X ASSESSMENT OF THE EXTERNAL SECTOR

10.1 More than a decade has passed since the balance of payments crisis of the early 1990s. Whereas the crisis of the early 1990s provided the proximate incentive for the subsequent macroeconomic stabilisation and structural reforms programme, the perimeter of the reform process turned out to be much broader. Structural reforms have virtually encompassed all areas of the economy, but these have been more widespread and extensive in the external sector arena. In the process, India has transformed herself from a relatively closed economy to a fairly open economy. A number of key features of this opening up process are discernible such as focus on export growth, attracting non-debt creating capital flows, de-emphasis on short-term external borrowings, and a flexible exchange rate policy. All these led to a number of consequences like build-up of adequate reserves, and reduction in short-term debt. It is now widely recognised that the reform process was marked by a sense of gradualism. Reform in the external sector is no exception to this general tendency – thus India has followed a cautious approach to capital account convertibility, exchange rate management, and trade liberalisation. Careful monitoring of capital account transactions to ensure orderly process of liberalisation and macroeconomic stability with a view to maintaining sustainability of the balance of payments and overall macro economic stability have been advocated.

10.2 The success of the policy reforms is evident in the strength and resilience built up in the external sector as reflected across a range of key indicators. The openness of the economy has almost doubled in the 1990s, with services and transfers remaining buoyant. The current account deficit has remained moderate before turning into a small surplus in 2001-02 and 2002-03 after a gap of 25 years. Substantial increase in capital flows with dramatic shifts in its composition has been witnessed. Up to the end of the 1980s, the bulk of capital flows into India were debt flows in the form of external assistance, commercial borrowings and non-resident deposits. Since the mid-1990s, more than half of net capital flows have been in the form of foreign investment. External debt-GDP as well as debt service ratios have almost halved and India is now classified as a less-indebted country by the World Bank. The Indian approach to exchange rate management with a focus on managing volatility has stood the test of time. The foreign exchange reserves have increased substantially from US $ 5 billion as at end-December 1990 to more than US $ 100 billion in December 2003. The distinct improvement in the external sector has enabled a progressive liberalisation of the exchange and payments regime in India. Quantitative restrictions on merchandise trade have been abolished and tariffs are progressively being brought down. A judicious policy is being pursued for management of capital account liberalisation. 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. For the first time after Independence, the fragility of the balance of payments is no longer a policy concern.

10.3 The previous Chapters analysed various issues related to the opening up of the Indian economy in detail. The present Chapter provides a normative assessment of the external sector reforms and the challenges ahead. Some issues relating to the linkages between monetary, fiscal and financial sector policies within an open economy framework are highlighted.

Merchandise Trade

10.4 India's policies towards progressive opening up of the economy since the early 1990s were undertaken with the professed objectives of improving the overall productivity, competitiveness and efficiency of the economy in order to attain a higher growth profile. Trade policy reforms were an intrinsic part of the structural reforms initiated in the early 1990s. Policies were geared towards reduction of import tariffs, a phased elimination of quantitative restrictions on imports, export promotion and strengthening of incentives. The momentum of trade growth witnessed in the early part of the 1990s, however, could not be sustained in the face of various domestic bottlenecks coupled with exogenous constraints. A series of financial crises beginning with that in East Asia coupled with the slowdown in the US economy dampened world trade growth. The domestic factors contributing to the slowdown included stagnation in investment rate and sluggish industrial growth.

10.5 Internationally, rising shares of investment and manufacturing value-added in an economy's total output are associated with a rising share of manufacturing exports in total exports and GDP. In more open economies, manufacturing exports have outpaced manufacturing value added by a large margin. In India, there has been a decline in both the investment rate as also the share of the manufacturing sector in GDP in the recent period. Consequently, the gap in the recent period between the relative share of manufacturing in India's GDP and merchandise exports has showed a marked divergence since 1997-98; however, there are signs of pick up in manufacturing exports since 2002-03. A higher overall investment rate may help in augmenting such exports further.

10.6 Despite significant reduction in the level of import tariffs since the early 1990s, import tarrifs in India remain amongst the highest in the world. India's average tariffs are more than twice that in China and Brazil and around four times that in Indonesia and South Korea. This suggests considerable scope for further reduction in import tariffs in India that would have a beneficial effect on the competitiveness of the economy. The most active and enduring means of encouraging outward orientation is to lower tariffs on imports so that the anti-export bias gets corrected. The increased interaction with the world economy is expected to be facilitated by the overall reduction in the cost of transaction and communication.

10.7 It is important to note that despite significant liberalisation of imports with reduction in tariffs, phasing out of quantitative restrictions and allowing bullion imports through the formal channel, the country's current account deficit has remained modest during the 1990s. Besides, the overall balance of payments has been in surplus for most of the years and consequently the country's foreign exchange reserves have increased significantly. Thus, in contrast to fears expressed at the time of the economy's opening up, import liberalisation policies, in conjunction with other external sector and overall structural reforms, have enabled a strengthening of the country's external sector since 1990-91. This suggests that tariff reductions could be carried out faster than envisaged earlier, without posing any significant risk to the balance of payments. While an across-the-board lower tariff regime is beneficial to the country's competitiveness, an effective and fast-responsive trade defence mechanism could take care of unfair trade practices. It is increasingly being realised that the desirable structure of tariff rates should comply with the basic principles of simplicity, transparency, stability and international best practices.

10.8 Against this backdrop, the greatest challenge facing the Indian economy is to enhance its productivity and competitiveness so as to achieve a sustained growth in exports of goods and services. As the Tenth Five Year Plan (2002-03 to 2006-07) recognises, growth prospects can be enhanced considerably by tapping the opportunities offered by the international economy in terms of markets, investment and technologies along with improvement in efficiency and absorbing excess capacity available in the economy. This would need an expanding production base of tradable goods and services, which is able to withstand external competition. The Tenth Five Year Plan projects a growth rate of 12.4 per cent in exports. The road map for the achievement of this export growth in the medium term is delineated in the Medium Term Export Strategy (MTES), which is aimed at augmenting the country's share in world trade to one per cent by 2006-07 from the existing 0.7 per cent which implies doubling exports from the present level. The MTES also takes into account the international developments and the complexities arising in the new world trade order under the WTO. A number of key macro policy issues for the commodities sector are discussed in the MTES, such as, price competitiveness, implementation of trade defence mechanisms, efficient administration of tax rebate schemes, and conclusion of strategic free trade agreements. The need to carry forward emphasis on movement of natural persons in WTO negotiations on trade in services, while utilising the opportunities already existing in other modes like consumption abroad Mode (Mode 2), has also been emphasised. Some of the sectors to be given emphasis are: engineering / electronic / electrical and allied sectors, textiles sector, gems and jewellery, chemicals and allied sectors, agriculture and allied sectors, leather and leather manufactures. An institutional mechanism is being set up to monitor the implementation of the strategy.

10.9 Export schemes need to be devised to help exporters to get back the input taxes paid by them efficiently and quickly. Such a system would get a boost from a comprehensive value added tax (VAT) system, introduced at every level. Lower customs and excise duties for major inputs needed for exports can minimise the need for duty drawback. Systems like Electronic Data Interchange (EDI) enable enhanced connectivity for exporters by processing documents electronically and through digital signatures that

reduce processing time and, thus, transaction costs. Increasing the accountability of export processing personnel will enhance reduction of transaction costs. Even if the labour cost of producing a unit of manufacturing exports in India is one of the lowest among the developing countries, labour market rigidity is perceived as a major operating constraint and, for boosting foreign investment infusion, labour policies will have to be made more flexible. There is a need for a radical strategy to promote services exports in which India has a competitive advantage.

10.10 In the aftermath of the negotiations of the WTO held in Cancun, the issues relating to multilateral co-operation, especially among developing countries, have assumed greater significance. The Ministerial Conference was unable to reach consensus on some outstanding issues. The negotiators, however, pledged to continue the process with a renewed sense of urgency in Geneva. In some quarters, concerns have been raised on the very structure of the WTO and its process of negotiations after Cancun. In this context, it may be noted that all the previous trade rounds took far longer to finish than planned (*e.g.* the Uruguay round took eight years to complete rather than the originally mandated three years). The Cancun Ministerial Conference was mainly stocktaking in nature and therefore, its inability to reach consensus should technically result only in lengthening of the negotiating period rather than abandonment of the whole mechanism.

Current Account

10.11 Drawing from the experience of the second half of the 1980s, a key policy objective has been to ensure a sustainable current account deficit. While the High-Level Committee on Balance of Payments (Chairman: C. Rangarajan) suggested that a current account deficit of 1.6 per cent of GDP was sustainable, the Committee on Capital Account Convertibility (Chairman: S. S. Tarapore) observed that sustainability of current account balance could be viewed in relation to growth in current earnings. The actual outcome during the 1990s was a very modest deficit in the current account – averaging around one per cent of GDP - and even a surplus in the recent two years. The modest deficits reflected, *inter alia*, a robust growth in invisible earnings led by a surge in software and other IT-enabled exports, buoyancy in private remittances and improved merchandise export performance. The ratio of current receipts to GDP more than doubled from 8.0 per cent in 1990-91 to 18.7 per cent in 2002-03. This reflected the policy push provided to exports of goods and services by the phased reduction in the anti-export bias through progressive lowering of import tariffs and removal of quantitative restrictions on imports as well as a market-determined exchange rate system. At the same time, the low level of current account deficits can also be attributed to lack of absorptive capacity of the economy.

10.12 The modest current account surpluses in recent two years, *viz.*, 2001-02 and 2002-03, are often attributed to cyclical factors such as subdued domestic demand at home and abroad. Over a longer period, current account dynamics reflect inter-temporal smoothing of consumption and, therefore, can be attributed to gaps between domestic savings and investment. Savings behaviour, in turn, is the result of evolving demographic patterns. Regional demographic trends indicate that the current account surpluses witnessed by India and other economies in recent period may not be temporary (Mohan, 2003). Given the higher share of the aged in their population, advanced economies are projected to experience a substantial decline in their saving rates relative to investment in the coming decades, which would then be reflected in current account deficits. These regions will switch to importing capital. Increasingly, it would be the moderate and the low performers among the developing countries which would emerge as exporters of international capital. India is entering the second stage of demographic transition and over the next half-century, a significant increase in both saving rates and share of working age population is expected.

10.13 In this scenario, the current phenomenon of overall surpluses in the balance of payments being run by several emerging market economies (EMEs), including India, may not be a temporary one. The key challenge for macroeconomic policies would be to ensure that the anticipated expansion in saving in developing countries is productively utilised within the economy and not exported abroad. Accordingly, it is vital to ensure that the investment rate rises in close co-movement with the saving rate. This requires massive investments to close the gaps between demand and supply in key infrastructural areas such as power, roads and highways, ports, telecommunication, cities and urban utilities. The future growth strategy will also need to be more labour absorbing to accommodate the projected expansion in the work force. Reforms in the labour market, educational system, pensions and medical care would gather importance within the overall intensification of

structural reforms so that an average current account deficit of 1.6 per cent of GDP during the Tenth Plan period (*i.e.*, 2002-03 to 2006-07) could be realised.

10.14 The cross-country evidence on current account deficits reveals that their persistence at high levels can pose serious problems for the external stability. The macroeconomic dimensions of current account balance that have received increasing attention are its linkages with the financial sector as well as the real sectors of the economy. In the medium to long run, current account dynamics reflect the forward-looking behaviour of agents on savings and investment decisions. In an open economy framework, the required rate of investment sets the level of current account deficits, given the domestic savings rate. The sustained productivity growth in goods as well as services producing sectors helps maintain higher marginal productivity of capital and thus, enhances the capacity of the economy to sustain higher rate of investment through external capital flows. Furthermore, the short-term deviations of consumption levels are seen to be smoothened by current account changes.

10.15 An important dimension of the current account dynamics that has remained at the core of policy debate in the aftermath of recent currency crises, particularly in the EMEs, is the spillover of fiscal deficits to the external sector. Imbalances in the external sector imply that the aggregate absorption in the economy exceeds the domestic production of goods and services. Excess absorption can emanate either from a decline in private savings relative to private investment or from a growing fiscal deficit of the government sector or both. More often than not, it is the fiscal deficit of the public sector that tends to be associated with large current account imbalances. The link between fiscal deficits and current account balance implies that if the private sector is in balance, the government deficit will be fully reflected in the current account deficit. Although the relationship between external and internal balance is essentially an *ex post* one, it shows that improvement in current account balances can be brought about either by an improvement in domestic public or private sector balances, or equivalently through higher income relative to domestic absorption. This is, of course, contrary to the theoretical construct of Barro-Ricardian debt neutrality. According to the latter, rational households fully anticipate that present borrowing has to be repaid later, and hence may not change their consumption in response to changes in taxes, given the path of government consumption. By now the practical irrelevance of the Barro-Ricardo equivalance is widely recognised (Feldstein, 2004). The results of cross-country causal relationship between current account balances and fiscal deficits suggest that for developing countries the causality runs from fiscal deficits to current account deficits. In India, the current juxtaposition of high fiscal deficits and low current account deficits or even surpluses reflects mainly high private sector savings, especially that of the household sector, coupled with sluggishness in investment demand. The spillover of fiscal deficits to current account deficits could easily occur in the event of a pick-up in investment demand. Thus, it underlines the importance of fiscal consolidation to avoid any spillover to external imbalances.

10.16 Invisibles surpluses have played an important role during the 1990s in providing resilience to India's current account. The current account dynamics have been significantly influenced by increasing tradability of services, particularly in developing countries. The sizeable trade accounts, which were structural in nature, have been to a considerable extent offset by rising invisible surpluses in India. Buoyant workers' remittances and a dramatic rise in exports of software and other IT-related services have been the key sources of the growing strength of India's invisible earnings. This can, in turn, be attributed to the availability of a vast pool of skilled and semi-skilled labour in India. In contrast to the Indian experience, the invisible account continues to reflect a persistent deficit in most of the emerging economies. Cross-country comparison of service orientation of domestic output and trade indicates that increasing export intensity of services is significantly determined by the domestic structure of output in favour of services.

10.17 Private transfers, particularly workers' remittances have increasingly become an important source of current account receipts and stable source of development finance for many developing countries. Moreover, the fastest growing segment among services exports of India is software services, which grew at an average rate of 46 per cent since the mid-1990s. India has emerged over the last decade as the most preferred destination for IT services outsourcing by clients in the US and the UK, accounting for more than 90 per cent of the export revenues generated from the Indian IT enabled services - Business Process Outsourcing (ITES-BPO) segment. A comparative analysis of India *vis-à-vis* its competitors in ITES segment clearly provides an edge

to India over others because of its quality of labour pool, cost advantage, English proficiency and supportive government policies. To preserve and build on its lead in IT services and BPO, it is essential for India to facilitate further deregulation and privatisation in key sectors, such as, financial services, retailing and telecom, penetrate new markets such as Japan, and make Indian exports more broad based.

Capital Account

10.18 One of the most significant characteristics of the 1990s has been the spectacular surge in international capital flows, with the expansion of capital flows being much greater than that of international trade flows. Private (bond and equity) flows, as opposed to official flows, have become a dominant source of financing large current account imbalances. Another noteworthy feature of the capital flows during the 1990s has been a shift towards equity flows (especially direct investment) away from debt flows. Foreign investment inflows, both direct and indirect, have emerged as the predominant source of capital inflows.

10.19 Like most of the financial flows, there are costs as well as benefits associated with cross-border capital movement. In principle, free capital movements foster economic growth and welfare, smoothen inter-temporal consumption and expose the domestic financial system to the rigours of international competition. In practice, large capital flows are not without problems, with the potential of destabilising macroeconomic management and constraining the conduct of monetary policy. The experience of the Asian crisis revealed that large and volatile capital flows influenced the exchange rate and interest rate, which led to overshooting of exchange rates often out of alignment with fundamentals. Such volatility imposes substantial risks on market agents, which they may not be able to sustain or manage. As a result, foreign exchange markets are often prone to herd behaviour, particularly during episodes of sudden reversal in capital flows. Furthermore, financial markets, driven by massive cross-border capital flows and the information technology revolution, immediately transfer the valuation of risks associated with uncertainty across the globe and this can lead to contagion. Indeed, global interdependence is marked by common shocks and a “confidence channel” rapidly transmits these shocks to various parts of the world (Mohan, 2003). In such circumstances, the key issue under consideration of the monetary authority is to determine whether the capital inflows are of a permanent and sustainable nature or whether such inflows are temporary and subject to reversal. In practice, this is often difficult to determine. Since external capital flows cannot be easily predicted and can also reverse even in the presence of sound fundamentals, monetary authorities have to make choices for day-to-day exchange rate and monetary management. Against this background, policy makers in developing countries, therefore, have to manage their capital accounts to ensure an orderly process of liberalisation. In this context, management of capital account involves management of control, regulation and liberalisation. Gradualism in liberalisation implies that the mix between controlled, regulated and liberalised capital transactions keeps changing gradually in favour of the latter (Reddy, 2000).

10.20 The debate on capital account convertibility (CAC) acquired a sharp focus all over the world during the 1990s. In the aftermath of financial crises in several countries, scepticism is being expressed about the apparent benefits of an open capital account – all the more so when the international financial community is hard pressed to come up with a conclusive set of prescriptions for taming ill-effects of such flows. The Asian crisis amply demonstrated the need to proceed with caution in opening the capital account. It has been recognised that capital account liberalisation needs to be undertaken as an integral part of economic reforms and synchronised with appropriate macroeconomic, exchange rate, and financial sector policies with prudential restrictions on short-term speculative flows.

10.21 In India, like in several other emerging market economies, liberalisation of the current account preceded the liberalisation of the capital account. Current account convertibility was achieved in August 1994 by accepting Article VIII of the Articles of Agreement of the IMF. Capital account transactions were gradually liberalised during the 1990s. Restrictions on inflows were relaxed first, with an emphasis on encouraging FDI and portfolio equity investment and discouraging short-term and debt-creating inflows. Restrictions on capital outflows are being gradually relaxed. Convertibility for capital of non-resident institutional investment has all along been a basic tenet of the Indian foreign investment policy.

10.22 The Indian approach to capital account convertibility has emphasised that capital account liberalisation is a process, contingent on achieving certain preconditions related to health and strength

of the financial sector, sustainability in the fiscal sector and containment of inflation. Over the years, the policy regime in regard to capital account inflows and outflows in India has witnessed a significant liberalisation. At present, foreign direct investment is allowed on an automatic basis in all sectors, except for a negative list, subject to specified sectoral limits. Portfolio investment is open to registered foreign institutional investors. A new, more liberalised external commercial borrowings (ECBs) policy to promote investment activity in industry has been announced. To attract stable non-resident deposit inflows, the interest rates on foreign currency deposits are linked to LIBOR. Similarly, capital outflows for joint ventures abroad have been permitted. Thus, over time, both inflows and outflows under capital account have been gradually liberalised. Notwithstanding a significant increase in overall capital flows to India during the 1990s, these remain smaller than other countries of similar economic size. There are, however, two areas where extreme caution continues to be exercised, *viz.*, (i) unlimited access to short-term external commercial borrowing; and (ii) providing unrestricted freedom to domestic residents to convert their domestic bank deposits and idle assets (such as, real estate).

10.23 The approach of multilateral institutions towards capital account convertibility has undergone a significant shift after the Asian crisis. In April 1997, the then Interim Committee of the IMF had come out in favour of amending the IMF's Articles of Agreements to make liberalisation of the capital account as one of the objectives of the IMF. Noting the linkage between rapid growth and large capital inflows, it was argued that although developing countries might experience increased volatility, it should be managed with greater exchange rate flexibility without imposing capital controls. In the wake of the Asian crisis, however, the basic premises of pursuing capital account liberalisation were questioned, as was the advocacy of vesting the IMF with the responsibility for promoting orderly liberalisation of capital flows. In the face of intellectual opposition to its policies, a moderation of the IMF's stance became evident. The IMF recognised the role of capital controls and acknowledged the existence of important preconditions for an orderly liberalisation of capital movements. Since then, the IMF, in general, has favoured a gradual approach to opening the capital account if the preconditions for effective liberalisation are not in place. The World Bank also came out with the suggestion that capital account liberalisation should proceed cautiously, in an orderly and progressive manner in developing countries, given the large risks of financial crises – heightened by international capital market failures. The multilateral institutions now underscore the importance of creating appropriate conditions for encouraging capital flows.

10.24 A policy concern in regard to capital inflows has been that actual foreign direct investment inflows have been low both in relation to approvals as well as compared to many other emerging markets. Since the FDI policy regime in India is considered as one of the most transparent and liberal amongst emerging markets, the modest FDI inflows are attributed largely to hurdles on account of domestic policy, rules and procedures. The thrust on attracting higher FDI inflows in the infrastructure sector should be dovetailed into the regulatory and pricing reforms in major infrastructure services such as power and transportation. Furthermore, export promotion policy needs to utilise the natural complementarity of FDI with export activity.

10.25 In the context of large foreign exchange inflows, the issues concerning extent of intervention in the foreign exchange market and sterilisation assumes paramount importance. It is evident that operations involving sterilisation are undertaken in the context of a policy response which has to be viewed as a package encompassing exchange rate policy, level of reserves, interest rate policy, along with considerations related to domestic liquidity, financial market conditions as a whole, and the degree of openness of the economy. India has made conscious attempt to manage external liabilities and assets to ensure growth with stability through coordinated policy framework and careful calibration of instruments to moderate market pressures without any distortionary shocks on the performance of the economy. As a result, consistent with its macroeconomic objectives, the Reserve Bank was able to offset the expansionary effect of foreign capital flows on domestic money supply. Nonetheless, the policy response was able to soften domestic interest rates.

10.26 Another noteworthy development in external sector management has been the containment of the country's external debt. Since March 1995, outstanding external debt stock has been largely stable, moving around US $ 100 billion. The increase

in the stock in the recent period is entirely on account of the conversion of maturing erstwhile non-resident non-repatriable deposits into deposits in repatriable schemes and their subsequent inclusion in the debt stock. The improvement in external debt position comes out clearly when viewed in relation to GDP - the ratio of external debt to GDP has almost halved from its peak of 38.7 per cent at end-March 1992 to 20.3 per cent by March 2003. Similarly, debt service ratio has more than halved from its peak of 35.3 per cent in 1990-91 to 14.7 per cent in 2002-03. Short-term debt remains modest at around five per cent of the total external debt. The improvement in India's external debt position is attributable to a conscious debt management policy that focussed on high growth rate of current receipts, encouraging non-debt creating flows, keeping the maturity structure as well as the total amount of commercial debt under manageable limits and encouraging stable non-resident deposits through interest rates close to international levels. In the recent period, external debt has been further consolidated through recourse to pre-payment by the Government as well as the corporates. The strategy that was actively put in place in the early 1990s has paid dividends with sustained improvement in external indebtedness position of the country, with India being classified presently as a less indebted country.

Foreign Exchange Reserves

10.27 The Asian financial crisis not only highlighted the need for maintaining adequate levels of foreign exchange reserves, but also underlined the need for prudent management of a country's reserves assets. Sound practices in the areas of risk management and liquidity management have attracted increased emphasis in recent times.

10.28 In the context of growing foreign exchange reserves, the issue of costs and benefits of reserve build-up has attracted a lot of attention. In any cost-benefit analysis of holding reserves, it is essential to keep in view the objectives of holding reserves which, include: (i) maintaining confidence in monetary and exchange rate policies; (ii) enhancing the capacity to intervene in forex markets; (iii) limiting external vulnerability so as to absorb shocks during times of crisis; (iv) providing confidence to the markets that external obligations can always be met; and (v) reducing the volatility in foreign exchange markets. Sharp exchange rate movements can be highly dis-equilibrating and costly for the economy during periods of uncertainty or adverse expectations. These economic costs are likely to be substantially higher than the net financial cost, if any, of holding reserves. In this context, it is important to note that in India, in the last few years, almost the whole addition to reserves has been made without increasing the overall level of external debt. The increase in reserves largely reflects higher remittances, quicker repatriation of export proceeds and non-debt inflows. Even after taking into account foreign currency denominated NRI flows (where interest rates are linked to LIBOR), the financial cost of additional reserve accretion in India in the recent period is quite low.

10.29 It is now widely recognised that in judging the adequacy of reserves in emerging economies, it is not enough to relate the size of reserves to the quantum of merchandise imports or the size of the current account deficit. In view of the importance of capital flows, and associated volatility of such flows, it has become imperative to take into account the composition of capital flows, particularly, short-term external liabilities, in judging the adequacy of foreign exchange reserves. An additional factor which is being built into this assessment is the need to take into account contingencies such as unanticipated increase in commodity/asset prices. Based on various indicators of the adequacy of reserves, India's reserves holding are comfortable. At their present level, the reserves provide a cover of more than 15 months of imports and over seven years of annual debt servicing. In terms of short-term debt, reserves are almost 16 times the volume of short-term debt. Apart from adequate level of foreign exchange reserves, the Asian financial crisis underlined the need for its prudent management. In this context, benchmarking the reserve management practices followed in India against some major countries reveals the comparability of India's position to these countries.

Exchange Rate Management

10.30 Conventionally, trade flows were deemed to be the key determinants of exchange rate movements. In more recent times, the importance of capital flows in determining the exchange rate movements has increased considerably, rendering some of the earlier guideposts of monetary policy formulation possibly anachronistic (Mohan, 2003). Furthermore, on a day-to-day basis, it is capital flows that influence the exchange rate and interest rate arithmetic of the financial markets. Rather than the real factors underlying trade competitiveness, it is expectations and reactions to news that drive capital flows and exchange rates, often out of alignment with fundamentals. Capital flows have been observed to

cause overshooting of exchange rates as market participants act in concert with pricing information and foreign exchange markets are prone to bandwagon effects. The effects of capital flows on the exchange rate are amplified by the fact that capital flows in 'gross' terms can be several times higher than the 'net' capital flows (Jalan, 2003).

10.31 In the face of large capital flows, considerations of maintaining a competitive exchange rate, on the one hand, and controlling inflation, on the other, create conflicting objectives for a central bank. It is essential to recognise that the capacity of economic agents in developing economies, particularly poorer segments, to manage volatility in all prices, goods or foreign exchange are highly constrained and there is a legitimate role for non-volatility as a public good (Reddy, 2003). Accordingly, the broad principles that have guided India after the Asian crisis of 1997 are: (i) careful monitoring and management of the exchange rate without a fixed or pre-announced target or a band; (ii) flexibility in the exchange rate together with ability to intervene, if and when necessary; (iii) a policy to build a higher level of foreign exchange reserves which takes into account not only anticipated current account deficits but also 'liquidity at risk' arising from unanticipated capital movements; and (iv) a judicious management of the capital account. This policy has stood the test of time and the Indian approach to exchange rate management has been even described as an ideal for Asia.

10.32 Empirical evidence shows that foreign exchange markets in India are efficient in the sense that while over the medium-term, forward premia and interest differentials move together, in the short-run, deviations from covered interest parity arise due to demand-supply mismatches. Short-run deviations from uncovered interest parity indicate that sterilised foreign exchange market intervention and monetary tightening can be effective in ensuring orderly conditions.

10.33 An analysis of the complexities, challenges and vulnerabilities faced by the emerging market economies in the conduct of exchange rate policy reveals that the choice of a particular exchange rate regime alone cannot meet all the requirements. The experience with capital flows has important lessons for the choice of the exchange rate regime. The advocacy for corner solutions – a fixed peg *a la* the currency board without monetary policy independence or a freely floating exchange rate retaining discretionary conduct of monetary policy – is distinctly on the decline. The weight of experience seems to clearly be in favour of intermediate regimes with country-specific features, no targets for the level of the exchange rate, exchange market interventions to ensure orderly rate movements, and a combination of interest rates and exchange rate interventions to counter extreme market turbulence. In general, emerging market economies have accumulated massive foreign exchange reserves as a circuit-breaker for situations where unidirectional expectations become self-fulfilling. It is a combination of these strategies that will guide monetary authorities through the impossible trinity of a fixed exchange rate, open capital account and an independent monetary policy (Mohan, 2003).

10.34 Recent experience has highlighted the need for developing countries to keep a continuous vigil on market developments, and the importance of building adequate safety nets that can withstand the effects of unexpected shocks and market uncertainties. The important message that comes out from the analysis of various episodes of volatility and the policy responses is that flexibility and pragmatism are needed in exchange rate policy in developing countries, rather than adherence to strict theoretical rules. Tackling of the contagion of the East Asian crisis clearly points out that there is a need for central banks to keep instruments / policies in hand for use in difficult situations. Against this background, India's exchange rate policy of focusing on managing volatility with no fixed rate target while allowing the underlying demand and supply conditions to determine the exchange rate movements over a period in an orderly way has stood the test of time. The Reserve Bank continues to follow the same approach of watchfulness, caution and flexibility in regard to the foreign exchange market. It co-ordinates its market operations carefully, particularly in regard to the foreign exchange market with appropriate monetary, regulatory and other measures as considered necessary from time to time.

10.35 Central banks all over the world are concerned over development of markets in order to allow market participants to manage their own risks, *viz.,* micro risks. As the market develops, the concern of the central bank is limited to managing the macro risks. Over the last few years, several measures have been taken in India to deepen and widen the foreign exchange market so as to allow the market participants to undertake foreign exchange transactions with reduced uncertainty.

International Financial Architecture

10.36 Increased financial globalisation provides greater access to international capital. At the same time, financial crises have been more frequent and severe since the 1990s than in earlier decades. A distinguishing characteristic of this period is the marked increase in volatility of capital flows and exchange rates and the associated contagion. A series of financial crises in the second half of the 1990s exposed various shortcomings of the international financial architecture in respect of both crisis prevention and crisis management. These shortcomings include: (i) lack of strict and reliable monitoring and surveillance of financial system; (ii) untimely and inadequate financial assistance; (iii) absence of an effective debt resolution mechanism; (iv) lack of comprehensive and reliable early warning system; (v) absence of effective means to involve the private sector in resolving crisis; and (vi) non-availability of adequate international liquidity to build confidence. Accordingly, efforts are underway to strengthen the structure of the existing architecture to reduce the probability of a crisis, contain the severity of crises when they occur, and insulate the global economy from contagion, while providing the desirable level of confidence to the national authorities to sustain the process of globalisation. The emphasis has been on establishing best practices through standards and codes, greater transparency and accountability, early detection, better supervision, stronger prudential requirements, sustainable exchange rate regimes and a greater sharing of the burden of crisis resolution with the private sector.

10.37 In the discussion on the international financial infrastructure, increased recognition has been given to three pre-requisites for efficient functioning of the financial sector, *viz.*, a well-designed infrastructure, effective market discipline, and a strong regulatory and supervisory framework. As a member of various international groups such as, the International Monetary and Financial Committee (IMFC) at the International Monetary Fund (IMF), Development Committee of the World Bank, the Bank for International Settlements (BIS), the Group of 20 and the Working Group set up by the Financial Stability Forum and various other organisations, India has been playing an active role in the discussions on the international financial architecture and related issues. India has been closely monitoring the developments on all aspects of the new international financial architecture and has been fine-tuning and strengthening the internal crisis prevention and management frameworks. India is also one of the first members to subscribe to the IMF's Special Data Dissemination Standard (SDDS) through which information, relevant for assessment of macro-economic stability is being disseminated regularly. India voluntarily agreed for Financial Stability Assessment Programme (FSAP). After the completion of the programme in 2001, India's internal frameworks for assessing financial system stability have been validated.

10.38 In addition to being closely associated with several international standards setting bodies, India was a part of the Task Force on the Implementation of Standards and participated in the Joint Committee Group meeting of the Financial Stability Forum (FSF). Recognising the importance of self assessment, the Reserve Bank, in consultation with the Government, appointed a Standing Committee on International Financial Standards and Codes (Chairman: Y. V. Reddy) in December 1999. In respect of Standards and Codes, India has been stressing the importance of ensuring that the manner in which these standards are developed and monitored does not degenerate into categorising countries as performers and non-performers.

10.39 In recent years, there has been a growing realisation that the finances available from the IMF would not be sufficient to meet the requirement if several member countries need them at the same time. Several suggestions have been put forward to improve the resources of the IMF. The decision of the Twelfth General Review of quota in January 2003 not to increase the Fund quotas has brought to focus the issue of Fund governance. Over the years, the prevailing system of quota and voting power has created distortions, which, in turn, have raised issues of equity. Effective governance of the IMF demands that the institutional benefits and burdens are equitably shared among the members and that checks and balances operate efficiently in the decision-making process. Improving IMF governance and thus reducing the 'democratic deficit' in its functioning needs to be approached through structural reforms aimed at redistribution of the voting power amongst member countries (Reddy 2003a).

10.40 Closely related to the issue of enhancing the Fund resources through revision of quotas is the evolving role of the Fund as the supplier of international liquidity. The arguments for a lender of last resort (LOLR) are centred around the requirements for providing adequate international

liquidity in times of crises. The role of IMF should not be viewed as a International Lender of Last Resort (ILOLR) as it is not in a position to supply unlimited liquidity. However, much can be done to improve the way IMF operates so that, in effect, it moves in that direction. The IMF has the option of assuming the LOLR function as under Article XVIII it can allocate SDRs "to meet the long-term global need, as and when it arises, to supplement existing reserve assets". In other words, "IMF can remain as a quasi lender of the last resort" (Reddy, 2003a) or it could be said as "IMF is lender of some sort" (Jalan, 1999). Coupled with the ongoing work on the Sovereign Debt Restructuring Mechanism (SDRM) as well as progress in Collective Action Clauses, this initiative would strengthen the IMF's effort towards crisis resolution (Reddy, 2003a).

10.41 Further improvements need to be made in ensuring quick and relatively less conditional access to emergency financing facilities with the IMF. The Contingent Credit Line (CCL) was expected to play a critical role to serve as a precautionary line of defence, reducing vulnerability and bolstering investor confidence in eligible emerging market economies. Unlike other existing Fund facilities, the objective behind CCL was to prevent crises by making available adequate liquidity upfront to a member with sound fundamentals so as to deal with the pressure of contagion. CCL, however, was not used by any member during the period of its operation and it was, therefore, allowed to expire in November 2003. The lack of resort to CCL reflected a number of concerns, including: (i) the entry problem, *i.e.,* the fear that access under CCL would convey a negative signal to the market; (ii) the exit problem, *i.e.,* the uncertainty about the withdrawal of eligibility; (iii) insufficient automaticity; and (iv) stringent pre-qualifying norms. This experience with CCL stresses the need for evolving workable strategies in the near future (Reddy 2003b).

10.42 A more supportive role of international institutions in crisis management is called for, with a greater sensitivity to the needs of developing countries in line with their increasing economic strength and participation in international trade and finance. In the ultimate analysis, however, the responsibility for coping with instability and uncertainty rests with each individual country. Preventing financial instability requires a number of conscious efforts, such as, (i) careful monitoring and management of the exchange rate without any fixed target, but with the flexibility to intervene as and when necessary; (ii) safety walls in the form of high levels of foreign exchange reserves covering not only anticipated current account deficits but also liquidity at risk arising from unanticipated capital movements; and (iii) prudent management of the capital account emphasising durable non-debt creating flows such as FDI and discouraging quickly reversing flows. Augmenting the access to lendable resources with multilateral institutions on a more automatic basis than now will hold the key to managing the disruptive effects of instability when crises do occur.

Fiscal Policy

10.43 In an open economy, a prudent fiscal policy is an essential ingredient of macroeconomic stability as well as a crucial determinant of external balance. Widening fiscal deficits over time get reflected in unsustainable external current account imbalances and higher inflation with adverse consequences for exchange rate stability as illustrated by developments during the second half of the 1980s in India. The recent twin deficits in the US – with both fiscal and current account deficit exceeding 5 per cent of GDP – and the sharp movement in the US dollar also bring forth the importance of fiscal prudence. In India, higher fiscal deficits in recent years have so far not been reflected in external imbalances and inflationary pressures, on account of subdued private investment. In a medium-term framework, external sector and overall macroeconomic stability will hinge upon fiscal prudence. In this context, the Fiscal Responsibility and Budget Management (FRBM) Act with its objective of a phased elimination of revenue deficit and reduction in fiscal deficit is a welcome step.

10.44 With greater opening of the economy, domestic taxes have to be in sync with those prevailing internationally. "Tax neutrality" would be the prime guide for any tax system designed to work with market forces. With increasing presence of multinational enterprises, divergent tax rates could provide incentives for transfer pricing. Transfer pricing needs to be regulated in ways that minimise conflicts with other jurisdictions and do not discourage future investment, while, at the same time, safe guarding their revenue base. Some of the measures suggested for developing countries include: (i) enactment of legally enforceable measures against transfer pricing practices which erode the tax bases; (ii) imposing withholding taxes at moderate rates on non-arm's length royalties and other fees paid abroad; and (iii) closer co-operation between customs and income tax departments to ensure against the practice of double invoicing of inputs - declaration of low prices

to customs authorities and high prices to income tax authorities. Finally, tax on services should be made an integral part of any comprehensive value added tax system to be introduced.

10.45 In a globalising economy, State intervention would have to be limited to providing public goods or goods, which have considerable externalities, natural monopoly or where information is asymmetric. The focus of the fiscal policy should, thus, be geared more towards facilitating the growth process rather than directly involving the State in the production and distribution of services. This may necessitate a step-up in public investment in infrastructure and human capital formation. External sources could play a vital role in providing the necessary resources.

Monetary Policy

10.46 Recent global developments have transformed the environment in which monetary policy operates, throwing up opportunities as well as challenges. Monetary policy formulation has become more complex and interdependent. Increasingly, monetary policy decisions have to be made in an environment of heightened uncertainty. A key factor that guides the conduct of monetary policy is how to reap the benefits of market integration while minimising the risks of market instability. An integral component of functions of any central bank is the development of financial markets that can increasingly shift the burden of risk mitigation and costs from the authorities to the markets. The adverse implications of excess volatility leading to financial crises are more severe for low-income countries. They can ill-afford the downside risks inherent in a financial sector collapse (Mohan, 2003). Maintenance of stability of the financial system must be regarded as a key objective of monetary and financial sector policies.

10.47 More recently, monetary policy in a number of emerging market economies, including India, is grappling with persistent external flows and their impact on exchange rate and inflation. If the central bank does not absorb excess supplies in the foreign exchange market, it can lead to appreciation of the exchange rate, with implications for external competitiveness. On the other hand, if the capital flows are absorbed by the central bank, this could lead to expansion in domestic money supply and, over time, to higher inflation. The policy response depends on several considerations such as: (i) trade-offs between the short term and the long term; (ii) judgement on whether capital flows are temporary or enduring; and (iii) the operation of self-correcting mechanisms in the market and market responses in terms of sentiments. Although the distinction between short term and long term flows is conceptually clear, in practice, it is not always easy to distinguish between the two for operational purposes.

10.48 Central banks use a combination of measures to deal with excess supplies in the market. Sterilisation through open market operations is the most popular policy response and has been used by almost all countries facing capital surges during the 1990s. Sterilisation as a policy response can be effective only for a limited time since there are practical limits to its size in view of implications for domestic interest rates, quasi-fiscal costs and availability of ample marketable government securities with the central bank to carry out the necessary open market sales. In addition to sterilisation, increase in cash reserve requirements and other tax measures have been widely used to manage capital flows. However, these measures impose a tax on the commercial banking system and promote disintermediation. Furthermore, their effectiveness would require progressive widening of the scope of the controls with long-run costs which may outweigh the short-run benefits. If capital flows persist, the monetary policy instruments would need to be supplemented by other durable macroeconomic policies, such as, fiscal adjustment, liberalisation of trade policies and capital outflows, and finally, a greater degree of flexibility in the exchange rate. Fiscal restraint as a policy response, however, is constrained by inflexibility of fiscal policy. Trade and capital account liberalisation to manage capital flows may be ineffective as it could induce further capital inflows since liberalisation might increase foreign investors' confidence in domestic economy.

10.49 In India, a number of steps have been taken to manage the excess supply in the foreign exchange market. The Reserve Bank's Working Group on Instruments for Sterilisation observed that while the Reserve Bank may continue to resort to the existing instruments of sterilisation, new instruments are needed to enhance ability to sterilise the impact of increase in its foreign currency assets. It is important to put in place durable and consistent policies that expand the country's capacity to absorb such capital flows so as to achieve the higher growth trajectory as envisaged in the Tenth Plan.

Financial Sector Policies

10.50 The financial crises have brought to the fore, *inter alia*, the need for strengthening the financial system. In the context of cross-border capital flows,

in the absence of procedures for dealing with international bankruptcy and facilities for the lender of last resort, the liabilities incurred on private account can devolve on public account. Since weakness in financial institutions plays a major role in perpetuating and exacerbating crises related to capital flows, sound balance sheets and regular operational procedures of financial institutions, mainly banks, is an essential ingredient of the package for mitigating the vulnerability of the economy as a whole to crises.

10.51 An efficient oversight of the financial system reduces the information asymmetry and moral hazard problems. In fact, supervision is about promoting financial market stability. Strengthening of the regulatory and supervisory framework and achieving international best practices in banking supervision has also been receiving due attention. Central banks, in particular, have an important role to play in promoting financial stability in emerging economies, ranging from providing liquidity (lender of last resort) to performing crisis management. Central banks, on account of their close interaction with financial intermediaries, do possess informational advantage compared to other supervisory entities. It is necessary that off-site monitoring of financial intermediaries supplements on-site monitoring to detect problems at an early stage and prevent them from spreading to other financial intermediaries. Under the prudential regulatory and supervisory framework, the key elements are: (i) sound capital adequacy standards; (ii) effective supervision; and (iii) risk-based management system. In relatively open economies, it is important to focus on foreign exchange transactions and external liability management in the exercise of oversight. In particular, short-term borrowings from abroad would need to be contained at sustainable levels. Accordingly, the Reserve Bank has been expressing concern over unhedged foreign currency borrowings by corporates since these entail significant but avoidable risks not only to corporate balance sheets but also a possible impact on the quality of banks' assets.

10.52 Cross-country empirical evidence has shown that the cost of financial intermediation declines and quality of financial services improves with opening of the economy. Openness should, however, be preceded by deregulation and strengthening of institutional framework in order to limit contagious influences. The strategy adopted in India was to maximise the beneficial effects of openness while minimising the adverse consequences. Financial crises, internally or from contagious influences in the neighbourhood, have been averted, while the financial system has been progressively deregulated and strengthened. The convergence of the domestic prudential norms with international best practices and of the performance of domestic banks *vis-à-vis* foreign banks in the domestic sector has provided the ground for further openness with minimisation of vulnerabilities that may arise therefrom. The policy of gradualism that has been followed by India may be attributed to evolution of appropriate institutional framework and the sequencing of reforms based on the experience gained as reforms progressed. Recent crises have also lent support to this approach towards reforms.

Concluding Observations

10.53 Looking ahead, there is a growing recognition that openness matters and globalisation is an irreversible process entailing both opportunities as well as challenges. With increasing openness, monetary and fiscal policies are expected to play a key role in ensuring macroeconomic stability while facilitating sustained economic growth within the framework of a market economy. In view of increased uncertainty, central banks need to take into account developments in the global economic situation, the international inflationary situation, interest rate situation, exchange rate movements and capital movements while formulating policy responses. The maintenance of financial sector stability has assumed much greater importance with opening up of the economy to the influence of globalisation.

10.54 Monetary policy would have to play an important role in this context by ensuring appropriate real interest rates and low and stable inflation. The key challenge for macroeconomic policies would be to ensure that the anticipated expansion in saving in developing countries is productively utilised within the economy and not exported abroad so that the investment rate rises in close co-movement with the saving rate. As sustainable growth hinges around the existence of a critical minimum in terms of physical infrastructure, an acceleration of growth in the future requires massive investments to close the gaps between demand and supply in key infrastructural areas such as power, roads and highways, ports and telecommunication, cities and urban utilities. More rational user charges have to be levied to finance the restoration of public investment in agriculture.

10.55 Real sector developments have close connection with the process of opening up. In order to reap the fruits of opening up, enabling conditions need to be created. Illustratively, decisive actions are required to promote agricultural diversification and active investment in rural infrastructure to enable greater food processing and value addition to agricultural products. A proper incentive structure needs to be put in place to encourage private investment in hi-tech horticulture with micro propagation, protected cultivation, drip irrigation, and integrated nutrient and pest management. A progressive correction is required in the incentive structure for agriculture so that the excessively high minimum support prices that currently exist for wheat and rice do not continue to distort resource allocation in agriculture as a whole. Corresponding changes would also need to be made in the current policies related to other subsidies, particularly those related to fertiliser, power and water. The reduction in various subsidies in these areas will provide a very significant fiscal dividend for the country enabling higher public investment where it is required, and particularly in agriculture. In view of the relatively high level of food security, the climate is now right for further policy reforms in agriculture. Similarly, the absorption capacity of the industrial sector has increased after initiation of the liberalisation process, which has impacted on its size and spread. The globalisation process brought about changes in the expenditure pattern of the industries, as there are evidences that the costs of production, including interest payments declined which resulted in increased profitability of the factory sector. The fact remains that whole package of reforms that has been carried out over the past 12 years was expected to lead to significant industrial restructuring. Resources should have moved from the more capital-intensive sectors to the more labour using ones, leading to both higher output and employment growth. It is felt that industrial restructuring in terms of more rapid bankruptcy procedures, easier reallocation of capital, faster transformation of urban land use, and flexibility in labour use, legislative changes, social security mechanism, and technological upgradation need priority.

10.56 The process of opening up of the Indian economy has given birth to a host of new challenges and opportunities. The spirit of the liberalisation process entails a conscious effort on the part of the policy maker(s) to optimise on these opportunities-challenges trade-offs. When a definitive history of the reform process pursued in the Indian economy will be written, it would probably hinge on the synergy between the domestic and external sectors, each throwing up its strengths and threats.