

FOREWORD

During the 1990s, India has witnessed wide-ranging economic reforms encompassing various sectors of the economy. A comprehensive assessment of the reforms process was undertaken last year in the Report on Currency and Finance, 2001-02. A critical ingredient of the reform process has been the reform of India's external sector.

With the opening up of the economy since the early 1990s, issues relating to the open economy macroeconomics have become more relevant for macroeconomic policy. With financial liberalisation and increasing globalisation, capital movements have come to play an important role in influencing the exchange rate and interest rate arithmetic of the financial markets on a day-to-day basis. The volatile nature of the capital flows triggering instability and the subsequent contagion effect has been demonstrated in various episodes of financial crises across the world during the 1990s. The growing interaction between the fiscal deficits, capital flows, exchange rates and interest rates have posed a number of macroeconomic policy challenges.

India's approach has been cautious in opening of the capital account, contingent on achieving certain preconditions to ensure an orderly process of liberalisation and ensuring macroeconomic stability. This approach has been vindicated in recent years with the growing incidence of financial crises elsewhere in the world. All the same, over the years, the policy regime in India in regard to current and capital account inflows and outflows has witnessed very significant change. The trade regime has been significantly liberalised with the abolition of quantitative restrictions and reduction in tariff rates. Non-debt creating flows are being encouraged. Moreover, building of institutions, financial infrastructure and putting in place appropriate supervisory and regulatory frameworks have helped to maintain financial stability in India while it has opened its economy very substantially since the early 1990s. The success of the policy reforms is evident in the strength and resilience built up in the external sector.

Against this backdrop and in recognition of the growing importance of the external sector in driving the economy, this Report is focused on the theme: "Management of the External Sector in an Open Economy Framework". The Report addresses issues related to the structural change and improvement in the current account, the continuing debate on the appropriateness of exchange rate policies pursued by emerging market economies, building up of reserves, the speed and sequencing of capital account liberalisation and the framework of international financial architecture. The Report attempts to provide India's perspective on several of these issues. The Report is timely and topical particularly in view of the large accretion to foreign exchange reserves that has taken place in India and other Asian countries in the last couple of years. Furthermore, the emerging confidence being displayed by Indian companies in an increasingly open economy calls for continuing analysis of these issues. I hope that some of the suggestions emanating from the analysis offered in the Report will provoke further debate and continue to aid policy formulation. Comments and suggestions on the Report would be welcome.

The Report has been prepared in the Department of Economic Analysis and Policy (DEAP) under the overall guidance, supervision and editing by Narendra Jadhav, Principal Adviser of the Department.

Coordination responsibilities were entrusted to a core team of economists led by Rajiv Ranjan. The core team comprised Snehal Bandivadekar, Sumit Basu, Subhra Bhattacharjee, Bhaskar Chatterjee, S. Chingaihlian, B.S. Choudhary, S.C. Dhal, Ramesh Golait, Sanjay Hansda, A. K. Jha, Avijit Joarder, Muneesh Kapur, Rajesh Kumar, Atri Mukherjee, Brijesh Pazhayathodi, N.C. Pradhan, Ajay Prakash, Anupam Prakash, M. Ramaiah, Arindam Roy, Satyananda Sahoo, Bhupal Singh and S. Suraj.

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Some of the issues raised in the Report are still evolving and it would take some time for them to settle down. The theme is challenging and could expand into covering the whole arena of macroeconomics in an open economy framework. The task of getting the right balance between theory and practice was difficult. The group of young economists, who undertook the challenge of drawing a fine balance, did so, with courage, determination and forthrightness. I would like to record my deep appreciation to the team led by Narendra Jadhav for their dedication and hard work in producing this analytical and thought provoking Report.

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Rakesh Mohan
Deputy Governor