EXCHANGE RATE DYNAMICS: HOW RELEVANT THEY ARE IN LEATHER INDUSTRY- **Mr.Maram Srikanth, AGM, CBG, IDBI Bank, Hyderabad**

The contribution of Indian leather industry to Gross Domestic Product (GDP), foreign exchange earnings and employment opportunities is well known. It is the tenth largest forex earner of India with exports of USD 3.8 Billion during the FY2010-11. The major export destinations from India are Germany, France, Italy, Spain, Britain and the US. Leather Industry is employing around 3 million people directly, mostly women; The industry has a large production base of 2100 tanneries across the country and has a global share of 3% in the world's leather production and it is estimated to reach 4% by 2017. In view of its export orientation, the impact of exchange rate dynamics should be well recognised and understood by the leather industry so as to manage the risks associated with foreign currencies.

India embarked upon liberalisation programme since 1991 and introduced various reform measures with a view to widening and deepening the market by relaxing foreign exchange regulations. The liberalisation of exchange control rules was initiated with an aim to improve the overall productivity, competitiveness and efficiency of the economy, in general and the foreign exchange market in particular.

As part of the economic reforms package, Indian Government devalued INR against USD by around 20% in July, 1991 so as to maintain export competitiveness. Subsequently, Liberalised Exchange Rate Management System (LERMS), a dual exchange rate system, was introduced in March 1992 based on the recommendations of the committee on BoP headed by Dr. C. Rangarajan. LERMS was a stop gap arrangement before introduction of 'unified market determined exchange rate system' in March 1993. Subsequently, India achieved Current Account Convertibility (CAC) in 1994 by becoming a signatory to Article VIII of the International Monetary Fund (IMF) Articles of Agreement.

Post introduction of CAC in India, turnover in foreign exchange market increased as well as the risk appetite of banks in view of wide-ranging reforms undertaken by the RBI, marked by its 'gradualism with caution' approach. The reform phase began with the appointment of Sodhani Committee (1995) which made several recommendations to improve the functioning of foreign exchange market. A number of its recommendations regarding introduction of various products and removal of restrictions in the foreign exchange market to improve efficiency and integration of domestic markets with foreign markets were implemented.

Subsequently, the implementation of some of the recommendations of Tarapore Committee on Capital Account Convertibility (1997) and Internal Technical Group of RBI (2005) deepened the Indian foreign exchange market further.

Over the years, Indian foreign exchange market has matured in terms of depth, liquidity and efficiency; this is evident from its higher turnover and lower bid-ask spreads. In India, the normal spot market quote has an average spread of 'half a paisa' while swap quotes are available with a spread of 'one to two paise per USD'. The bid ask-spreads of USD/INR have almost *converged* with those of other convertible currencies in the international market. On some occasions, in fact, the bid-ask spread of USD/INR was *lower* than that of some major currencies (Mohan, 2007). More than 96% of India's foreign exchange turnover is denominated in USD as per the BIS Central Banks' Triennial Survey, 2010. As per the Survey, Indian foreign exchange market is the 15th largest market in the world with a daily average net turnover of USD 27.4 billion (market share increased from 0.1% in 1998 to 1% in 2010).

Currencies, for all practical purposes, are like commodities. Hence, exchange rates are determined by a wide variety of economic & political factors and are mainly dependent on the market forces at any given moment. According to a research study, it is observed that Real Effective Exchange Rates (REER), Balance of Payments, Relative Money Supply, Index of Industrial Production and Interest Rate Differential are the *most significant* variables in determination of USD/INR exchange rate during the period January 1999 through March 2011. It is also observed that forward premia and RBI's Net Intervention do affect exchange rates but their impact is found to be minimal. Besides, factors such as relative costs of factors of production, infrastructure facilities, corruption index, transparency and liberalised trade do influence determination of exchange rates. It is felt that market *sentiments, actions, expectations, perceptions and positions (speculative, trading and proprietary)* have a role in determination of exchange rates. Further, exchange rates are also driven by any *news* item that has an impact on the real and financial sectors.

Indian foreign exchange market has become *deep, liquid and efficient* over a period of time especially after introduction of market determined exchange rate system in March 1993 and gradual liberalization of inflows and outflows in foreign currency. However, INR came under heavy pressure in the foreign exchange market during the last one year mainly due to

Euro Zone crisis, weak external demand, high inflation, sticky interest rate regime, policy inertia and downgrading of India's sovereign credit rating etc.

With the introduction of derivatives such as Currency Futures, Options and Swaps, most of the firms and individuals have more choices to manage their exchange rate risks. One should keep in mind that ***the basic objective of derivatives is not to make a windfall gain but to reduce the probable loss arising out of fluctuations in exchange rates.*** Though numerous exchange rate models are available to forecast the behaviour of exchange rates, there is no unique model which can forecast well for all currencies and at all time horizons.

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