The exchange rate plays an important role in economic policy in developing economies. The conduct of exchange rate policy depends to a great extent on the choice of exchange rate regime. Since the macroeconomic considerations ruled out the feasibility of floating in LDCs, countries could peg either to a major currency or to a currency basket. However, the matter did not end with the selection of a peg, it required to make difficult judgements as regard to when and how much to adjust the peg. In recent years, there has been erratic shifts in the exchange rate regimes of the developing countries, characterized by the move towards floating and more flexible arrangements. The review of country experiences show that most of these regime switches have occurred due to the persuance of the macroeconomic policies that are inconsistent with the chosen peg, and, in most cases, the exchange reforms were a part of the IMF-World Bank stabilization programme.

The evolution of India’s exchange rate regime upto 1966 has been viewed in the context of the dominant-dependent relationship between Britain and India, with the rupee maintained at 1sh 6d during 1931-66. The switch over from sterling to basket peg in 1975 was desirable as India’s trade was getting diversified and the world currency markets were witnessing unprecedented volatility from which the rupee needed protection. However, India’s basket peg did not represent a complete break with sterling, as the pound served in several ways, including the currency of intervention and designation, till its final replacement in March 1992. The empirical
evidence reveal that the rupee broadly reflected the fluctuations of the free market exchange rates, in spite of the basket system. The real exchange rates were somewhat more volatile than the nominal rates. The monthly data show that there were periods of appreciations followed by depreciations in the real exchange rates, and this might have created significant exchange rate uncertainty to the traders.

As the exchange rate policy aims at protecting the international competitiveness of a country’s exports, the location of a suitable indicator of export competitiveness becomes important. The study computes an indicator of export competitiveness, called as the real effective exchange rate, through a disaggregated model covering India’s principal trading partners and commodity exports. The real effective exchange rates show sharp depreciations since the basket peg.

The review of India’s exchange rate experiences shows that the authorities often aimed at a real exchange rate target, achieved through nominal devaluation of a creeping-type. By 1991, the rupee was found to be undervalued in relation to its PPP level. The real devaluations of the rupee adopted during 1975-91 had very little impact on India’s exports and imports and, finally, on balance of payments. The external sector of India was hit hard by several unfavourable internal as well as external shocks during the two decades upto 1991-92: The impact of three oil shocks, the terms of trade deterioration, world recession, crisis of concessional aid, domestic supply-demand factors and high internal inflation. Currency devaluations have always been undertaken in the event of rising current account deficits, although it is clear by now that the persisting deficits were not due to an overvalued rupee. On the contrary, the devaluation of the rupee had inflationary impact on the Indian economy, although the total impact was small.
Generally, the LDCs that are subject to balance of payments crisis the devaluations are normally recommended and in the process most of the developing countries have undertaken substantial devaluation of their currencies, in their effort to generate an export surplus from the same group of OECD countries. The simultaneous devaluations by a number of developing countries during the eighties have led to depressed primary commodity prices and loss of export revenues. It may be high time that the developing countries realise the perils of competitive devaluations on their terms of trade and real resource transfer.

The study assesses India's trade regime and trade performance and the impact of exchange rate depreciation. India's manufactured exports have been constrained principally by the inward looking trade regime. The export subsidisation and import liberalization strategy seem to have had no discernible impact on India's exports, as seen from the industry level data. The structure of manufactured exports have remained predominantly of primary origin. The exports from the agriculture and other primary sectors have witnessed volume growth but not accompanied by the growth in dollar earnings due to sharp decline in global primary commodity prices. The important factors determining India's commodity exports were found to be the domestic supply and foreign demand. The rupee devaluations have had only fortuitous trade repercussions. Recognition of this fact is important for an understanding of the role of exchange rate policy to promote stabilization and export growth in the present context of macroeconomic reforms in India. Indeed devaluations have led to cost escalations in sectors using imported inputs. The landed costs of manufactured imports are almost twice of their levels as compared to 1986-87, even after a substantial reduction of the tariff rate in recent periods.
While an overvalued currency can create trade imbalances and distort resource allocation an excessively undervalued rate can also impose economic costs as it perpetuates the import substituting trade regime and protects the country's export inefficiency at high exchange rates. Therefore choosing a right exchange rate becomes an important policy issue for the developing countries that wishes to pursue an export-led growth.

The study concludes by making certain observations about the prospects of new foreign exchange regime in India based on full convertibility of the rupee. The new regime seems to be unsustainable given the macroeconomic imbalances and the strength of the tradable goods sector. The exchange rates during the convertible periods have displayed considerable short run instability. The exchange rate is a crucial variable in the process of liberalisation. The policy makers should endeavour to stabilise it and provide an anchor for the new price structure to prevail under the convertible regime.