of Basel committee norms on computing foreign exchange position limit and recommending a special capital backing for open position. What does it mean? It means that the Basel committee who the committee which framed the guidelines for risk management practises for bank.

The guideline provided, the Basel committee provided the guideline for particularly the foreign exchange position, open position of foreign currency, the capital position of the foreign currency and in this process Sodhani committee recommended that RBI should adopt these Basel committee recommendation and allow the bank to go for a risk management practices as per the norms of the Basel committee for the their open position. And also for their position for what is called requirement of capital to absorb the upward position.

Whenever there is a open position; there will be a risk in fluctuation of exchange rate to and for this to absorb this risk banks should have significant amount of capital. And as per the Basel committee recommendation, the Sodhani committee recommended that RBI should adopt the Basel committee recommendation and provide the open position risk management capital backing system for the foreign for the banks in India.

So, Sodhani committee primarily recommended a clear cut path for the development of Indian foreign currency derivative market and particularly for preventing or absorbing the risk in fluctuation of foreign currency. And in this process they adopt, they recommended the RBI to prepare guideline comprehensive guideline for the for risk management practices of bank in India; particularly in the area of foreign currency market.

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## Tarapore Committee

- Tarapore Committee on Capital Account Convertibility, 1997, had recommended a comprehensive measure for foreign exchange market.
- Foreign direct investment, portfolio investment, investment in Joint Ventures/wholly owned subsidiaries abroad, project exports, opening of Indian corporate offices abroad, allowing acceptance credit for exports, allowing FIIs to cover (forward cover) their exposures in debt and part of their exposures in equity market, etc.
- The Committee as part of improving the risk management, recommended for introduction of interest rate swaps and FRAs
- Recommended for registering Indian fund managers, including Mutual Funds, to invest in overseas markets subject to SEBI guidelines.

If you see there are another committee which committee particularly after the 1996 1997; it was established by the RBI which is called as Tarapore committee. The deputy governor of RBI headed the committee and they recommended what is called a capital account convertibility. Convert capital account convertibility comprehensive guideline for the foreign exchange market development and also they recommended for the corporate sector joint venture. Then also recommended what is called FI limit for different FI that is foreign institutional investment in India, foreign direct investment in India. And also a recommended what is called as mutual fund for foreign currency transaction side. That is particularly in the area of opening up Indian currency capital account.

The capital account particularly deals with as you known in case of earlier we discussed about the capital account convertibility side. Capital account primarily foreign exchange large scale. Foreign exchange transaction involve it involve the foreign exchange security aspect, foreign exchange of foreign currency securities or investment aspect. Here the FII FDI joint venture foreign limit in what is called limits for foreign investment in India. These are the part of capital account convertibility side and the Tarapore committee was established for the giving recommendation for capital account convertibility side and Tarapore committee take took into account the policy framework for developing the FII investment, FDI investment, mutual fund investment, the joint venture side. And also, me guidelines they provided for the reframing the SEBI act.

If you see the capital account Tarapore committee recommendation; the Tarapore committee recommendation comprehensive for the comprehensive in the (( )). In the sense, that it provide a clear guideline for the opening of the capital account. In case of India the foreign direct investment foreign portfolio investment, investment in joint venture, wholly owned subsidiaries abroad, project export opening, opening of Indian corporate offices. All are the part of the recommendation of the Tarapore committee for Tarapore committee.

The Tarapore committee mention that foreign direct investment would be liberalised different sector of the economy, particularly different industrial segments of the economy where the foreign direct investment requirements are there they should be diluted. And there should be the tap in foreign exchange investment direct investment should be reduced. And foreign direct investment should be allowed in different sector of the economy other than the sensitive difference sector let us say sensitive (( )) sector. And here also they will they allow they mention that the Tarapore committee mentioned there are corporate houses should be allowed to open offices in abroad, corporate houses should be allowed to borrow money from abroad in foreign currency, corporate house with corporate debt management practices should be developed.

Corporate should be allowed to raise foreign currency from the abroad market in the form of ADR GDR issue, in the form of foreign currency borrowing. And at the foreign currency in the same time they also mention that FII investment in different sector of the economy should be look into further. There should be liberalisation of FII investment in Indian stock market and FII limit for different sector, different segments of economy should be should be reduced. So, that FII can invest further in Indian foreign currency market and in this process we can develop our foreign currency reserve.

The portfolio investment in case of FII should be should be look into in such a way that the defensive sector, different sector particular different segment national security reasons security reasons are there. National importance those sectors are very important for security should be from the FII investment and other sector should be open up for FII investment and also they recommended that Indian corporate houses those who have good corporate rating, those who have good in good company rating; they should be allowed to allowed to raise foreign currency from abroad.

They should be allowed to open their offices in abroad. So, that the subsidiary, wholly owned subsidiary in abroad can be a part of the domestic investment sector. The committee on the Tarapore committee as a part of improving the risk management practises recommended for the introduction of interest rates swap and FRA, the forward rate agreement. These are the risk management product particularly in the foreign exchange market and they also recommended registering Indian mutual fund each mutual funds manager including the mutual fund to invest in overseas market subject to SEBI guideline.

So, Indian fund manager including the mutual fund should be allowed to invest in overseas market over see market as per the SEBI guideline. So, what the Tarapore committee primarily addressed, primarily address the capital account convertibility side. The capital account convertibility side capital account convertibility primarily having a different aspect of foreign currency inflow, and outflow; this inflow outflows are large in the sense that involves FDI's foreign direct investment foreign institutional investment portfolio investment, joint venture joint venture etc. And the Tarapore committee wanted to increase our foreign currency reserve.

So, significant reserve provide us a some kind of stability in foreign currency market. It will enhance the sovereign rating for India and for this they provide a recommended a significant liberalisation on the part of on the part of the RBI. From the part of government of India to increase the FII inflow, FDI inflow Indian domestic market and in this process they also allow they also recommended that Indian domestic players particularly the big corporate houses having good rating they should also be allowed to open their overseas office, they should also be allowed to borrow from foreign currency market. And in this process they can get cheap foreign currencies (( )) foreign currency fund which lead to lead to further investment in India.

In this process the Tarapore committee, Tarapore committee recommended for the significant liberalisation of Indian capital Indian capital account convertibility side and in this process has been adopted over the year. If you see Indian foreign currency foreign exchange market at present; the capital account has been significantly liberalised and over the year the RBI, the government of India government of India allow the FII to invest in India both in both in equity market and debt market.

Even FII'S are allowed to invest in Indian g sec market that is the government security market, government the corporate debt market and portfolio investment particularly the FII investment has been liberalised significantly. FDI sector also foreign direct investment side, Indian government has liberalised many sector for the for the FII FDI investment except the defence sector all other sectors has been liberalised significantly. The manufacturing sector, financial services sector the FDI's are allowed and also in mining sector, mining quarrying site FII'S are allowed now.

FDI also FDI in case of in case of retail sector, in case of foreign direct investment, in case of large scale investment FDI's are allowed in different segments of the Indian industrial sector. And in this process at present Indian capital account has been significantly liberalised.

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## Recent Policy Changes

- Inflows and outflows by non-residents have been partially deregulated.
- Portfolio investment in India is allowed through foreign institutional investors.
- Global depository receipts (GDRs) or other forms of overseas equity issues, External Commercial Borrowings (ECB) are allowed with due permission from RBI and the government.
- Foreign institutional Investors (FIIs) can invest in a company under the portfolio investment route
- Foreign Investment Promotion Board (FIPB) can considered applications for FDI upto 100% for Oil refining sector, business-to- business e-commerce and Internet service providers.
- FDI is permitted in the Special Economic Zones.
- Foreign equity participation upto 26 per cent has been allowed in the insurance sector.

Tarapore committee also recommended a significant measures, significant measure particularly the how to develop the foreign currency reserve system. Here also they they mention that there should be proper foreign exchange management system.

The foreign currency reserves which are the reserve in the form of FDI, FII'S are coming to India. How to manage this reserve the reserve management aspect are optimum foreign currency reserve are the Tarapore committee also recommended a significant policy side for the establishing what is called optimum foreign currency reserve for case in case of India. Recent liberalisation if you go through our recent liberalisation we have

significant recent liberalisation. Recent particularly after the 2006 onwards, the Indian foreign exchange market liberalised significantly. Inflow outflow by non Indian resident Indian has been partially deregulated, non resident Indian those who are NRI their inflow outflow even partially deregulated. They can they can in they can inflow side there is no regulation, outflow side also significant liberalisation has been done.

The portfolio investment in India is allowed through foreign institutional investor portfolio investment, particularly investment in Indian stock market - Indian debt market Indian mutual fund market are allowed through the registered foreign institutional investor. The foreign institutional investors are registered as per the SEBI guideline. Through them anybody in abroad can invest in Indian stock market Indian debt market Indian mutual fund market.

The registered FII'S are there. As per the SEBI guideline they register in India either through them. The foreign portfolio the portfolio investment are being are being done. Then equity side in the foreign exchange in the foreign exchange institutional investor can invest in company under portfolio investment route. The FII can also invest in Indian company through portfolio investment.

The portfolio investment they can directly invest in Indian stock market, purchase companies shares. And also they can they can directly invest in Indian bond market purchase company debt instrument. And that is through the portfolio investment side. Then also India government of India and the RBI established what is called foreign investment promotion board what is called FIPB. FIPB through FIPB considered all kind of foreign direct FDI investment and setting the limit for different sector of the economy. They also are responsible for the liberalising the FII FDI investment in case of India.

In this process they have also liberalised different sector of the economy. Many sector of the economy many industrial segments has been has been 100 percent FDI investments are there except the foreign direct, foreign Indian defence sector many other sector the FDI investment have been liberalised more than 75 percent. If you see the FIPB investment side, oil refining sector, business to business e-commerce and internet service provider; these are 100 percent liberalisation recently approved by the FIPB that is foreign investment promotion board. FDI is permitted in the special economic zone.

Government of India and the ministry of commerce has established different sector of the different segment of the economy in the form of special economic zone. There are many special economic zone in India and these special economic zone FDI 100 percent investments are there. Foreign direct investors can invest 100 percent in FII special economic zone. It is considered as the export processing zone. All whatever the manufacture take place took take place in export processing zone or the special economic zone; they are hundred percent FDI investments will be there. All goods and services will be exported from there and the and domestic sales of goods and services produced by the special economic zone are not allowed. FDI investment in the special economic zones are 100 percent.

FII foreign equity participation up to 26 percent has been allowed in insurance sector, up to 75 percent allowed in Indian banking sector and also many other sector particularly the financial services sector, the FDI's are allowed significantly. FII if you see the foreign institutional investment foreign institutional investment and foreign direct investment they are they are going at par, because first they are allowing FI investment. There after that they are allowing liberalising the foreign direct investment. In this process the foreign ownership ownerships are changing. In case of direct investment direct investment the owner are the FDI because they participate with the domestic firms domestic company and FDI investment take place.

In case of FII investment no doubt the investment is taking place in equity market or debt market. However, there also ownership patterns are changing. But FDI is more stable in nature FII'S are more volatile in nature. So, FDI brings policy, brings technology, brings experience. However, FII there is only portfolio investment which is highly volatile and over the year government of India providing more experience, more learning through process of liberalisation of foreign exchange market and experiencing the and experiencing the volatility in the stock market, try to address this issue through the FII investment.

However FII investments are more volatile in nature, it is very, very important for us to have more FDI in in in directly in our economy rather than giving more importance to FII investment side. However, together we are liberalising both FII sector and FDI sector. Together we are liberalising and we are giving more importance to FDI side and also at the same time FII side also.

However, FDI requires some kind of a basic requirement, some kind of infrastructure facility. After that only FDI investment can come to India. FII investment requires the liberalisation of Indian financial sector. That is that is the policy framework on the part of the RBI, on the part of the government of India. However, if you see the recent policy changes; recent policy changes primarily focussed on more foreign currency inflow to India and also giving importance to FDI side rather than FII side.

Indian at this juncture government of India has allowed the RBI has allowed the Indian domestic company particularly those who have good foreign good corporate rating, those who have those who have established company to go for go abroad and dilute their equity indirectly. What is called through GDR approach. Global depository receipt and American depository receipt. And these some extent provide equity dilution side of domestic company in an in foreign in international market. We will be discussing in detail about the depositary side.

However, depository side provide significant revenue significant capital inflow foreign currency inflow to Indian currency Indian foreign exchange market. The good company in India those who are good corporate rating, having significant amount of profit good profitability parameter; they have been they have diluted their equity through GDR or ADR routes and mobilising significant part of the foreign currency and this also another way other than going through the ECB route. What is called external commercial borrowing routes? External commercial borrowing in the form of debt instrument which need to be repayment for after the maturity period and also in between there should be interest outflow will be there or external commercial borrowing depends upon the rating of the particular Indian company.

However, GDR ADR is GDR ADR that is global depository receipt or the American depository receipt is a debt instrument through equity. The underlying asset is equity and through the equity they are these company are getting foreign currency from abroad by issuing equity debt. Debt related equity investment debt related equity investment in the sense that the debt the equity underlying assets equity converted into debt and the debt are being listed in NASDAQ, listed in near stock exchange market stock exchange and this process they get the that procedure of this GDR ADR. They are getting they are getting what is called a dividend in the dividend not the interest rate. The dividend or interest rate may not be constant.

Here, also there is no repayment on the part of the as per the ECB side. There is there is repayment of principles are there in GDR ADR side there is no repayment because underlying asset is equity. In the events of the abroad investor wants a wants the repayment he has to sell the GDR ADR in Indian domestic market and converted the equity at the at the prevailing price and get the principle outflow. And in this process GDR ADR provide some kind of avenue on the part of the domestic company to list their share in abroad market and get good amount of valuation for their company. And if the recent policy changes one part of the GDR ADR, another part is the FDI investment FDI investment in different sector of the economy. Another part is what is called dilution of equity particularly foreign institutional investment, foreign direct investment in case of financial services side. And also the economic zone investment special economic zone where FDI investment can be 100 percent.

Then another part is the oil. Oil refining sector business to business e-governance sector internet service provider these are the foreign direct investment 100 percent are allowed. Foreign institutional investment retards to particularly portfolio investment should be routed to what is called the list listing of the what is called registering of the FII in with the SEBI and through them there will be portfolio investment will take place in India. These provide some kind of guideline for enhancing the Indian FII investment side and FDI side.

However, the recent policy changes there are there are significant policy changes in the form of what is called debt market development. That is called infrastructure side also the foreign direct investment can take place in India. Many segments of the infrastructure are being where the FDI limits has been enhanced and foreign institutional foreign direct investment in infrastructure side are allowed through the FII, through FII FIPB what is called foreign investment promotion board. There see there looking at the infrastructure side and specific infrastructure they are allowing 100 percent FDI investment side.

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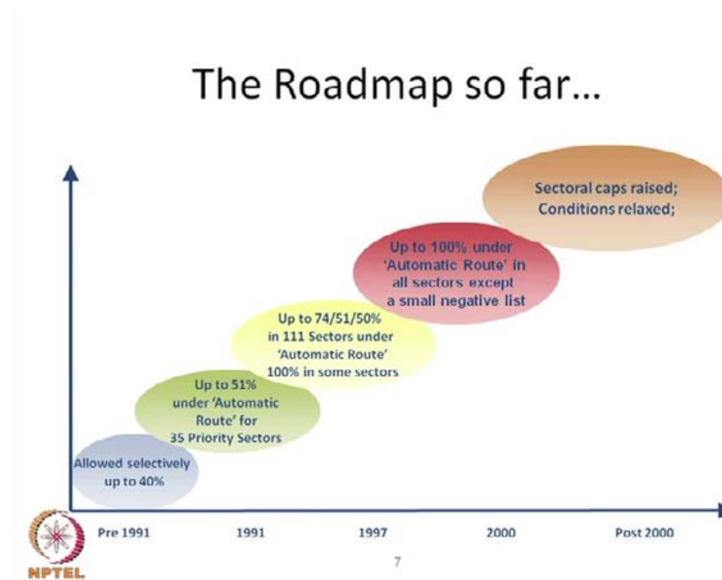


If you see the roadmap; roadmap in case of India the roadmaps are if you see the how the foreign exchange market in India developed over the year particularly after 1978 99 1947 to 1978 the government of India followed a strict exchange rate control regime. 78 authorised dealers or commercial bank allowed for intraday transaction side. After this continue up to 1991. After 1991 we have liberalised our foreign currency market through the financial sector development policy and in 1991 the government of India follow what is called a dual exchange rate system. Dual exchange rate system the exporter allowed to selectively allowed for converting the export processing export proceed particularly the export earning for 60 percent. 60 percent at the rate of RBI declared rate and 40 percent allowed for market determined exchange rate.

This dual exchange rate dual exchange rate was essential for going towards or the beginning for going towards what is called a market determinate exchange rate regime. 92 March onwards government of India declared the current account convertibility side. The current account convertibility side there should the current account exporter importers are allowed to get the rate as per the market rate. Authorised dealer allowed to quote foreign exchange market foreign exchange rate and there are different rates for different authorised dealers and in this process ninety one further liberalisation in the form of what is called a automatic routes. That is called FII, FDI through automatic route. There is no need of any kind of permission on the part of the FDI or FII to come over India. 35 sectors were declared for automatic routes for 51 percent FDI or FII FDI

investment and these FDI investment further increase in 1997 to 1974 percent and many 111 sectors were included in automatic route and hundred percent foreign FDI investment are allowed in sector.

Then up to 100 percent under automatic route to all sector except small negative list. Their government of India 2000 declared a negative list for defensive sector, for different national importance sector like nuclear power sector, there is no foreign exchange FDI investment in this sector. All other sector 100 percent FDI investments are allowed and all sectors are included in automatic route; all sectors except national importance defence sector nuclear power sector these are negative list and all other sectors are allowed to invest a automatic route of 100 percent.

Then, in two post 2000 sectoral cap raised and condition relaxed. Sectoral cap for FII investment, sectoral cap for FII investment equity market, sectoral cap for FII investment in debt market mutual fund market and it has been relaxed. The financial services sectors were deregulated particularly financial sector for investment foreign FII investment, FDI investment financial services sector also allowed. Financial services particularly the insurance sector banking sector (( )). FII investments was allowed. These are the policy framework over the year. How the foreign exchange market developed and foreign exchange market development requirements are there. There should be clear guideline for FII FDI inflow foreign purchase of foreign security, foreign assets, foreign security and foreign assets requirements are there for the development of Indian foreign exchange market.

The foreign exchange market also requirements are there should be stability in policy framework and government of India has adopted the policy framework for stability region. For stability region a stable policy requirements are there for the development of foreign exchange market because as I as we have discussed earlier foreign exchange market is highly volatile. Any kind of pulse or negative pulse if they are any demands of the foreign exchange market it lead to outflow of foreign currency and we have seen the Chilian crisis, we have seen the Mexico crisis, we have seen Asian foreign exchange currency crisis.

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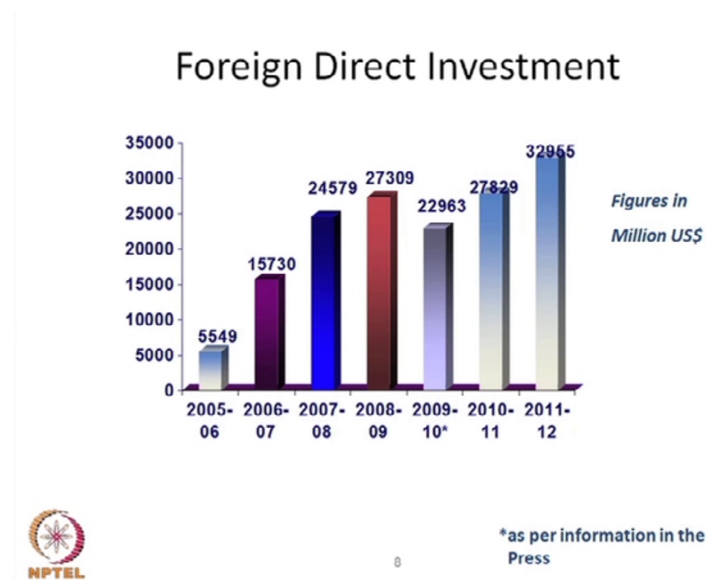


So, foreign exchange market is stability requirements are there for policy framework side if you see foreign direct investment over the year you see how the foreign direct investment has increased over the year since 2005-6. I have given the data for 2005- 6 to 2011-12. Over the year thus there has been significant increase in foreign direct investment this has come all because India adopted a stable foreign direct investment policy.

In 2005-6 it was 5419 million which increased to 32955 million US dollar over the year last infact 7 years. And this this this justify the what the a positive framework in policy side from the government of India, from the RBI side on the foreign direct investment and if you this is the end of this end of this session. Particularly we have discussed here the development of Indian foreign exchange market.

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## References

- RBI Annual Reports : 1992-2011
- Economic Survey, Government of India, 1991-2011.

And further references are there if you want to study more for the how the liberalisation took place in India in case of foreign direct investment; you can go through the different annual reports of RBI from 1992 to 2011 and also you can go through the economic survey of government of India 1991 2011 in different economic survey government of India. And the RBI outlined the foreign exchange policy and we can go through that so that further references what is called information you can get from this report.

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## MODEL QUESTIONS

- Discuss the liberalisation of Indian Foreign Exchange Market.
- What would be the strategies for optimum forex reserves for India.

And for the model question; I have framed two questions for you. You can discuss what is called discuss the liberalisation of Indian foreign exchange market. As in this question you have to discuss the development of Indian foreign exchange market. How the Indian foreign exchange market from the pound sterling to a US dollar market developed over the year. How from 1978 to 2000 1992 we have government of India or the RBI for RBI put forward, what is called or practice what is called a strict exchange rate regime.

The strict exchange rate regime was required because that time foreign currency inflow was very less for India. In Indian exports were not significant to out way the import or imports were highly very high compared to our export. We required we required to preserve our foreign currency. For that reason they Indian government and the RBI adopted a strict exchange rate regime. However, 91 92 we liberalised the exchange rate. And over the year we implemented different policy framework for the development of Indian foreign exchange market.

The policy framework primarily address what is called convertibility of rupee on the current account side, on the capital account side. We have liberalised the current account significantly particularly after 91-92; we liberalised the capital account. Exporter importers are allowed to allowed to get their required foreign currency from the market authorised dealers are allowed to trade in foreign currency quote foreign currency. Then FDI (( )) FI if I I investments were liberalised significantly and over the year capital account convertibility was significantly liberalised Indians were allowed to allowed to keep foreign currency, allowed to trade in foreign currency, allowed to purchase foreign currency assets and liability.

Companies in Indian companies are allowed to raise foreign currency from abroad in the form of external commercial borrowing in the form of dilution of equity through ADR and GDR issue. How and also over the year how the SEBI has liberalised the policy for foreign investment and foreign institutional investors are registered under SEBI. They are practicing portfolio foreign portfolio investment in India, FDI different sector of the economy has been liberalised and this in this and you have to discuss all these in the liberalisation of foreign currency market in India.

Second question was on what would be the strategy for optimum foreign exchange Forex reserve for India. So, what should be the strategy? This question was discussed in

Tarapore committee recommendation. Tarapore committee recommended what how much foreign currency reserve India the RBI should have because whenever you receive foreign currency; it was preserved with RBI. And RBI used this foreign currency for stability purpose. Any foreign currency whether it is a dollar or pound sterling or yen or euro is generally converted into what is called a domestic rupee.

So, whenever there is a foreign currency inflows are there is converted into domestic rupee and there will be domestic money circulation that is the Indian rupee circulation increases in the Indian market. It creates what is called artificial inflation in the country. This hot money we call the foreign institutional investment, portfolio investment are hot money because they are hot in the sense their speculation, their speculation what is called speculation because Indian debt market Indian equity market giving good return. They speculate the return and. In fact, in India and get their profit go out from India.

This inflow outflow of FI FI create uncertainty or create volatility in the Indian stock market. At the same time they also increase the rupee circulation in Indian economy. So, there will be inflation in Indian economy. So, any so when the RBI keep more foreign currency though there will be artificial inflation in the economy; what is called the broad money supply in the economy increases. So, there should be optimum reserve should optimum reserve we should have. Then how to decide the optimum reserve? There is some guidelines are issued by the Tarapore committee the guidelines is like is our foreign currency reserve should optimum. In the sense that when it covers the 1 year 12 month requirements of our imports and other payments. Our foreign currency reserve is optimum in the sense that our requirements for payments of foreign currency for 1 year should be should be made.

Another way they we can we can have the foreign currency requirement is sufficient. So, sufficient in the sense that it should not create inflation in our economy. It should not artificially increase our interest rate in the economy and also the foreign currency requirement is sufficient when you are in a position to our export, in a position to pay for our imports. And but there is no clear guideline what should be the criteria of foreign currency, optimum foreign currency reserve because the foreign currency market I as I mentioned earlier is highly speculative market highly volatile market or what is called highly sensitive market. Any pulse any kind of any kind of negative (( )) in any segments

of the market directly affect the foreign currency market and we have seen overnight how the Mexico 40 billion dollar outflow from the economy.

We have seen the foreign exchange currency crisis; how a minus minor policy changes on the part of Thailand create a havoc in exchange foreign exchange currency market. So, the foreign currency market or foreign currency optimum reserve is very difficult to decide and it is on the part of the RBI should understand that the requirements of foreign currency in India and RBI should follow a policy stability in the foreign currency market in Indian context. There will there we cannot say you cannot say what should be the foreign currency optimum reserve in case of India. Only we can provide some kind of criteria foreign currency optimum reserve. There will be no scientific way to declare that the optimum reserve is 200 billion or three hundred billion, because the reserve requirement changes overnight.

Thank you we will be discussing the time.