Capital Flows and Self Reliance Redefined

Mr. President and friends,

I consider it a great privilege and an honour to be invited to deliver the 27th Frank Moraes Memorial Lecture. While I did not have the privilege of meeting Mr. Frank Moraes, I am an admirer of his writings, which are at once, objective, informative, illuminating, and inspiring. I must compliment the United Writers Association for keeping alive his memory in a befitting manner.

I must also compliment the organisers for their tradition of inviting distinguished people from various walks of life, public and private sectors, scholars and administrators, scientists and statesmen to deliver these Lectures. The organisers had kindly made available the copies of the Lectures and they make a fascinating reading. Among them, I found one by Dr. C. Rangarajan, then Member, Planning Commission on "An Approach to Balance of Payments Problems", delivered in June 1992. In the external sector, our journey from problems of 1992 to comfort in 2000 has been exciting, in which both of us have been, in different degrees, associated. My address reflects the excitement of that journey and ponders over the future – to a path of self-reliance through greater openness combined with self-respect. The title of the subject, "Capital Flows and Self-reliance Redefined" captures the growing significance of capital flows in managing the external sector, and the changing dimensions of external trade impinging on self reliance.

Self Reliance : A Framework

I am well aware that in these days of international integration, it is no longer fashionable to talk about *self reliance.* I do, nonetheless, think that this concept needs to be contextually revisited.

It is not easy to have a clear-cut definition of self reliance, though in the context of this address it relates to a country's economy vis-à-vis the rest of the world, and not an individual or a community. I would present, for convenience three broad though overlapping approaches to self reliance : "Restrictive self reliance" meaning self sufficiency; "cautious self reliance", aimed at minimising exposure to external sector and "dynamic self reliance" which implies resilience against external shocks.

First, *restrictive self reliance* could imply self sufficiency to the point of isolation or aversion to excessive exports (since terms of trade may be adverse).

Secondly, *self sufficiency* may be attempted in respect of specific commodities (say, food or steel) or activities (defence) which would be in the nature of cautious self reliance.

Thirdly, *cautious self reliance* could aim at minimising dependence on imports (import substitution) and / or self sufficiency to pay for all imports (or current expenditures) only with exports (or current receipts) or self sufficiency extended to create surplus on current account. To the extent there may be a gap between savings and investments and/or between foreign exchange availability and needs in the process of development, such a gap could be met by debt provided such debt is kept within reasonable limits. This is yet another facet of self reliance.

Fourthly, the *dynamic self reliance* aims at improving strengths of the economy to a point that vulnerability to shocks from external sector is minimised and possibly eliminated, even though the economy may have a greater interface with the rest of the world. Such dynamic self reliance will have to have a non-ideological or neutral approach to degree of openness in current and capital account.

Some explanatory remarks on the above framework are essential. It is necessary to recognise that the most relevant issue is risks and rewards in linkage of an economy with the rest of the world, which are a function of several factors viz. size of economy; geopolitical considerations, commodity composition of exports/imports, and parameters of capital flows. It is clear that parameters of feasibility of a policy of self reliance would take into account technological developments, bureaucratic rigidities to cope with changes, communications and information and mobility of people. In brief, any approach to self reliance has to be both contextual to the country and changing with times.

Links with Capital Flows

While self reliance, as popularly understood, relates to trade, and to some extent current account, the surplus or deficit on current account is reflected in capital account, with potential impact on future flows on current account. Thus, the extent and nature of capital flows becomes subject matter of policy of self reliance. There are several important developments in regard to capital flows that impinge on the approach to self reliance.

First, the volume and diversity of instruments of capital flows have increased. Second, the volatility of such flows has increased and such volatility may sometimes have less to do with domestic policies. Third, official flows which could play the role of counter cyclical treatment at times of shock, whether on trade account or capital account are diminishing rapidly. Fourth, debt flows which were considered in popular perception to be less irreconcilable with self reliance, compared to equity flows, especially Foreign Direct investment, have in recent times, sometimes tended to be more disruptive to an economy in times of crises. Thus, policy of self reliance implying avoidance of non-debt creating flows to eliminate the adverse consequences of presence of multinationals has been under review. Fifth, maintaining adequate level of reserves is one way, though not necessarily the only effective way in ensuring self reliance, provided it is in conjunction with other complementary policies.

Our Policy of Self Reliance : A Shifting Perspective

Over the first three decades of planned development, successive Plans emphasised the need for financing development largely from resources mobilised domestically. The external sector was treated as a handmaiden of the domestic sector. First, our planners shared the export pessimism then pervading the developing world. Secondly, the existence of a large domestic market provided scope for internalising forward and backward linkages. Thirdly, the development strategy hinged upon a programme of industrialisation to break through the vicious circles of backwardness. Fourthly, the availability of foreign exchange was a major consideration, especially after the dissipation of the sterling balances during the 1950s and 1960s.

Export pessimism permeated the policy stance throughout the early decades of our Planning. This thinking was based on four premises. First, it was believed that only after industrialisation has proceeded some way that increased production would be reflected in larger export earnings. Secondly, it was argued that given the large domestic market, exports need not be an engine of growth. Thirdly, growth in external demand for India's products was likely to be inelastic because of the traditional nature of our exports. Finally, there was what was known as the Prebisch-Singer argument that primary commodity exports face a secular deterioration in the terms of trade. Accordingly, exports were regarded as a residual, a vent-for-surplus on those occasions when such surpluses were available.

Import substitution was the principal instrument of trade policy and was regarded in the early years as not only the correct strategy but also inevitable in a continental economy such as India. First, the need for a widely diversified and resilient industrial base was recognised as an imperative to break through the constraints faced from the adverse international environment. Imports of capital goods, intermediates and technology were essential for building the industrial base and for strengthening the expenditures of substituting imports. Secondly, the possibilities of expanding import purchasing power through exports were considered extremely limited. Thirdly, the objective of self-reliance was interpreted in terms of indigenising availability through domestic production rather than through the foreign trade sector.

By the mid-1960s, serious reconsideration of this strategy was warranted. First, while the industrialisation-oriented trade policy did result in a resilient and diversified industrial base, it created a high cost economy reflected in a high incremental capital output ratio and declining productivity of capital. Secondly, the regime infused a positive discrimination against exports. Thirdly, policy makers underestimated the import intensity of the industrialisation process and this put considerable strains on the balance of payment. Fourthly, the policy of import and adapt imparted a technological lag to Indian industry. The sheltered environment of restricted competition provided very few incentives for technological upgradation. Fifthly, import regulation was achieved not via the exchange rate and tariffs but through comprehensive licensing cum exchange control. This in itself resulted in inefficiencies in allocation of resources, high cost of administration and diversion of transactions away from the banking channels.

It may be of interest to note that the objective of self reliance did not find explicit commitment in the First, Second and Third Plans which were mainly concerned with generating the foreign exchange resource requirement of the Plans. The Third Plan reflected the first signs of rethinking in the policy strategy by dedicating itself to 'self sustaining growth' which required 'domestic saving to progressively meet the demand of investment and for the balance of payment gap to be bridged over'. While it envisaged that normal capital flows will continue, it set out the early indications of the concept of self reliance by foreseeing a steady reduction in the reliance on special foreign aid programmes and dispensing with them after a period of time. The Third Plan also brought out the need for regarding exports as the key instrument for achieving freedom from aid.

The Fourth Plan contained quite an aggressive approach to achieving self reliance. Export growth of 7 per cent per annum was considered an essential element of the strategy. It was envisaged that the dependence on foreign aid would be halved during the course of the Fourth Plan (1969-74) and PL480 imports would be eliminated. As a consequence, trade policy became the primary instrument for achieving a more dynamic concept of self reliance than what was prevalent in the early decades.

While the Fourth Plan made a conscious effort to approach the goal of self reliance through the active use of exports, it was in the Fifth Plan (1974-79) that self reliance was recognised as an explicit objective. The Sixth Plan (1980-85) emphasised the strengthening of the impulses of modernisation for the achievement of both economic and technological self reliance.

The Seventh Plan (1985-90) noted the conditions under which the concept of self reliance was defined earlier, particularly in the preceding plan. It conceptualised

self reliance not merely in terms of reduced dependence on aid but also in terms of building up domestic capabilities and reducing import dependence in strategic materials. The concept also encompassed the achievement of technological competence through liberal imports of technology in the areas of atomic energy, space, agricultural and medical research. In the aftermath of the Gulf crisis, macroeconomic management undertook two sets of interrelated policy actions to simultaneously achieve stabilisation and structural change. External sector policies designed to progressively open up the Indian economy, formed an integral part of the policies for structural reforms. In this context, the High Level Committee on Balance of Payments (Dr. Rangarajan Committee, 1993) recommended the instrumentality of the approach to self reliance:

(i) improvement in exports, both merchandise and invisibles;
(ii) modulation of import demand on the basis of the availability of current receipts and a sustainable level of net capital receipts;
(iii) reduction in exceptional financing and the debt service burden;
(iv) building up the foreign exchange reserves to avoid liquidity crises; and
(v) elimination of the dependence on short term debt

The parameters of the external position adopted in the Eighth Five Year Plan (1992-97) were consistent with the approach indicated by the Committee. A current account deficit of 1.6 per cent of GDP, volume growth of 13.6 per cent in annual exports and import elasticity of 1.5 were treated as normative.

The Ninth Plan (1997-2002) viewed strengthening of efforts to build self-reliance as a specific objective. It recognised export performance as critical to the achievement of this objective. It also viewed the ability to attract foreign investment as promoting the objective of self reliance by providing access to technology and by avoiding a build-up of external debt. It also recommended cautious liberalisation of the capital account. Thus the Ninth Plan has unambiguously endorsed the dynamism embodied in the objective of self reliance with a clear recognition of the preferred instruments to achieve it.

Changing Character of Capital Account

An important element of external sector developments over the past five decades is the changing character of the capital account. The first period from 1948-49 till the end-seventies represented the era of the dominance of external assistance in the capital account. The second era began from 1982-83/1983-84 onwards when the costlier external commercial borrowings (ECBs) and non-resident deposits together or even individually shared equally with external assistance in external financing. This period coincides with a surge in current account deficits. From relatively modest levels, India’s external debt rose rapidly during the eighties. The debt/Gross Domestic Product ratio increased from 14 per cent in 1980-81 to 30 per cent in 1990-91. There was also an increase in the debt service ratio from 10 per cent in 1980-81 to a peak of 35 per cent in 1990-91.

The third phase began from 1993-94 as foreign investment flows came to dominate the capital account. This was the result of the deliberate policy effort to reduce the dependence on debt creating flows in favour of non-debt creating flows. For instance, foreign investment inflows formed almost 46 per cent of net capital receipts during the recent four-year period 1996-2000 (as against negligible levels in earlier periods) with a concomitant decline in the share of debt creating flows. This is reflected in a decline in the debt/GDP ratio and the debt service ratio to 18 per cent in 1998-99 and 22 per cent by end December 1999, respectively.

Review of Balance of Payments Developments

The balance of payments reflects the impact of diverse developments, both internal and external. While these factors may affect specific components of the balance of payments in varying degrees, the full impact on the external accounts is best tracked through the behaviour of summary indicators of the external sector. Updating an article on "India's External Sector Since Independence : From Inwardness to Openness" by Muneesh Kapur, in the RBI Occasional Papers (June-September 1997), it is possible to delineate co-movements and diverse pulls of summary indicators of India's balance of payments since Independence into five clear sub-periods:

(1) 1950-66, a period of deterioration; (2) 1966-80, transition and improvement; (3) 1980-90, emergence and persistence of structural imbalances, and (4) 1991-96, stabilisation and strengthening; (5) 1996-97 onwards, resilience in addition to strength. Correspondingly and, in fact interwoven into this phasing are developments associated with the planning strategy set in motion by the Second Plan, the terms of trade shocks of the seventies, incipient pressures of the 1980s stoked by internal imbalances, the crisis of 1990 and structural reforms, and resilience to several shocks. .

(i) *1950-66 :* Although the balance of payments came under pressure immediately after Independence due to Partition, deficit was financed almost entirely by running down sterling balances, and the balance of payments position remained comfortable over the First Plan. Signs of pressure came from the Second Plan onwards as import spurted on account of the basic and heavy industry led planning strategy. The strain on the reserves was eased as external assistance picked up from 1958-89. Improved export performance and a deceleration in import demand allowed for an improvement in the Current Account Deficit (CAD) to 1.8 per cent of GDP in the Third Plan period from 2.4 per cent in the Second Plan; but the external balance continued to be unsustainable. A step-up in flows of external assistance met the external financing requirements of the Plan period and the overall deficit improved to near balance. The summary indicators reflected the deterioration in the external payments position during 1950-65 period and exceptional financing support from the International Monetary Fund (IMF) during the Second Plan Period became necessary.

(ii) *1966-80 :* The phase marked the onset of a degree of activism in external sector management. The policy endeavour to boost exports was signalled by the devaluation of the Rupee in 1966, which was also an attempt to rationalize the system of *ad hoc* export subsidies, which had grown up in lieu of a formal devaluation. Nevertheless, the CAD widened in the period of the Annual Plans as the devaluation did not produce the desired result on exports immediately. The period 1975-80, was one of comfort because of a continuous step-up in export growth coupled with an improvement in invisibles. As workers' remittances surged in the wake of the demand for the Indian labour in the oil rich countries, the current account deficit declined sharply in 1975-76 and, in fact, turned into a surplus over the following two years. The major exception was 1974-75 due to the full impact of the First oil shock, which was financed by recourse to various IMF facilities.

(iii) *1980-90 :* The second oil shock started another round of stress on the balance of payments in 1980-81. As the current account deficit surged in the first three years (1980-83) of the Sixth Plan in the face of a deceleration in export growth, it was financed partly by rising capital flows, partly by running down reserves and by a heavy recourse to Extended Fund Facility (EFF) of the IMF. The limited

improvement in the balance of payments over the Sixth Plan was due mostly to the reduction in the Petroleum Oil and Lubricants (POL) import bill dues to expansion in domestic production of POL.

The critical phase turned out to be the Seventh Plan period (1985-90) culminating in the balance of payments crisis of 1991. The current account deficit averaged more than two per cent of GDP as the period was marked by a surge in imports and a deterioration in net invisibles. As flows of external assistance fell short of the financing need, recourse to costly sources of finance in the form of external commercial borrowings (ECB) and non-resident deposits became relatively large. With persistently large CADs, even these flows were not sufficient and the cumulative impact was a reserve loss.

(iv) *1990-96 :* The weaknesses in the Indian economy were exposed by the Gulf hostilities of 1990 and ensuing developments. The Gulf crisis had multiple effects : it led to increased POL imports, partial loss of export markets in West Asia, a set back to remittances and tourist earnings while also involving some foreign exchange expenditure on repatriation of Indians from the affected countries in the Middle East. The current account deficit, amounted to 3.2 per cent of GDP in 1990-91. Around the same time, credit rating of the country was lowered, restricting the country's access to commercial borrowings (in particular, the short term credits in the form of Bankers' Acceptance Facility). There was a temporary loss of confidence leading to a flight of Non Resident Indian (NRI) deposits. Exceptional financing measures became inevitable, and the overall deficit in 1990-91 was financed almost equally by recourse to IMF and drawdown of reserves. The import cover of foreign currency assets declined to just one month of imports at end of 1990-91 and dipped further to less than half a month by July 1991 as reserve decline continued in the first half of 1991-92.

With the onset of structural reforms in 1991-92 accompanied initially by severe import compression measures and determined efforts to encourage repatriation of capital , there was a turnaround in the second half of 1991-92. Over the next three years (1992-95), thanks mainly to foreign investment flows, robust export growth and better invisible performance, the balance of payments situation turned comfortable and reserves surged by US $ 14 billion. However, in 1995-96, an overall deficit was recorded, as capital flows ebbed and import requirements increased to meet the needs of strong industrial growth.

(v) *1996-97 Onwards :* Despite the financial crisis in Asia, Russia and Brazil, the impact of sanctions, developments in Kargil and finally, the recent sharp rise in international crude prices, the country's foreign exchange reserves increased in each of the years from 1996-97 onwards proving the sustainability of the external sector. The CAD remained modest averaging 1.1 per cent of GDP during 1996-2000 (1.4 per cent during 1990-96). The outcome was partly on account of officialisation of receipts accompanying the liberal policy on gold imports that earlier did not enter the system and partly the result of the routing of current receipts through banking channels resulting in a buoyant growth in private transfers from NRIs and a robust growth in software exports. Another factor contributing to the containment of the CAD during the period 1996-2000 has been the sluggish growth in non-oil non-POL customs imports inspite of liberalisation of trade.

At the same time, the capital account has seen further restructuring and diversification with foreign investment acquiring a pre-dominant role. Within foreign investment, while the period 1990-96 was dominated by portfolio investment flows,

the more recent period has seen a welcome pick-up in direct investment. Amongst other components of capital account, while external assistance and non-resident deposit inflows have remained stable, the commercial borrowings have been lacklustre in the recent past.

With total capital flows exceeding the current account deficit in each of the years, the foreign exchange reserves have increased by US $ 16.3 billion between 1996-2000 to US $ 38.0 billion at end-March 2000. In the process, the import cover of reserves has increased from 6 months at end-March 1996 to over 8 months by end-March 2000. The ratio of short-term debt to reserves has almost halved from 23 per cent at end-March 1996 to 13 per cent at end-December 1999. The ratio of short-term debt and cumulative portfolio inflows to reserves declined from 71 per cent at end-March 1996 to around 60 per cent at end-March 2000.

Indicators of Self Reliance

It is possible to argue though not conclusively that the dynamic perspective of self reliance in the development strategy and the policy responses are to some extent reflected in the behaviour of selected indicators. An attempt has been made to compile a set of indicators and compare our changing policy perspectives and our performance since the First Plan till date, and it is presented in Table attached. The shift in the stance of trade policy from inwardness to outward orientation is reflected in the improvement in the current receipts/current payments ratio which has occurred in the 1990s in contrast to the deterioration witnessed during the second half of the 1950s, the 1960s and again in the 1980s. With liberalisation of trade policies in the 1990s, the current receipts have financed more than ninety per cent of current payments.

The proportion of domestic capital formation financed by foreign saving has conventionally remained below 10 per cent except during the import hump associated with the industrialisation strategy of the Second Plan and the drought and war disruptions of the Third plan. The 1980s witnessed a rise in this ratio to around 11 per cent as the reliance on external saving was stepped up to accelerate the growth process. In the 1990s, foreign savings have contributed less than 5 per cent of the domestic investment. Reflecting these trends, the current account deficit has been averaging 1 per cent in the 1990s although it reached peaks of nearly 2.5 per cent in the Second Plan period and again in the Seventh Plan period.

Aid flows have been the major source of capital flows to India over the period 1950 - 80. Their share in net capital flows has, however, declined from almost 100 per cent upto the 1970s to less than 10 per cent in the latter part of 1990s.

The debt indicators are showing signs of consolidation and stability. The debt- GDP ratio has declined from its peak of 41 per cent in March 1992 to around 22 per cent at present. This healthy movement is mirrored in the behaviour of the debt service ratio, which has fallen from 35 per cent during 1990-91 to around 18 per cent in 1998-99.

The indicators of reserve adequacy also point to resilience in the balance of payments. After falling to a precariously low level of one week of imports during the crisis of 1990 - 1992, external sector policies have enabled a reconstitution of the foreign currency reserves to a level of eight months imports at present in terms of the conventional norm. In the 1990s when capital flows have dominated the balance of payments, the adequacy of reserves is assessed in terms of the cover they provide against volatile capital movements. The ratio of short term debt to reserves has also moved down from a peak in the Seventh Plan period to 13 per cent at end-December

1999. The total stock of portfolio investment accounts for about half of the level of reserves.

If an indicator of self reliance is the capacity to withstand exogenous shocks, the statement attached would show how the different types of shocks were met in the past. The latest increases in oil prices, though not far different in magnitude compared with the past, and other related events passed without a specific policy response except raising Resurgent India Bonds, reflecting resilience of external sector in late 1990s. In fact, multiple shocks were absorbed without recourse to exceptional financing and the external sector has continued the strengthening trend.

Self Reliance Redefined

As mentioned, the Report of Rangarajan Committee gave an operational framework as refinement to self reliance, but India has further changed since 1993 , in terms of economic structure as well as growth expectations while global developments in trade and international financial architecture are also noteworthy. These dynamics would warrant a review of the concept of self reliance.

An exploratory redefinition of self reliance could be as follows : First, the reality of global trends in trade in goods and services warrants international competitiveness as a key to a sustainable trade regime. In other words, a differential approach to export sector and import of goods or services is becoming increasingly difficult to operationalise. Consequently, barriers to efficiency, especially physical and institutional infrastructure would operate against economic strength and thus against self reliance. It must be recognised that large scale poverty and illiteracy and malnutrition undermine a nation's capacity to achieve and maintain competitiveness.

Second, as Governor Bimal Jalan has been emphasising, adequacy of level of reserves is a key component for managing our external sector. Furthermore, an appropriate exchange rate policy, coupled with price stability as a component of macroeconomic policies is also critical to maintain competitiveness of economy both to facilitate exports and fine-tune imports.

Third, the remotely possible vulnerability on trade account is mainly on import front and it relates to food (for which there is a more than adequate buffer stock); fuel (POL on which imports are still large); and fertilisers (which are essential). Policy initiatives to ensure economies in managing such potential shocks, taking advantage of emerging instruments of hedging would add to a sense of comfort and thus to self reliance.

Fourth, on capital account, there are several developments in regard to international trade in goods and services, international business, technology, cross border flows of capital, etc. that would necessitate a more active management of capital account, with a view to continuously assessing the costs and benefits of liberalisation vis-à-vis control or regulation.

In this context, management of the 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. In fact, if the option of re-imposing controls to meet an emergency is contemplated, the management of capital account should always contain control, regulatory and liberalisation options.

Fifth, as an economy becomes more sophisticated, we need to recognise that as other countries find it profitable to invest in India, we too can benefit from selective investments abroad. It is in this context that we have to view Indian investments abroad. It is erroneous to equate all capital outflows with capital flight. In

fact, selective investments abroad which are being progressively liberalised could ultimately make a significant contribution to the resilience of Indian industry.

Sixth, there is a need to recognise the resource and other limitations on multilateral and other official bodies to extend adequate support if a large economy like India were to face a highly vulnerable situation. The resource and other constraints on international financial institutions and systems have been demonstrated in the recent Asian crises and hence India has to take extra precautions to minimise vulnerability and continue to be risk averse in this area.

Finally, it is clear that while several initiatives are proposed at the global level, the task of preventing a crisis is essentially a national responsibility though an enabling international environment is sought to be put in place to facilitate action by individual countries. No doubt, in today's globalised world, prevention of crises as well as mitigating the effects require multilateral efforts, but the social consequences of such crisis are to be met by the national governments concerned. In this sense, the ultimate responsibility in regard to crisis prevention and management rests primarily on the policy makers of the countries concerned.

Thus, the concept of self reliance can no longer be defined in terms of degree of openness but in terms of competitive strength in trade in goods and services on the one hand, and managing balance of payments (supply shocks on trade account and capital flows) to avoid vulnerability on the other.

Briefly stated, currently, self reliance of a country lies in its economic strength and resilience to potential vulnerabilities.

Managing Capital Account for Self Reliance : Challenges

There are several aspects of self reliance, and managing capital account is indeed one of them. Some of the important challenges that need to be addressed by us in this context are worth flagging.

First, do we need enhanced capital flows? It would depend essentially on the absorptive capacity of the economy and the level of CAD that could be considered sustainable, in the light of global developments. Currently, the flows appear adequate to meet a CAD not exceeding 2 per cent of GDP and also add reasonable amounts to reserves. However, the impact of possible increased investment activity in the future, particularly in infrastructure on the level of current account would have to be assessed. In doing so, the fact that the combined share of exports and imports has gone up from about 13 percent of GDP in the latter half of eighties to over 20 percent in the recent period as well as the sharp increases in capital flows and the level of reserves could be kept in view. In this background, and on the assumption of sustainable level of non-volatile capital flows, the possibility of an acceptable band of sustainable current account deficit may need to be conceptualised.

Secondly should there be further liberalisation of capital outflows other than those related to inflows? While outflows will have to continue to be permitted with prudential regulatory requirements for financial intermediaries, there is a case for progress in liberalisation and automatic approvals with regard to overseas ventures. At an appropriate time in the future, we can also consider permitting a modicum of outflows on individual account for residents within prudential limits commensurate with the very reasonable limits allowed for individuals for comfortable current account transactions. These measures would clearly demonstrate sign of strength of the economy and in no way compromises the overall strategy of self reliance.

Third, whether composition of capital flows needs to be changed keeping in view redefined self reliance as protection against vulnerability? Clearly, the emphasis

on non-debt creating flows and avoidance of short term debt has served us well. The greater thrust on FDI appears clearly warranted. As regards portfolio investment, similar to short term debt, there is usually a concomitant need to add to foreign currency reserves to avoid vulnerability. Thus, there is an international opinion that about 30 to 40 per cent of incremental portfolio flows need to be ideally added to reserves to provide cushion against vulnerability. Thus, the real addition to investment in the country through the portfolio investment route may be significantly less than what such flows indicate.

Fourth, whether official flows, from multilateral and perhaps bilateral sources should be encouraged ?

India has paid the last instalment amount of about US $ 25 million to the IMF in June, 2000. In fact, by pursuing appropriate policies, we have been able to repurchase all our obligations to the Fund. Besides, during the 1990s, we have built up our foreign exchange reserves to over $ 36 billion as of date, while maintaining external debt almost constant. So long as macro policies continue to be sound to ensure progress in desirable directions of efficiency and stability, there will be no need for us to approach the Fund for any assistance.

With a comfortable external sector position, significant reduction in the Government's fiscal deficit should help the Government to phase out its dependence on International Development Association (IDA) whose level of resources is in any case getting depleted.

Over the medium-term, it should also be possible to earmark all loans from IBRD for utilisation in long gestation but commercially viable projects such as those in infrastructure, in the quasi-Government sector.

As regards bilateral sources, there is clearly aid fatigue and there are many improbables that add to the cost of such flows.

In brief, I believe that an initial step in managing capital account may be, not merely preferring non-debt creating flows but phasing out official debt or bilateral and multilateral aid.

Freedom from Aid

Dr. I.G. Patel, former Governor of Reserve Bank of India in his fifteenth Pant Memorial Lecture delivered in New Delhi on September 20, 1992 elaborated the theme "Freedom from Foreign Debt". Referring to the contours of freedom, he indicated that "foreign indebtedness comes in many forms and that it is certainly not necessarily desirable to seek freedom from all of them." On private-investment flows, his preference was not to shun them but warned severely against any concession or incentive, particularly government guarantees for private capital flows – direct or portfolio, loan or deposit .

Reiterating the dangers of sovereign guarantees to any form of capital flows, he mentioned "it certainly needs to be emphasised that as a long-term policy, the sequence of independence must be from international institutions first and private financial markets later, if at all".

On bilateral aid, Dr. Patel was even more forthright when he said "when it comes to indebtedness to foreign governments, the case for seeking complete freedom from it is perhaps the strongest. An enduring relationship of borrowers and debtors among sovereign states is not a healthy one to sustain, and it is doubtful if public opinion at home or abroad will support this vexatious and debatable relationship decade after decade."

As mentioned by me earlier in this address, the policy-objective of reduced dependence on aid was already articulated in the Third and Seventh Five Year Plans, in pursuit of self-reliance.

From a technical point of view, I personally believe that our domestic economic strengths especially those relating to external sector as well as international financial environment facilitate a decision to phase out, as explained in this lecture and in a time bound manner, bilateral as well as multilateral aid and this could be pursued without giving up our right to access facilities available to us in international institutions of which we are a member.

Conclusion

The description and analysis of changing character of capital flows and changing perspectives on self-reliance leads us to some conclusions:

First, in view of global technological developments, larger role of private capital flows, membership of World Trade Organisation, subscription to Article VIII of the International Monetary Fund on Current Account Convertibility etc., self-reliance in external sector has to be viewed increasingly in terms of managing capital flows.

Second, in the present context, self-reliance relates more to the strengthening of the economy and building a capacity to withstand vulnerabilities to external or domestic shocks, rather than merely concentrating on achieving self-sufficiency. In other words, self reliance now acquires an outward looking bias rather than the earlier inward looking orientation.

Third, policy-developments in our country have reflected to a perceptible degree, the changing dimensions of self-reliance and management of capital account. A review of these developments clearly shows that, dynamic self-reliance defined to reflect resilience to face shocks and increasing economic strength is made possible more by cautious open-ness in the Indian economy. Self-reliance and openness of the economy are not conflicting, rather they are compatible and complementary.

Fourth, our economy can sustain strengths and resilience, thus assuring dynamic self-reliance mainly by a combination of efficiency-enhancing and socially sensitive policies of higher growth and rapid reduction in poverty and illiteracy.

Fifth, dependence in normal times on non-commercial sources of funding such as aid, bilateral or multilateral is incompatible with the spirit of self-reliance. Government guarantees in the external sector should be abjured and the next step towards self-reliance should be freedom from aid while continuing careful management of current and capital account to ward off any need for exceptional financing in future.

Twenty Seventh Frank Moraes Lecture delivered by Dr.Y.V.Reddy, Deputy Governor, Reserve Bank of India at Chennai on July 13, 2000. Dr.Reddy is grateful to Dr.M.D.Patra, Dr.A.Prasad and Mr.Muneesh Kapur for their assistance.

SELECTED INDICATORS OF SELF RELIANCE

INDICATORS	Current Receipts- Current Payments Ratio (%)	Foreign Saving- Total Investment Ratio (%)	Current Account Deficit-GDP Ratio (%)	Net Aid-Net Capital Flows (%)	Debt-GDP Ratio (%) #	Debt Service Ratio (%)	Reserves- Imports (months)	Short Term Debt-Reserves Ratio(%) #	Porfolio Investment Reserves Ratio (%) #
1st PLAN (1951-56)	85.13	4.63	-0.10	127.78	2.05	N.A.	14	N.A.	N.A.
2nd PLAN (1956-61)	58.19	19.31	-2.40	67.70	8.06	N.A.	3.29	N.A.	N.A.
3 rd PLAN (1961-66)	60.88	14.84	-1.80	103.00	N.A.	N.A.	2.61	N.A.	N.A.
ANNUAL PLANS (1966-69)	63.53	14.91	-2.10	108.38	18.65	N.A.	3.86	N.A.	N.A.
4th PLAN (1969-74)	83.49	6.94	-0.30	105.62	13.59	21.15	4.16	N.A.	N.A.
5th PLAN (1974-78)	84.10	1.46	0.20	152.03	13.37	14.375	9.66	N.A.	N.A.
ANNUAL PLANS (1978-80)	67.81	4.00	-0.40	50.89	11.74	11.35	7.30	12.6	N.A.
6th PLAN (1980-85)	46.46	8.49	-1.60	56.27	15.47	13.78	4.65	52.6	N.A.
7th PLAN (1985-90)	62.66	11.21	-2.30	31.33	30.40	28.38	1.85	189.3	N.A.
ANNUAL	84.62	8.91	-1.90	47.04	41.00	31.8	5.4	76.7	2.6

PLANS(1990-92)									
8th PLAN(1992-97)	91.60	4.94	-1.20	19.21	26.20	26.76	6.5	23.2	47.9
9th PLAN(1997-2000)*	93.25	4.95	-1.1	9.11	22.1@	17.77	8.2	12.2 @	48.6

Notes:

1. # relates to end of period
2. @ relates to end December 1999
3. N.A. : Not Available.

Statement

Period	Type of Shock	Policy Response
1. Second Plan period (1956-58)	Industrial Import Hump	Sterling Balances, Aid Flows (Aid India Consortium)
2. Third Plan period (194-65)	Drought, War	Aid, PL480 Food Assistance, IMF, Devaluation
3. First Oil Shock (1973-74)	Terms of Trade – PoL	Aid, IMF(CFF, Oil Facility)
4. Second Oil Shock (1979-80)	Terms of Trade – PoL	IMF (EFF)
5. Third Oil Shock (1990-91)	Terms of Trade – PoL Confidence – Capital Flight	IMF (Reserve Position, CFF, Standby), Exceptional bilateral Assistance (Japan, UK), Exceptional multilateral support (World

		Bank, ADB), gold pledge, IDBs, Immunities scheme, Devaluation, Stabilisation, Structural reform
6. Multiple Shocks (1997-2000)	Asian Crisis Sanctions - Pokhran Border Tensions - Kargil Terms of Trade - PoL	No adverse impact due to dynamic policy response. No approach to exceptional finance. Strengthening of external sector All dues to IMF repaid

CFF : Compensatory Financing Facility
EFF : Extended Fund Facility
IDBs : India Development Bonds
PoL : Petroleum Oil Lubricants