Exchange Rate Developments

6.67 The exchange rate of the rupee against the US dollar continued to be broadly market determined. During 1999-2000, the exchange rate market displayed reasonable stability, with the rupee depreciating by about 2.9 per cent from the annual average of Rs.42.07 per US dollar in 1998-99 to Rs.43.33 in 1999-2000. In contrast, the year 2000-01 witnessed significant downward pressures on the rupee-dollar rate from mid-May 2000. The forex markets were affected by considerable uncertainty with the rupee depreciating by 6.7 per cent between end-April and end-October 2000 from Rs.43.655 per US dollar to Rs.46.775. Since November 2000, the situation has shown large improvement and the forex markets have been relatively stable. At the end of January 2001, the exchange rate of the rupee was Rs.46.415 per US dollar, showing a depreciation of 6.1 per cent, compared with the rate of Rs.43.605 at the end of March 2000.

6.68 Some of the factors which had a strong bearing on the developments during the first half of 2000-01 were: (i) the price of crude oil imported by India increased further during the year on top of the sharp increase recorded in the previous year. As a result, there was a substantial increase in the quantum of foreign currency demanded by Indian Oil Corporation and other bulk importers of crude oil; (ii) for various reasons, including uncertainty about the prospects of the equity market in India, there was a sharp reversal in capital flows on account of Foreign Institutional Investors, having a bearing on the supply of foreign exchange in the market; (iii) the increase in US interest rate in May 2000 coming on top of several earlier increases significantly reduced the interest rate differential in respect of holdings in US dollar vis-à-vis Indian rupee; (iv) driven by the favourable outlook for the US economy and in view of the continuing uncertainty about the recovery in Japan and the outlook for European economies, the US dollar appreciated sharply against most major currencies, especially the Euro and the Pound Sterling, and also against Thai Baht, Philippines Peso and Indonesian Rupiah between end-May and end-September. In tandem with the appreciation of the US dollar in the international currency markets, the Indian rupee has also appreciated against the Euro and the Pound Sterling.

6.69 The RBI responded with a combination of measures to cope with the adverse effects of the above factors, which persisted for several weeks. These included: (a) use of foreign exchange reserves to partially meet the excess demand in the currency markets, particularly on account of oil imports and government debt servicing; (b) increasing the cost of bank financing for imports and overdue export bills; (c) increasing the bank rate to the pre-April 2000 level in order to partially reverse the narrowing of interest differential between dollar / rupee holdings and improve inflows. In addition, the very short-term Repo and reverse Repo rates were increased to make holding of daily long positions in US dollar less attractive. CRR was also increased by one-half per centage point in order to mop up some excess liquidity in the system; and (d) repatriation of 50 per cent of balances held in EEFC accounts along with reduction in entitlement in respect of further accretions to these accounts (which was restored to the earlier entitlements subsequently).