Notes on Liberalized Exchange Rate Management System (LERMS)

Programme: Third Year B.Com.

Subject: Economics

Paper Code: CEC 104

Paper Title: International Economics (CC 18)

Unit: 2. Balance of Payments & Exchange Rates

Module Name: Liberalized Exchange Rate Management System (LERMS)

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Notes:

Liberalized Exchange Rate Management System (LERMS)

As a part of new economic reforms initiated in 1991 the rupee was made partly convertible from March 1992 under LERMS. In LERMS, 60% of all receipts on current account (i.e, merchandise exports and invisible receipts) could be converted freely into rupees at market determined exchange rates quoted by authorized dealers. While 40% of them was to be surrendered to the Reserve Bank of India (RBI) at the officially fixed exchange rate. 40% exchange receipts on current account was meant for meeting Government needs for foreign exchange and for financing imports of essential commodities.

Partial convertibility of rupee on current account meant a dual exchange rate system. Adopted so that essential imports could be made available at a lower exchange rate to ensure that their prices do not increase much.

Full convertibility of rupee at that stage was considered as risky due to large deficit in Balance of Payments (BOP) on current account. As even after partial convertibility of rupee, the foreign exchange value of the rupee remained stable, full convertibility on current account was announced in the Budget for 1993-94. From March 1993, the rupee was made convertible for all trade in merchandize. In March 1994, even invisibles and remittances from abroad was allowed to be freely convertible into rupees at market determined exchange rates. However, on capital account the rupee remained non-convertible.

Capital Account Convertibility of Rupee

Under Capital Account Convertibility any Indian or Indian company is entitled to move freely from the Rupee to another currency to convert Indian financial assets into foreign financial assets and back at an exchange rate fixed by the foreign exchange market and not by RBI.

S.S. Tarapore Committee (1997): India has been moving in the direction of allowing full convertibility in this account, but with required precautions.

India is still a country of partial convertibility (40:60) in the capital account, but inside this overall policy, enough reforms have been made, and to certain levels of foreign exchange requirements, it is an economy allowing full capital account convertibility. Complete capital account convertibility can increase the inflow of capital in the country but if the conditions become unfavourable there is a great risk of the outflow of capital from the home country. This can lead to higher volatility in the exchange rates.

As per the Committee report, most important preconditions like fiscal consolidation, inflation control, low level of Non-Performing Assets (NPAs); low and sustainable current account deficit, strengthening of financial markets, prudential supervision of financial institutions, etc, should be met before India embarks on the path of full capital account convertibility. Presently, India has current account convertibility. However, investments and borrowings are restricted.