I THEME OF THE REPORT

1.1 The Indian economy witnessed wide ranging reforms in trade, industrial, financial, monetary and fiscal sectors during the 1990s. A comprehensive assessment of the reforms process with a focus on the underlying rationale of the reforms, their content, impact and emerging lessons for the future was undertaken last year in the Report on Currency and Finance, 2001-02. With the institution of structural reforms, the entire gamut of trade, exchange rate, industrial, foreign investment, fiscal and monetary policies began to be operated under the open economy macroeconomic framework. The pressure of globalisation called for a careful monitoring of capital account transactions with a view to maintain sustainability of the balance of payments and overall macro economic stability.

1.2 A striking feature of the structural reforms in India has been the strength and resilience built up in the external sector. Over the 1990s, the current account deficit in the balance of payments remained sustainable, averaging around 1 per cent of GDP, before turning into a small surplus in 2001-02 and 2002-03 after a gap of 25 years. The turnaround from persistent current account deficits of the 1980s occurred on account of a strong improvement in the ability to earn foreign exchange through both merchandise and invisible exports. India's market share in global exports improved *albeit* modestly. New sources of export competitiveness, such as, software have emerged, where India is among the world leaders. Substantial increase in capital flows with significant shifts in composition has occurred. Up to the end of the 1980s, the bulk of capital flows into India were mainly debt flows in the form of external assistance. Since the mid-1990s, more than half of net capital flows have been in the form of foreign investment, reflecting the high degree of international investors' confidence in the Indian economy. Indian corporates are listing on international stock exchanges and are engaged in acquisition of companies abroad. In the last three years alone, the foreign exchange reserves have increased dramatically crossing US $ 100 billion mark in December 2003. Indeed, the Indian economy has come a long way since 1991 when the foreign currency assets had dwindled below US $ 1 billion. It is also noteworthy that contemporaneous policy efforts to consolidate external debt have brought down the debt/GDP ratio and the debt service ratio to levels associated by the World Bank with the status of 'least indebted' countries. Significantly, short-term debt constitutes barely 5 per cent of total external debt and less than 7 per cent of the level of reserves.

1.3 The distinct improvement in the external sector in India has enabled a progressive liberalisation of the exchange and payments regime. The exchange rate is market-determined. Exchange rate management is flexible without fixed or pre-announced targets or bands, with interventions primarily to ensure orderly market conditions. India's exchange rate policy is perceived to be realistic and the exchange rate is among the least volatile in emerging market economies. Quantitative restrictions on merchandise trade have been abolished and tariffs are progressively being brought down to international levels. Payments restrictions on all current account transactions have been removed with the acceptance of the obligations of Article VIII of the IMF's Articles of Agreement. A cautious and calibrated policy has been pursued for management of capital account liberalisation. Non-debt creating flows in the form of foreign direct and portfolio investment, and long maturity commercial borrowings have been encouraged, while short-term debt, banking capital and non-resident deposits have been modulated. In the recent period, significant relaxations have been allowed for capital outflows in the form of direct and portfolio investments, non-resident deposits, repatriation of assets and funds held abroad. Indian residents can now open foreign currency accounts with banks in India. The sequence and pace of liberalising capital transactions has been determined by the strength of the macro-economic fundamentals and by the evolving international environment.

1.4 Against the backdrop of the significant transformation of external sector of the Indian economy and in recognition of the growing importance of the external sector in driving the economy, this Report attempts to address the theme

"Management of the External Sector in an Open Economy Framework". The focus of the Report is on the changing contours of the management of the external sector in India in a progressively open economy framework. The rest of the Report is organised as follows.

1.5 The Chapter II entitled "Recent Economic Developments" presents an update on the developments during 2003-04 highlighting the strong recovery in economic activity as seen in various sectors of the economy. The update on the economy is analysed against the background of the developments last year.

1.6 Chapter III on "Conduct of Macroeconomic Policy in an Open Economy" attempts to look into the changed context and paradigm of policymaking for an economy proceeding towards greater degrees of openness. The changing contours of the policy framework under the process of opening up of the economy has been analysed at an aggregative level embracing the three major arms of monetary, fiscal and financial policies. A discussion of the synchronicity of business cycles across economies provides the context for the sections on the real sector. Increasing openness of the economy complicates task of fiscal policy formulation because of the uncertainties about the magnitude, speed and direction of the trade and capital flows. The Chapter, therefore, dwells on agenda for public policy in an open economy which includes, reforming the tax system and administration, facilitating comprehensive expenditure reform, providing quality infrastructure and services of social nature including health and education. As regards monetary policy formulation, central banks need to take into account, *inter alia*, developments in the global economic situation, the international inflationary situation, interest rate situation, exchange rate movements and capital movements while formulating their policy response. Openness should, however, be preceded, by deregulation and strengthening of institutional framework in order to limit contagious influences.

1.7 Against the background of a noticeable increase in world trade along with structural and compositional shifts in production towards higher technology intensive products, particularly in Asia, the Chapter IV entitled "International Trade Dynamics" examines the changing structure and composition of India's trade. The Chapter examines, *inter alia*, the relevance of reservation of products for small scale industries (SSI) in an open economy context. Issues like trade openness, competitiveness of exports, foreign investment and trade and pass-through of exchange rate have been highlighted in the Chapter. The Chapter also dwells in detail on developments in the WTO and regional fora.

1.8 Chapter V entitled "Current Account Dynamics in an Open Economy" highlights the issues of sustainability of current account deficits and twin deficits in the international context as well as with reference to India. Other issues covered in the Chapter include saving-investment relationship in an inter-temporal framework; desirability of financing the required rate of investment in a developing economy through the current account deficits when the domestic savings rate is low; and competitiveness of services exports. The sources of current account balances emerging from public or private saving-investment gap which have implications for future sustainability are also dealt with in the Chapter. Finally, the Chapter also focuses on workers' remittances, their sources and the determinants.

1.9 Chapter VI entitled "Management of Capital Flows" focuses on the capital account of the balance of payments against the background of noteworthy expansion of capital flows *vis-à-vis* trade flows. The Chapter dwells on the surge in the overall capital flows, the compositional shift towards private and equity flows, the volatility associated with these flows and linkages of capital flows with demography and growth. Specific components of capital flows, such as, foreign direct investment, portfolio investment, external commercial borrowings, non-resident deposits and external assistance are covered. India's transactions with the IMF highlighting on India becoming member of the IMF's Financial Transaction Plan are discussed. The Indian experience with management of large and sustained capital flows, their implication for monetary management and the policy options are presented in this Chapter. The Chapter also highlights the usefulness of the balance sheet approach, which is helpful in identifying financial inter-linkages, imbalances, vulnerabilities and risks for the economy.

1.10 The need for a more dynamic and pragmatic approach towards management of exchange rates, reserves and external debt, keeping in view the country specific circumstances, is increasingly being felt by many countries after several crises of the 1990s. Chapter VII, which is entitled "Foreign Exchange Reserves, Exchange Rate and External Debt Management" focuses on these three major areas. The need for maintaining foreign exchange reserves has been strongly felt with increased globalisation and large and volatile cross border capital flows. An attempt is made to assess the costs and benefits of holding reserves. India's foreign exchange management practices are benchmarked against the cross-country experience. The Chapter encompasses a review of the debate relating to choice of exchange rate regime. It is highlighted that in the face of large capital flows and their reversal, flexibility and pragmatism are needed in exchange rate policy in developing countries, rather than adherence to strict theoretical rules**.** The Chapter then dwells on various issues relating to exchange rate management practices in India. Interest parity conditions have also been tested in the Indian conditions. A cross-country comparison of external debt is undertaken followed by an analysis of India's external debt over the years.

1.11 Chapter VIII entitled "Approach to Capital Account Convertibility" focuses on capital account liberalisation in India and abroad against the background of large and volatile capital flows. Country experiences on capital controls are covered with focus on four broad group of countries which applied capital controls based on various motives. Speed and sequencing of capital account liberalisation, their costs and benefits are also discussed. Approaches of the multilateral institutions like the IMF, the World Bank, OECD and European Union to capital account liberalisation are also presented in the Chapter. The Indian experience of capital account liberalisation is covered in detail with special reference to the recommendations of the Report of the Committee on Capital account Convertibility.

1.12 Inadequacies in the international financial architecture have, time and again, underscored the need for a new framework. Against this backdrop, Chapter IX entitled "International Financial Architecture" presents, in detail, the international financial architecture in the pre-East Asian crisis period and the one that has been evolving after the crisis. The Indian perspective on the new international financial architecture is covered delineating some of the issues for further reform.

1.13 The final Chapter entitled "Assessment of the External Sector" undertakes an assessment of the external sector reforms and the challenges ahead.