FOREIGN EXCHANGE TRADE IN INDIA – AN HISTORICAL REVIEW

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***Abstract*— *The foreign exchange market is the largest market in the world; it is conducted Over-the-Counter (OTC) through the use of electronic trading platforms, or by the telephonic trading desks with volume that exceeds commodities, financial futures, and stocks. The industry estimates that around $5 trillion of turnover occurs daily. Foreign exchange markets are the back bones of the international trade and for global investment. It is particularly important in relocating capital and thus providing growth. By the highly developed financial system, a country can observe a greater share of capital, technology, human resources etc. This chapter focuses on advent and the legal framework of foreign exchange market in India.*

Keywords—OTC, Foreign Exchange, Financial System, Growth

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1. INTRODUCTION

Foreign exchange is the process of converting one currency into another currency. Foreign exchange transaction is an agreement between a buyer and a seller that a given amount of one currency is to be delivered at a specified rate for some other currency. The foreign exchange market is a market in which foreign currencies are bought and sold. It provides the physical and institutional structure through which the money of one country is exchanged for that of another country, the rate of exchange between currencies is determined, and foreign exchange transactions are physically completed.

It is the largest market in the world, it is conducted over-the-counter (OTC) though electronic platforms. These markets are not limited by any geographical boundaries. It does not have any regular market timings and operates 24 X 7 throughout the year. These are characterized by growing trading volume, great heterogeneity among market participants with big institutional buying and selling million of dollars. The foreign exchange markets are highly liquid, turnover is high, the market participants are very large and individual players in the foreign exchange market cannot create any kind of pressure in determining the market exchange rate.

2. CLASSICAL THEORIES ON FOREIGN EXCHANGE

Economists have developed several theories to explain why there should be trade between nations and what goods should a country export or import. Some of the classical theories are

The Theory of Mercantilism:

The first theory of international trade is known as mercantilism. It emerged in England in the 16th Century. This theory was suggested that the wealth of a nation consisted of gold and silver which were then the currency of trade between countries. In order to accumulate gold and silver, a country should increase its exports and decrease in the balance of trade. Government intervention is necessary for this price. This theory is favored the regulation and planning of economic activity for strong nation.

Theory of Absolute Cost Advantage:

This theory was propounded by Adam smith in 1776, absolute cost advantage may come due to factors of climate, quality of land and natural resource, difference in labour, capital technology and entrepreneurship. Adam smith opposed mercantilism and argued that certain goods can be produced at a lower cost in one country than in another country. Therefore, a country should specialize in the production of goods for which it has an absolute cost advantage and then trade these goods for goods produced by another country.

The theory of Comparative Cost Advantage:

The main limitation of absolute cost advantage theory is that it does not explain what happens when one country has an absolute advantage in the production of all goods. David Ricardo removed this limitation in his book, "Principles of Political Economy, published in 1817. According to Ricardo's theory of comparative cost advantage, it is beneficial for a country to specialize in the production of goods that it produces most efficiently and to buy the goods that it produces less efficiently from other countries.

Hecksher-Ohlin theory:

As per this theory, the comparative advantage of a country arises from differences from in national to endowments. Countries will export those goods that make intensive use of factors that are locally abundant, while importing goods that make use of factors that are locally scarce. This theory also suggests that free trade is beneficial, but unlike Ricardo's theory, it argues that differences in factor endowments rather than differences in labour productivity determine the pattern of international trade.

The Product Life-Cycle theory:

Raymond Vernon developed the product life-cycle theory in 1996, the focus of his theory is not the product rather that the country and its cost advantage. The product life-cycle theory suggests that over a period, a product undergoes different stages along with changes in knowledge, technology, information and costs. It contains three stages as, new product, Growth product, and mature product.

3. EXCHANGE RATE SYSTEMS

The exchange rate system we see today is the latest state in a world of continuing change. The systems that have preceded the present floating exchange rate system varied between Gold Standard and systems in which the US Dollar was considered as good as gold. In the beginning, there was Gold standard system as the major international monetary systems of the 12th Century.

Gold Standard System:

There is no official starting date for the advent of Gold Standard system, but engaged from 18th Century. The main feature of this system is fixed exchange rates between participating countries; stable exchange rates were considered a necessary ingredient to increase trade among nations. This system is limited the rate of growth in a country's money supply. This was due to the fact that all money had to be backed by gold and the supply of gold in the world increased quite slowly during this period. This system prevents Governments from deciding their own independent monetary policies.

The Bretton Woods System:

The bitter experiences of the World War forced many countries to create a stable and multinational monetary system, which would help in the restoration of international trade. United States and Great Britain took the lead in this accordance with the agreement reached at the conference; the International Monetary Fund established was established in 1946, this exchange system under the IMF came to be known as Bretton Woods System. The main objectives of the system is

1. To establish a system with stable exchange rates;
2. To eliminate existing exchange controls; and
3. Bring about convertibility of all currencies.

4. FOREIGN EXCHANGE MARKET IN INDIA AFTER INDEPENDENCE

The development of foreign exchange trade in India can be grouped in three distinct phases,

Phase – I:

During 1947-71, India followed the exchange rate of par value system. RBI fixed rupee's external par value was Rs. 4.15 grains of fine gold. RBI allowed the par value to fluctuate within the permitted margin of ±1%. 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. 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.

Phase – II:

This phase refers to during the period of 1978-1992, where the exchange rate of rupee was officially determined in terms of weighted basket of currencies of India's major trading partners. During this period, RBI set the rate by daily announced 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.

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 million to shore up its precarious forex reserve.

Phase - III

This phase covered 1992 onwards, 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. 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 or company can undertake forex transactions. Through FEMA, Government liberalized the export-import policy, limits of FDI & FII (Foreign Institutional Investors) investments and repatriations, 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. 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.

5. Conclusion

The Indian foreign exchange market has operated in a liberalized environment for more than a decade. A cautious and well-calibrated approach was followed while liberalizing the foreign exchange market with an emphasis on the need to safeguard against potential financial instability that could arise due to excessive speculation. Exchange rate regimes do influence the regulatory framework when it comes to the issue of providing operational freedom when it comes to the issue of providing operational freedom to market participants in respect of their foreign exchange market operations.

In the coming years, the challenge for the RBI would be to further build up on the strength of the foreign exchange market and carry forward the reforms initiatives, while simultaneously ensuring that orderly conditions prevail in the foreign exchange market. Reforms in the financial markets is a dynamic process and need to be harmonized with the evolving macro-economic developments and the level of maturity of participating financial institutions and other segments of the financial market.

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