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Financial Openness and Exchange Rate Volatility: Evidence from India

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Abstract: This study constructs a time-varying financial openness index by estimating a small open economy model of interest rate determination and examines the implications of capital account liberalization for exchange rate volatility over the period April 2001–March 2025. The evolution of the openness index closely mirrors the trajectory of financial liberalization policies implemented during this period. Empirical evidence from a Threshold Autoregressive Heteroscedasticity model indicates that both real and nominal depreciations of the rupee tend to increase exchange rate volatility more than appreciation of the same magnitude. Moreover, the results reveal that exchange rate volatility rises with greater financial openness, emphasizing the need for prudent official intervention in the foreign exchange market, particularly during episodes of capital outflows, to maintain exchange rate stability.

Keywords: Financial Openness, Kalman Filter, Exchange Rate Volatility, FMOLS

JEL Classification Number: F36, F40, F43

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