SPEECH

INDIA'S BALANCE OF PAYMENTS: THE EMERGING DIMENSIONS*

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Ladies and Gentlemen,

It is a great honour to be asked to deliver the memorial lecture named after Shri Govind Ballabh Pant. A towering personality of the independence movement, Pantji belonged to a select band of followers of the Mahatma, who provided leadership and guidance to the independence struggle. Freedom, which was a dream became a reality in their life time. Pantji's contribution to the Indian administration and polity after independence was as significant as his contribution earlier. As Chief Minister of Uttar Pradesh for ten years and Home Minister at the Centre for six years, he showed how a political administrator must function both in relation to the permanent civil service and the Parliament. In his administrative ability he had few equals in the country. May his memory inspire all of us in our work, at a stage in our history, when more than ever, the need of the hour is improved governance and administration in all spheres.

2. I want to focus today on some of the dimensions of India's balance of payments as are likely to emerge over the medium term. The importance of the theme is assuming new significance as the pace of economic recovery gathers momentum, policies to promote long-term growth are put in place, and corrections made of some of the home-grown problems. Sustainable solutions have to be found to the question of possible external constraints to growth. In fact, no other issue has dominated economic policy making in the last few years as much as the problems arising from India's balance of payments. The situation by the end of 1990 had become so critical that the country was almost on the brink of default. Foreign exchange reserves of the country were barely adequate to finance three weeks imports. Since then, however, the turnaround has been dramatic. Even as we survey the emerging dimensions of India's balance of payments, it is useful to look back and trace briefly the developments in India's external sector since the Seventies.

A. Trade Policy - An Overview

3. As we embarked on a period of planning, during the fifties, import substitution came to constitute a major element of India's trade and industrial policies. Planners more or less chose to ignore the option of foreign trade as an engine of India's economic growth. This was primarily due to the highly pessimistic view taken on the potential for export earnings. A further impetus to the inward orientation was provided by the existence of a vast domestic market. In retrospect, it is now abundantly clear that the policy makers not only under-estimated the export possibilities but also the import intensity of the import substitution process itself. It has been as a consequence that India's share of total world exports declined from 1.91 per cent in 1950 to about 0.53 per cent in 1992.

4. The inward looking industrialisation process did result in high rates of industrial growth between 1956 and 1966. However, several weaknesses of such a process of industrialisation soon became evident, as inefficiencies crept into the system and the economy turned into an increasingly 'high-cost' one. Over a period of time this led to a 'technological lag' and also resulted in poor export performance.

* Sixteenth Govind Ballabh Pant Memorial Lecture delivered by Dr. C. Rangarajan, Governor at India International Centre New Delhi on January 18, 1994.

5. In the meantime, some change in the attitude towards exports became perceptible. Several export promotion measures were put in place from the early 1960s. The 1966 devaluation, while not resulting in the expected improvement in trade deficit due to a combination of circumstances, brought out the problems stemming from an overvalued exchange rate. Nevertheless, it will be correct to say that until the end of the 1970s, exports were primarily regarded as a source of foreign exchange rather than as an efficient means of allocating resources. Import substitution over a wide area remained the basic premise of the development strategy.

6. Foreign trade policy issues became the subject of intensive discussion in early eighties. It came to be realised that a scheme of import licensing under which imports were permitted only to the extent that domestic production fell short of domestic demand irrespective of difference in cost and prices, could only lead to inefficiency. The view gained ground that a more liberal policy of imports of capital goods and technology would enable India to reap the benefits of international division of labour. The attempt therefore was to move away from import substitution *per se* towards efficient import substitution, so that considerations relating to cost and efficiency were incorporated in the overall policy framework. It also became increasingly clear that production for export could not be isolated from production for the home market and that trade policy had to be integrated with the policy for domestic industrialisation.

7. While the signs of liberalised trade policy became visible in the latter half of eighties, it was only in 1991 that the country embarked on a truly liberalised trade policy with a short negative list of exports and imports and with quantitative controls over imports withdrawn for all, except consumer goods. It was recognised that trade, exchange rate and industrial policies must form part of an integrated policy framework if the aim was to improve the productivity and efficiency of the economic system.

B. A Decade of Comfort: The Balance of Payments in the Seventies

8. India's balance of payments remained comfortable during the Seventies. The adjustment to the first oil shock of 1973-74 was rendered smooth by a happy combination of buoyant exports, spurt in private transfer receipts and increased inflow of aid. Exports, benefited by the expansion in global trade, rose at an annual rate of 6.8 per cent in volume terms and by 15.6 per cent in US dollar terms during the decade. An effective depreciation of the rupee occurred due to the link with Pound Sterling until 1973 and later, because of the lower growth in prices in India relative to other countries. Private transfers rose seven-fold from $ 296 million in 1974-75 to $ 2175 million in 1979-80 and in fact, in the post first oil shock period, financed roughly 80 per cent of the trade deficit. Within two years of the shock, the current account balance turned into surplus and it was only in 1978-79 that a deficit of about 0.2 per cent of GDP appeared. The utilisation of aid was significant and was substantially higher than the financing requirement for the decade, allowing for a build up of reserves. At the close of the decade the foreign exchange reserves stood at $ 7361 million providing cover for over 7 months of imports.

C. The Period of Difficulties: Balance of Payments upto 1981-82

9. During the eighties, issues relating to the balance of payments came to occupy the centre stage in terms of India's macro-economic management. The impact of the second oil shock of 1979, the full effects of which spilled over into the eighties, was more severe than of the event of 1973-74. Between 1978-79 and 1981-82, imports almost doubled. The increase in POL imports accounted for a little over half the increase in the overall imports. This was followed by the second-round effects on

non-POL imports. Export performance was depressed by the severe international recession of 1980-83 and recorded a volume growth of just a little over 3 per cent. Net invisible receipts continued to provide support to the balance of payments, largely in the form of earnings from tourism and the sustained buoyancy of private transfers. However, the sharp widening in the merchandise trade deficit resulted in a turnaround in the current account balance from a surplus in 1977-78 to a deficit in 1981-82 of the order of U.S.$ 3,166 million or 1.8 per cent of GDP. Adjustment efforts consisted essentially of an Extended Fund Facility (EFF) negotiated with the IMF, although there were also intensified efforts to improve domestic production of crude petroleum.

D. Easing of Pressure: Balance of Payments during 1982-83 to 1984-85

10. A reprieve came during the period 1982-83 to 1984-85, with the easing of pressure on the balance of payments mainly due to a decline in the volume growth of imports from an average rate of 11.0 per cent during 1978-82 to a little over 2 per cent. Net oil imports (net of crude oil exports which commenced in 1981-82 after the discovery of crude oil in Bombay High), declined substantially as domestic production spurted to 29.0 million tonnes by 1984-85. This indeed was the main cause of the easing of the balance of payments. Non-POL imports rose at an average rate of 3.6 per cent in dollar terms. Exports however, grew only at an average rate of 3.2 per cent, in volume terms, due to a combination of adverse internal and external conditions. The invisibles account deteriorated as the interest payments to service external borrowing acquired a steady rising trend. Private transfers stagnated with the arrest in the labour migration boom. As a result, invisibles including private transfers and other surpluses, which had financed 89 per cent of the trade deficit in 1978-79 could meet only 57 per cent of the trade deficit in 1984-85. The current account deficit fell to U.S. $ 2,416 million or 1.2 per cent of GDP in 1984-85 and reserves, which were U.S.$ 5,952 million at the end of the year, stood to cover a little over 4 months of imports. 29 per cent of the financing requirement of the first half of the eighties was met by the EFF. Commercial borrowings and non-resident deposits emerged as important sources of finance, meeting 21 per cent and 15 per cent respectively of the financing need. However, external assistance remained the major source of foreign capital inflows, accounting for 39 per cent of the financing requirement.

E. The Build up to the Crisis: Balance of Payments, 1985-90

11. The second half of the eighties witnessed the building up of strains on the balance of payments. Current account deficits acquired a structural character, remaining at high levels throughout. Large trade deficits occurred year after year despite a robust growth in exports. Recovering from the stagnation in 1985-86, the volume growth of exports in the succeeding four years ranged between 10 to 12 per cent per annum on an average. The share of manufactured exports rose from 56 per cent in 1980-81 to 75 per cent in 1989-90. Imports in U.S. dollar terms rose in every year of the period. The volume of net POL imports increased from 12.4 million tonnes in 1984-85 to 23.5 million tonnes in 1989-90. However, the fall in crude oil prices during the period helped to contain the oil import bill. On the other hand, non-oil imports rose sharply by an average of 13.4 per cent in US dollar terms partly due to large imports of foodgrains in 1988-89. Imports of capital goods rose by an average of 16.2 per cent during the period. Export-related imports as well as other miscellaneous imports also rose significantly. The category of non-DGCIS imports, comprising defence imports and imports of ships and aircrafts etc., also rose significantly from about U.S.$ 1.2 billion in 1985-86 to U.S. $ 3.1 billion by 1989-90. The support from invisible receipts fell in the face of steadily growing interest payments and the outgo on account of profits, dividends, royalty, technical fees and professional fees. The current account

deficit averaged $5.8 billion or 2.4 per cent of GDP during the period as against the Planning Commission's estimate of 1.6 per cent. The period also marked a deterioration in fiscal imbalances as the ratio of gross fiscal deficit to GDP rose from 6.3 per cent in the first half of the eighties to 8.2 per cent during 1985-90. Repurchases from the IMF under the EFF exacerbated the deterioration in the balance of payments. External assistance, commercial borrowing and non-resident deposits shared equiproportionally in the financing need. The result was a doubling of external debt and a rise in the debt service ratio from 13.6 per cent in 1984-85 to 30.9 per cent in 1989-90.

F. The Crisis: 1990-92

12. Even though the events of the recent years are fresh in our mind, it may be of interest to recall the sequence of events. The Gulf crisis of 1990 led to an unprecedented crisis in the balance of payments. The immediate impact was the rise in the oil import bill. It also resulted in a decline in workers' remittances as well as additional burden on repatriating and rehabilitating non-resident Indians from the affected zones in West Asia. As a consequence of the increase in the price of oil as well as certain other oil related imports, the trade deficit for the year 1990-91 deteriorated by around US $ 2 billion. Since, there was a deterioration in the invisible account also, the overall current account deficit in 1990-91 at US $ 9.7 billion was US $ 2.8 billion higher than in the previous year.

13. The major problem faced in 1990-91 was, how to finance the current account deficit? With the deficit rising, the only way it could be met was by drawing down the reserves. As at the end of December 1990, the foreign currency assets of the Reserve Bank of India stood at US $ 1.2 billion. This was despite the drawal of our reserve tranche in IMF of SDR 487 million. The low level of reserves in its turn triggered a number of consequences. India's recourse to the commercial borrowing totally dried up as the credit rating agencies down graded India. Simultaneously, there began an outflow of non-resident Indian deposits. In addition there were serious difficulties in the rolling over of short-term credit, which was roughly of the order of US $ 5 billion. While current account deficit of the order of $ 8 billion was easily financed in 1988-89, a deficit to $ 9.7 billion in 1990-91 became almost impossible to finance. The task before the Government, therefore, was to explore means to finance the deficit. It was under these circumstances that India approached the IMF for an accommodation under the CCFF and first credit tranche.

14. The year 1991-92 began badly with a further draw down of reserves. The tasks before the Government were, on the one hand, to take steps to bring about a sharp compression in imports and on the other, to find sources of 'exceptional financing' to meet the current account deficit. A tight monetary policy was therefore put in place. Severe import compression measures which were adopted earlier continued to operate. For raising the needed reserves to meet the current account deficit, unorthodox steps were taken, including the pledging of gold. In the meanwhile, a stand-by arrangement with IMF was negotiated. Steps were also taken to obtain fast disbursing assistance from the World Bank, Asian Development Bank and some bilateral donors. Adjustment in the exchange rate, along with structural reforms in trade, industrial and foreign investment policies were simultaneously initiated. The loss of reserves was stemmed and from October 1991 onwards there was a steady build up. With the sharp decline in the absolute level of imports, 1991-92 ended with a current account deficit of less than one per cent of GDP.

G. Recent Developments: The Balance of Payments

15. During 1992-93, overall export performance remained subdued with a growth rate of 3.1 per cent in US dollar terms over the year. Exports to the General Currency Area,

however, exhibited resilience in the face of recession in industrial countries and social disturbances, which affected transportation activity in Bombay. These exports rose by 10.4 per cent during 1992-93. Exports to the Rupee Payment Area, mainly to the erstwhile USSR, fell by 62 per cent in dollar terms and acted as a drag on the overall exports. The invisibles account recorded a deterioration as travel receipts continued to suffer from the decline in tourist arrivals. Private transfers remained broadly stable. On the other hand, there was a rise in the outgo on interest payments, royalties, technical fees and miscellaneous payments. As a result, the current account deficit which had shrunk to 2.1 billion in 1991-92 rose to $ 4.9 billion or 2.1 per cent of GDP in 1992-93.

16. During 1993-94, a distinct improvement in the balance of payments has occurred. A strong export growth of over 19 per cent in dollar terms, fall in international prices of crude oil and the continuing slack in non-POL imports have resulted in a sharp contraction in the merchandise trade deficit. During April-November 1993 it was US$ 532 million as against U.S.$ 3,097 million in the same period of 1992. The decline in international interest rates has also provided a measure of saving in the invisibles account. Strong growth in remittances in response to the introduction of the market determined exchange rate has helped to counteract the deceleration in earnings from tourism. Despite some slackening in export growth in recent months, by current reckoning, the year could well end with a current account deficit of significantly less than 1 per cent of GDP.

17. At the same time, significant developments in the capital account have taken place. There is clearly a perceptible shift in the financing pattern in favour of non-debt creating flows, which by present trends could amount to about US $ 3 billion by the end of the year. This would be accompanied by a reduction in the dependence on traditional capital flows such as aid and commercial borrowings. There are also policy efforts to reduce dependence on the FCNRA Scheme and to offer in its place attractive deposit avenues to non- residents, which however do not carry exchange guarantees from the RBI. Indeed, the withdrawals from the FCNRA in response to discontinuation of exchange guarantees to banks of maturities up to 2 years has been more than compensated for by inflows into newly instituted Schemes such as NR(NR)RD and FCNR(B). In the overall sense, non-resident deposits have yielded net inflows. Also, for the third year in succession, there has been a build up of the foreign currency assets of the RBI. During 1993-94, so far, the foreign currency assets have risen by US $ 3.4 billion and presently stand at US $ 9.9 billion, a cover for nearly 5 months of imports.

H. The Management of Balance of Payments: Some Issues

Linkages Between Fiscal and External Policies

18. Imbalances in the external sector reflect the fundamental fact that aggregate absorption in the economy is in excess of the domestically produced goods and services. Measures to reduce excess demand in the economy, therefore, constitute an important policy ingredient of the adjustment towards creating a sustainable balance of payments environment. Excess absorption can originate either from the private or the public sector or from both. In reality, however, it is the fiscal deficit of the public sector that is found to be associated with excess demand and the consequent deterioration of the current account balance. The link between the fiscal deficit and the current account balance can be derived from the following economy-wide financial balance identity:-

Current Account Deficit = Income – (Consumption + Investment + Government Expenditure) = (Fiscal Deficit) + (Private Saving–Investment Gap).

or, in the usual notation:

$$(X-M)=Y-(C+I+G)=(T-G)+(Sp-Ip)$$

19. This relationship between the internal and external sectors is merely an *ex post* identity and it does not bring out the dynamics that takes the economy from the initial balance to a new one. The identity, nevertheless underlines an important policy issue. An improvement in the current account balance can be achieved either by an improvement in the combined balances of the private and public sectors or by an increase in national income relative to domestic absorption. There is, of course, one exception to this generalisation, which stems from the Ricardian equivalence proposition, which assumes that government fiscal plans will be fully neutralised by opposing economic behaviour of the private sector. Ignoring the debt neutrality proposition, the absorption approach recognises fiscal dimension to the current account improvement.

20. The dynamics of the inter-relationship between domestic absorption and external balance works both through income effect and price effect and therefore the speed with which a given domestic policy change can bring about external adjustment depends on the relevant elasticities and marginal propensities out of income. In a situation of crisis, the identity implies that serious policy measures aimed at curtailing domestic absorption will be a necessary pre-requisite for improving the external situation. However, over the medium term, what the identity means is that a sustainable level of current account deficit is related to the relative rates of growth of income and absorption. Thus, in any effort to maintain a reasonably comfortable level of current account deficit, domestic economic policy aimed at maintaining absorption at an appropriate level has an important role to play.

21. Developments since 1985 clearly show how precariously balanced is our balance of payments. Any external shock such as a rise in oil prices can put the economy in a serious situation at least in the short run. A tight balance of payments situation is, however, endemic for developing countries. Literature on development economics used to emphasise the two gaps that countries in the process of development were likely to face, namely, the domestic savings and investment gap and the external gap between imports and exports. To be comfortable, the current account deficit must be kept at a level that can be financed by normal capital flows. When the total stock of external debt is low, it becomes possible to finance a fairly large level of current account deficit because the lenders are prone to be less demanding at that time. Therefore, the ease with which the deficit can be financed should not become the criterion for incurring debt. Taking several factors into account our country should move towards reaching a level of current account deficit which is no more than one per cent of the GDP.

The Merchandise Trade Balance – What Lies Ahead?

22. The viability of India's balance of payments, over the next several years, will crucially hinge upon a vigorous export drive with exports growing by at least 15 per cent per annum in US dollar terms. The ability to achieve this rate of growth, however, would necessarily depend upon the international trading environment, which has recently been witnessing rapid structural and policy changes. East-Asian economies stand out as outstanding examples of how a strong growth of export can contribute significantly to a sharp increase in income. By establishing a pro-export regime supported by various forms of State intervention, these countries achieved rapid increases in productivity. But a relevant question which arises in this context is, whether the export-push strategies that succeeded in the golden age of world trade growth between 1950 and 1973 can still be successful in today's environment. Despite misgivings on several aspects of the recently concluded agreement, at least from the trade angle, the successful completion of Uruguay Round should provide greater opportunities for exports from developing countries, including India. The tariff reduction offers from developed countries cover US $ 464

billion of the industrial imports. The share of duty free merchandise imports to the developed countries from developing countries, are expected to rise from 22 per cent to 45 per cent. The progressive dismantling of the Multi-Fibre Agreement should strengthen India's exports in areas where it has a strong comparative advantage. India's share in the enhanced market access through tariff reduction has been tentatively estimated between US $ 1.5 billion - US $ 2 billion per annum. However, the emergence of regional trading blocs is a matter of concern. Whether these trading blocs turn out to be fortresses or friendly coalitions, is something that the future alone can tell. However, India needs to develop an appropriate strategy to confront the emerging situation. Today, India's share in the world exports stands at 0.5 per cent. If the global exports increase by 5 per cent annually, even with an annual growth rate of 20 per cent in US dollar terms, India's share in world export would still be below one per cent after a five year period. Thus, it will not be the international trading environment which will constrain India's ability to sustain an export growth rate of 15 per cent per annum in US dollar terms, as much as its ability to build the necessary infrastructure to support such an export drive and create necessary domestic surpluses.

23. During the current year import growth has been sluggish. As of now, the level of imports are lower than the previous year. While the slow growth in industrial production is one of the reasons, there are also certain fundamental factors which are operating to slow down import growth. With greater confidence in the stability of import policy, imports for inventory purposes have come down. The stability of the exchange rate has also reduced imports in anticipation of need. Besides, the market determined exchange rate has encouraged larger sourcing of domestic supplies. The income elasticity of imports, which used to be around 1.5 has already shown a decline. With real output growing at an annual rate of 5 - 6 per cent and some rise in import prices, as recovery sets in among developed economies, imports can be expected to grow at a rate of 9 - 10 per cent in the coming years. During the recent period the category of non-DGCIS imports has been subdued mainly reflecting the deceleration in defence expenditure and the lack of access to international financial markets, which in turn has prevented the acquisition of ships and aircrafts. In the medium-term, a pick-up in these imports can be expected for maintenance reasons. POL imports presently account for roughly a quarter of total imports. The demand for POL in the economy has been growing and shortfalls in domestic production have added to the underlying growth in import requirements. The import bill has not shown any sharp increase because of the low price for oil now prevailing in the international markets. In any future projections for imports, one needs to be conscious of the fact that oil prices can at any time rise again. A potential area of threat to the viability of our balance of payments, therefore, lies in oil imports. Better conservation and augmenting the domestic sources of energy must constitute an integral part of the balance of payments management strategy. However, as a short-term measure when oil prices are low, we should build our inventories or enter into some futures contracts. With an export growth of 15 per cent per annum and import growth of 9 - 10 per cent per annum, the future scenario may turn out to be manageable. However, there can be slippages on both counts and we need to guard ourselves against these. Even when the current account deficit comes down, the balance of payments will still need watching, as financing requirements will be large because of the repayments of old debts that will fall due.

Issues in Exchange Rate Management

24. Exchange rate management plays a role complementary to trade policy. With the abandonment of the Bretton Woods exchange rate rules, exchange rates of most countries have been floating. In the first decade of the floating exchange rate regime, serious concerns were

expressed on the volatility and mis-alignment of currencies. However, in the more recent period, there has been a general acceptance of the floating exchange rate regime, with all its shortcomings. In fact, many developing countries, including India, have opted for a market determined exchange rate system.

25. Influencing the exchange rate movement is one of the instruments available for correcting the imbalances in the current account. Obviously, besides exchange rates, there are a host of other factors, such as, world demand, quality of products, marketing skills and supply availabilities which have a bearing on export growth particularly of developing countries. Nevertheless, many studies including those on India have shown, that real effective exchange rate is an important explanatory factor of export growth. Considerable attention, therefore, has to be given to the behaviour of the real exchange rate.

26. The foreign exchange market in India today arouses considerably more interest than ever before. Over the past two years significant changes have been brought to bear on the exchange rate regime as part of the overall strategy to improve the functioning of the financial system. It is towards this goal that a correction for over-valuation through two step downward adjustment of the rupee was undertaken in July 1991. Simultaneously, the EXIM Scrip Scheme was introduced under which certain imports were permitted only against export entitlement. The merit of the scheme was, that besides providing additional incentives to exporters through premium on the scrips, it tried to establish a quantitative link between imports and exports. This was followed by a dual exchange rate arrangement, which entailed the surrender of 40 per cent of the exchange earnings at the official rate facilitating import of certain commodities at the official exchange rate. During the period of the Liberalised Exchange Rate Management System (LERMS), the market performed remarkably well, equilibrating 60 per cent of current receipts which were realised at the market exchange rate with a large section of imports, which had to be financed by foreign exchange obtained from the market. The market exchange rate itself remained stable; the spread between official and market rates moved in a relatively limited range around 17 per cent. The overall stability in market conditions witnessed during this period, in fact, enabled the unification of exchange rates later. The new exchange rate system came to be market-determined and almost all foreign exchange transactions began to be put through the market from March 1, 1993 onwards.

27. The market response has so far been heartening. In the initial months, exchange rate rapidly came down from the February 1992 level and has remained more or less steady at the level of Rs.31.37 per dollar. There has been no similar period in recent history when the rate has remained so stable for such a period of time. In fact, the period has been marked by fairly substantial purchase of foreign exchange by the Reserve Bank of India. Between April 1993 and December 1993, the Reserve Bank bought US $ 8 billion while it sold US $ 1.4 billion. The net purchase thus amounted to around US $ 6.6 billion. This enabled the Reserve Bank to improve the quality of reserves by eliminating the volatile elements. The large inflow of resources has come because of the substantial improvement in the current account deficit as well as capital flows in the form of portfolio investment by foreign financial institutions and the raising of resources by corporate entities in the foreign markets.

28. The large purchases made by the Reserve Bank of India have prevented the appreciation of the rupee. While capital inflows do play an important part in the transformation process and may to some extent reduce the adjustment cost, its impact on the real exchange rate has also to be kept in mind. Capital inflows which result in a real exchange rate appreciation can have adverse consequences for export promotion. Besides, one has to take a view on the sustainability of such flows over the long period.

29. There has been considerable discussion in recent days about the convertibility of the Indian rupee. Perhaps, this was a subject which would not have merited discussion a few years ago. It is the unification of the exchange rate and more so the strength shown by the rupee in the last several months which have brought to the fore the issue of convertibility. In fact, the question of convertibility does not arise when the exchange rate is over-valued. Convertibility essentially means the ability of residents and non-residents to exchange domestic currency for foreign currency, without limit, whatever be the purpose of the transactions. A distinction, however, is made between current account convertibility and capital account convertibility. In relation to current account convertibility, there is a clear definition which is embedded in Article VIII of the International Monetary Fund Articles of Agreement. The clause reads "no member shall, without the approval of the Fund, impose restrictions on the making of payments and transfers for current international transactions." This implies that anyone, whether domestic importers or foreign exporters should be able to exchange domestic money for foreign currency to settle any transactions involving the purchase of goods and services from abroad. With the significant changes that have occurred in India's exchange rate system, as well as the foreign trade regime, we have very nearly achieved convertibility on current account transactions. However, there still are restrictions relating to some of the invisible transactions, such as travel. To conform to Article VIII of the IMF, we will have to remove or considerably relax controls on these items.

30. On capital account transactions convertibility implies the movement of funds in and out of the country without restrictions. While such a regime may stimulate greater flow of investment, there are risks attached to it. The major risk is the possibility of capital flight. Another risk is the possibility of macro-economic instability arising from the movement of short-term capital movements, very often described as 'hot money'. A free movement of funds will lead to integration of financial markets and, therefore, an efficient domestic financial system free from administrative restrictions is a pre-requisite for the introduction of capital account convertibility.

31. In relation to convertibility on capital account transactions, it must be noted that there already are some elements of the capital accounts transactions which enjoy that status. For instance, in the case of both direct and portfolio investments, foreign investors have the freedom to bring in funds and take them back. However, as far as resident Indians are concerned, they are subject to control as regards their external borrowings. It should be possible to introduce convertibility on capital transactions in stages, giving greater freedom regarding short-term and long-term borrowings. A further strengthening of the reserve position will help in this regard. Its structural strengthening will help to even out any volatility in the flow of funds. The international capital markets will also have to open up for our borrowers which can occur. in a bigger way only when the credit rating of the country improves. This again should be possible as the macro-economy stabilises further and we are able to further build up our foreign exchange reserves.

Elements in the Capital Account

32. Over the last two decades, there have been significant compositional shifts in the pattern of external financing. External assistance played a dominant role in financing current account deficits during the seventies. This even enabled building up of the reserves. However, during the first half of the eighties, the share of external assistance fell to 38 per cent. Drawals under the EFF contributed 29 per cent while commercial borrowings accounted for 21 per cent. NRI deposits provided 15 per cent of the financing need. During the second half of the eighties the share of commercial borrowings and non-resident deposits rose, each meeting 23 to 24 per cent of the financing need. External

assistance declined to 29 per cent, reflecting poor utilisation of concessional loans, while the reserves met 12 per cent of the financing and the rest came by way of other capital flows. In relation to capital account, there are three elements on which some observations may be appropriate.

(i) Commercial Borrowings

33. Recourse to external commercial borrowings in the form of loans from international banks, bond placements, trade-related credits and institutional lines was essentially a phenomenon of the eighties. In the face of a deterioration in the utilisation of external assistance and persistent large deficits in the current account, commercial borrowings emerged as an effective source of external finance. During 1985-90, commercial borrowings provided 24 per cent of the financing need, almost equal in importance to external assistance. During the late eighties, the cost of commercial borrowings was on favourable terms to the country with average maturity of seven years. Gross disbursements of commercial borrowings averaged $2.0 billion per annum over the second half of the eighties, rising to a peak of $2.8 billion in 1988-89. In 1989-90, the year immediately preceding the payments crisis of 1990-1992, gross disbursements of commercial borrowings amounted to $2.5 billion, comprising, mainly trade-related credits and syndicated bank loans. Borrowing in the form of securitised instruments, especially in the Japanese bond market also entered the portfolio of India's commercial exposure.

34. Bank loans and bond placements virtually stopped during the years of the payment crisis, as India's credit rating was downgraded. Export credits supported by official export credit agencies emerged as the single source of commercial borrowing. Net of repayments, commercial borrowing yielded an outflow of $0.5 billion in 1992-93.

35. In the current year 1993-94, even though credit rating continues to be low, preventing access to international financial markets, there are encouraging developments. While trade related credits continue to be the major source of disbursements, there has been a modest increase in access to bank loans. Borrowings in the form of loans, including trade credits, presently account for 50 per cent of disbursements. Placements of convertible bonds in the Euro market have emerged as an important source of commercial borrowing and could well account for a third of gross disbursements during the year. There could also be modest disbursements through other securitised instruments. Aggregate disbursements could be in the range of $2.5 billion - $3.0 billion during 1993-94.

36. In the years to come, disbursements of commercial borrowings could be even higher than the levels reached in the late eighties reflecting the international perception of strengthening of the fundamentals of the economy. Access to syndicated loans and securitised borrowings could return to the levels of pre-crisis years. Euro issues would remain an important avenue of accessing commercial markets. Thus, even though amortisation of commercial borrowings would be in the range of $2-3 billion per annum over the next few years, with a peak of $5 billion in 1996-97, as the India Development Bonds mature, in net terms, commercial borrowings could well yield inflows of $1 billion per annum over the medium term.

(ii) NRI Deposits

37. During 1985-90, non-resident deposits accounted for 23 per cent of the financing need. In a large measure, the inflow of funds under these deposits was a response to conscious policy incentives in the form of attractive interest rate differentials, exchange risk guarantees to banks and fiscal concessions. However, the experience of the crisis of 1991-1992 clearly revealed that excessive dependence on

non-resident deposits must be avoided. Mobilisation of deposits under the FCNRA was also not cost effective, especially when the hidden costs in terms of exchange guarantees are taken into account. In pursuance of the recommendations of the High Level Committee on Balance of Payments, a restructuring of the FCNRA Scheme was effected during 1993-94. Deposit maturities up to two years have been discontinued and interest rate differentials narrowed. Simultaneously, two new schemes viz., the Foreign Currency Non Resident (Banks) Scheme and the Non-Resident (Non Repatriable) Rupee Deposit Scheme have been introduced. While carrying all the features of the FCNRA Scheme, exchange guarantees are no longer borne by the RBI under these schemes. Thus, for the depositor the incentives for depositing in India continue to be available. Incentives have also been offered to banks to encourage them to mobilise deposits. To compensate for the withdrawal of exchange guarantees and yet encourage banks to mobilise funds, these deposits have been made free of reserve requirements. Under the NR(NR)RD Scheme, banks are even free to fix interest rates corresponding to various maturities.

38. The response to these policy initiatives has been encouraging so far. Outflows from the FCNRA Scheme have been more than compensated for by inflows under the new schemes. Indeed, if all the deposit schemes are taken together, there has been a net inflow of $ 180 million upto November 1993. This healthy trend is expected to continue but it is necessary to ensure that these deposits come out of the genuine savings of non-resident Indians.

(iii) Short-term debt

39. Short-term debt, which constituted 10 per cent of total debt at the end of March 1990 has been reduced sharply, as efforts have gone into liquidating the overhang accumulated in the period up to 1991. The level of short-term debt as a percentage of imports or as a percentage of total debt is less than that of other comparable countries. As has happened in many countries, recourse to short-term credit to bridge the balance of payment deficit can land the country in serious problems. When the situation turns bad, short-term credit can be easily withdrawn by not being rolled over. Short-term credit must, therefore, be restricted to the level required to finance purely trade. The current policy in regard to the management of short-term debt aims at ensuring that it is permitted only for trade-related purposes and under normal terms.

I. External Debt

40. A country's external indebtedness is a mirror image of the behaviour of the current account in the balance of payments. In this sense, the outstanding volume of India's external debts represents the accumulation of deficits in the current account over the past years. Based on the data now available, India's external debt as at the end of March 1993 amounted to US$ 85.4 billion. Bulk of this debt was accumulated in the eighties. Although India is the fourth largest debtor, in terms of nominal value of debt (according to World Bank, World Debt Tables: 1993-1994), the volume of debt comes down when measured in terms of 'present value method'. The share of concessional loans at around 35 per cent is quite high as compared with other developing countries.

41. India's external debt as proportion of GNP was less than 12 per cent in 1980. In 1985 the Debt-GNP ratio at 19.3 per cent was still one of the lowest. In 1992, the Debt-GNP ratio jumped to 32.3 per cent. It has marginally exceeded the ratio for Brazil though it is lower by three percentage points than that of Mexico. India's debt ratio remains lower than that of Pakistan (48 per cent), Indonesia (67 per cent) and Thailand (36 per cent). However, the debt service ratio in 1992-93 at 30.4 per cent was higher than that of Brazil though significantly lower than that of Mexico. This is explained by the fact that the external sector is a small part of the GDP in India.

42. Debt owed to multilateral institutions constitutes the largest component of external debt with its share rising from 25.6 per cent at the end of March 1990 to 29 per cent at the end of March 1993. Multilateral debt is for the major part, concessional although the concessional element declined from 66 per cent to 62 per cent over the reference dates. Bilateral debt the next largest category in India's debt stock has remained virtually unchanged in terms of its share between the end of fiscal 1990 and 1993 at around 18 per cent. Bilateral debt is largely concessional in character.

43. The level of external debt however should be such that debt service payments over a period of time are within reasonable limits. While there is no precise way of determining what this ratio should be, the general view is that debt service payments as a proportion of exports of goods and services should not normally exceed 30 per cent. When exports of goods and services tend to grow faster, then the burden comes down.

44. In terms of debt management, the initial efforts have been to hold down and phase out the volatile and costlier components. There are ceilings on the levels of publicly guaranteed commercial borrowings and short-term debt. Policy measures have also been instituted to reduce the dependence on FCNRA and to have in its place alternative schemes, which are cost-effective in terms of the absence of exchange guarantees from the monetary authority. The non-repatriable deposits will reduce the external debt. The sweeping changes brought in under foreign investment, technology and industrial policies have also ushered in a compositional change in the pattern of capital flows which lends strength to the debt management strategy. Even as debt is being consolidated, the gaps in external financing have been filled by an inflow of non-debt creating flows in the form of direct and portfolio investment from abroad. The inflow of foreign investment during 1993-94 is large by the standard of our past record. As the process of reform gathers momentum, these flows of foreign investment can be expected to be maintained and even increased. An enduring strategy of sustainable debt management essentially is a function of the behaviour of the current account. With the decline in current account deficit to around one per cent of GDP and the compositional changes in the flows to finance the deficit it may be possible to bring down the stock of external debt and the debt service ratio.

Foreign Currency Reserves and Reserve Management Strategy

45. The payments crisis of 1990-92 clearly underscored the acute problems of liquidity and international confidence that arise when reserves are depleted to finance overall deficits in the balance of payments. The High Level Committee on Balance of Payments recommended a reserve management policy which envisages a moving target range of foreign currency reserves fixed from time to time taking into account factors such as the need to instil confidence in the international financial community, the capacity to meet debt service obligations, the need to smoothen the seasonal flux in foreign exchange transactions and the ability to counter speculative attacks on the currency.

46. The institution of the market determined exchange rate system has led to a massive inflow of foreign exchange into the country. In the absence of demand for foreign exchange in the market, these surplus inflows have been purchased by the RBI to build up the reserves. The accretion to the reserves has been accompanied by a healthy reorganisation of the components thereof. It has enabled the ebbing away of costly and volatile elements such as swaps, FCBOD, FCNRA and the overhang of short-term liabilities. The foreign currency reserves at US$ 9.9 billion provide cover for about 5.4 months of imports. While this is a healthy development, it is by no means high as compared to other developing countries such as Argentina (7.1 months of imports), Brazil (10.4 months of imports), Singapore (6.3 months of

imports) and Thailand (6.7 months of imports). However, the cover that reserves provide should be interpreted to include debt service payments, as recommended by the High Level Committee. By this criterion, our foreign currency reserves presently stand cover for 3.7 months of imports and debt servicing which can be taken as a core level of reserves to be maintained at any point of time. It must be recognised that there will always be some transitory elements in the composition of reserves.

J. Conclusion

47. We have come a long way from the crisis years of 1990-91 and 1991-92. The period of nightmare is now over. But the lessons of the period should not be forgotten. The ease with which financing requirements can be met from different sources, should not become the basis for incurring current account deficits. This is very often deceptive. In fact, international capital flows are fair weather friends. They begin to reverse and flow back the moment trouble spots appear. We, therefore, must aim at a level of current account deficit which can be sustained by *normal* capital flows.

48. The key to the maintenance of a viable balance of payments, lies in stepping up exports. Our level of imports is one of the lowest even when compared with many of the developing countries. If exports grow at an annual rate of 15 per cent in dollar terms and with a modest current account deficit, we should be able to meet adequately our import requirements. It is sometimes asked whether a liberalised trade regime can land us back in the problems we faced a few years back. The discipline of the market determined exchange rate should steer us towards a near equilibrium situation. The market may also provide some advance warning signals. However, some elements of our merchandise trade balance, such as energy imports, will require special attention if we are to protect ourselves from external shocks. With an annual growth in exports of 15 per cent, which is a must, and with the change in the composition of the financial flows, we can look forward with cautious optimism to less traumatic years in relation to balance of payments.

Thank you.