Liberalized Exchange Rate Management System and Devaluation in India: Trade Balance Effect

Rajat Acharyya*
University of Burdwan, India

Abstract

This paper examines the short run trade balance effects of the recent exchange rate policies in India in terms of the extended Jones-Corden [1976] model. With rigidity of money wage rate as the target of concurrent fiscal policy, a change in the LERMS formula improves trade balance only if non-tradeables are relatively labour-intensive. A devaluation might still fail to improve trade balance, on the other hand, in presence of imported input. The Jones-Corden condition thus gets modified in presence of imported input.

I. Introduction

In efforts to come out of the balance of payments (BOP) crisis the LDCs have time and again resorted to the exchange rate policies. India is no exception also. Facing the severe BOP constraint by the turn of this decade, it has begun to liberalize its trade and exchange rate regime. The first phase of it consisted of devaluation of the Rupee by nearly 20 percent during June-July 1991, followed by some import liberalization policies. In the second phase, the Liberalised Exchange Rate Management System (LERMS) was introduced in March 1992. In this system 60 percent of all export earn-

* University of Burdwan, Burdwan 713 104, India; The author wishes to thank Dr. Sugata Marjit for his valued comments that have led to substantial improvement of the paper.

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ings and inward foreign exchange (forex) remittances were allowed to convert at the market-determined exchange rate, and the rest at the official discount rate. This 40:60 LERMS formula was, however, only a transition phase with the aim at making it 0:100 one.¹ This year's Union Budget finally introduces this thereby abolishing the dual exchange rate regime in operation during last one year.

The move to the present system of unified market-determined exchange rate system can also be seen as an once-for-all export-incentive scheme or one-way devaluation. A devaluation by making exports cheaper and imports dearer in terms of the foreign currency (with respect to which the domestic currency is devalued), acts as a combination of export-subsidy and import-tax. On this interpretation the move from 40:60 to 0:100 LERMS formula emerges as an implicit one-way devaluation. Once we realize this, it becomes clear why the Indian policymakers expect better export performance and a consequent BOP improvement following LERMS.² Optimism also stems from the success of financial liberalization in the countries like Argentina, Chile, Mexico, Peru and South Korea.³

The purpose of this paper is to examine the BOP and other macroeconomic effects of the above mentioned exchange rate policies in terms of the two-sector structuralist model developed by Findlay [1973] and Jones and Corden [1976]. In doing so we extend the Jones-Corden (hereafter J-C) model by introducing an imported input. Thus, our analysis can also be

¹ The 40:60 LERMS formula is often labelled as “partial convertibility” whereas the 0:100 formula as the “full convertibility of Rupee on trade account.” But actually full convertibility is something else than just this 0:100 formula. After all, LERMS does not allow unrestricted purchase of foreign currencies. At best, it can be seen as a system of “limited” or “managed” float.

² But providing incentives to the exporters, whether in the form of direct subsidies or in the present form of LERMS, may not be a sufficient condition for better export performance (relative to imports) and hence a BOP improvement. At least the Indian experience in recent past does not indicate so. Instead, the export-incentive schemes, in operation for several years in the past, have resulted in an incentive-bargaining environment (Jalan [1991]).

³ Contrarily, external debt as a percentage of GNP for these Latin American countries have increased significantly during 1980s. Also, Mexico ranked second among highly indebted countries in 1990 (World Development Report [1985, 1987, 1992]).