Managing Capital Flows*

Capital inflows to developing countries have many beneficial effects, especially in financing investment and economic growth; but they are also sometimes problematic for policy makers in developing countries. Large capital flows could push up monetary aggregates, create inflationary pressures, destabilise exchange rate, affect domestic financial sector, and finally disrupt the economy if and when such flows get reversed or drastically reduced. The experience so far has, therefore, brought to the fore the issue of managing such flows – specifically, how to maximise the benefits of such flows, and minimise costs of such flows, including the cost of risk of reversal of such flows. India is a relatively late entrant into the league of recipients of large private capital inflows and is still not a dominant player. Yet, there is a lively interest in the way in which India managed its capital flows, maximising growth and minimising costs - including the contagion effect. I intend sharing with you our experience in managing capital flows during the 'nineties, when we were putting in place a gamut of structural reforms.

The presentation will be in nine sections and these would cover: (a) the growth path and role of capital flows in the 'eighties and during the reform period, (b) policy framework for capital flows, (c) size and composition of capital flows, (d) tools of management of capital flows, (e) link with current account management, dollarisation, and internationalisation, (f) exchange rate management, (g) crises-avoidance strategies, (h) liberalisation of capital account, and (i) outlook.

Growth Path and Capital Flows

Macro parameters, viz., rate of growth in real Gross Domestic Product, savings and investment rates, movements in the incremental capital output ratio, current account deficit, capital flows and foreign exchange reserves, growth of money and domestic credit, and the rate of inflation are indicated in Table 1.

A quick look at the data presented in Table I will reveal that the growth rate in real GDP was consistently above 5 per cent throughout the 'eighties and 'nineties so far, except during the adjustment year of 1991-92. The investment rate has been consistently high at over 20 per cent during the period with over 90 per cent financed by gross domestic saving. The current account deficit was kept low below 3 per cent of GDP, barring the crisis year of 1990-91. On the inflation front too, a reasonable record was maintained barring a few years when it reached double digit. Broad money growth and domestic credit expansion have been, by and large, under control and more recently reserves have grown both in absolute terms and as a proportion to imports.

Briefly stated, the dependence on external flows was restricted and as will be explained, was deliberately, as a policy, kept at low levels. Growth performance, as well as productivity (as measured by ICOR) indicate at least a moderately successful performance during the whole period.

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Policy Framework

India, after independence, opted for a model of development characterised by what was then perceived as self-reliance. This meant that, until the ‘eighties; (a) financing of investments was almost wholly through domestic saving with recourse to foreign flows at the margin only; (b) reluctance to permit foreign investments or private commercial flows in general; (c) almost total reliance on official, especially multilateral flows, mainly on concessional terms; (d) recourse to IMF facilities to meet extraordinary situations such as the drought in 1960s, oil shock of late 1970s, an Extended Fund Facility (EFF) in the 1980s and more recently, in the early 1990s, the Gulf crisis; and (e) relatively greater emphasis on import-substitution rather than export-promotion. In brief, till 1980s, external financing was confined to external assistance through multilateral and bilateral sources, mostly on concessional terms to or through Government.

In the ‘eighties, global developments, particularly the perceptible decline in the availability of official concessional flows in relation to the external financing needs of developing countries, changed the external sector situation at a time when India was initiating liberalisation. The compulsions of repayments to IMF during the late ‘eighties (of the EFF drawals in the early ‘eighties) added to the problems. Hence, recourse to external debt on commercial terms became inevitable. In addition to institutional sources (such as Export-Import agencies), syndicated loans and bonds, and deposits from non-resident Indians were accessed. These had to be supplemented, in the late ‘eighties with significantly large recourse to short term facilities including, in particular, short-term non-resident deposits. The justification for this approach was to sustain the momentum of growth of the Indian economy which jumped from around 3 per cent per annum during 1950-80 to over 5 per cent in the ‘eighties, and to maintain the impressive export performance of the late ‘eighties.

The onset of the ‘nineties, however, saw the impact of the Gulf crisis on India. Combined with the large fiscal deficits of the ‘eighties and political uncertainties, repercussions of this development in the Gulf resulted in drying up of commercial sources of financing, withdrawal of non-resident deposits, large depletion in reserves and significant short-term debt overhang, in what could be described as a severe liquidity crisis in the balance of payments. Another global dimension that affected India’s management of the balance of payments during this period was the serious disruption of trade with the erstwhile USSR on top of worrisome recessionary tendencies in the industrialised countries and loss of export markets in West Asia.

The broad approach to reform in the external sector after the Gulf crisis was laid out in the Report of the High Level Committee on Balance of Payments chaired by Dr. C. Rangarajan. The Committee recommended the introduction of a market-determined exchange rate regime while emphasising the need to contain current account deficit within limits. It recommended, *inter alia*, liberalisation of current account transactions leading to current account convertibility; compositional shift in capital flows away from debt to non debt creating flows; strict regulation of external commercial borrowings, especially short-term debt; discouraging volatile elements of flows from non-resident Indians; gradual liberalisation of outflows; and dissociation of Government in the intermediation of flow of external assistance.

The policy framework for the external sector based on the Rangarajan Committee Report was implemented along with policy changes in trade, industrial and financial sectors.

Under trade policy, there has been a virtual elimination of licensing, a progressive shift of restricted items of imports to Open General Licence (OGL), and lowering of tariff barriers. Industrial policy has been characterised by delicensing, removal of monopoly clauses defining large industrial houses and removal of most reservations for public sector enterprises. The reforms in the area of financial sector were guided by recommendations of the Narasimham Committee (1991). Alongside the deregulation of the banking industry including entry for new private sector banks, the general thrust of monetary policy has been towards reduction in pre-emptions, greater recourse to open market operations, deregulation of interest rates and widening and deepening of financial markets. Simultaneously, measures have been undertaken to strengthen the institutional framework in banking, non-banking financial companies, financial institutions and stock markets through prudential norms, capital adequacy stipulations, improvements in payments and settlement mechanisms and strengthening of the supervisory framework. Institutional measures have also included recapitalisation of banks, improvements in debt recovery and most important, setting up of the Board for Financial Supervision and strengthening Bank's supervisory mechanisms. A second Narasimham Committee (1998) has recently given a road map for further reform of banking sector, and a number of recommendations on prudential norms have been announced in the latest policy statement on Monetary and Credit Policy.

Fiscal adjustment has been undertaken and a very significant measure is that the system of automatic monetisation of the fiscal deficit has been replaced by a system of Ways and Means Advances.

In brief, reform in the external sector was meshed with reform in other related sectors and within the external sector reform, capital flows were managed keeping in view the needs of efficiency and stability. There was a fairly smooth movement from an administered exchange rate system to a market-determined exchange rate. Reserve Bank attempts to ensure that volatility and speculative elements are curbed through both direct and indirect measures.

Size and Composition of Flows

Table 1 shows clearly that since the gradual liberalisation of capital account initiated in 1991, capital flows were in excess of current account deficit (CAD) except in 1992-93 and 1995-96, thus adding to reserves. It is interesting to note that the stock of external debt came down steeply from US $ 99.0 billion to US $ 93 billion during the year 1995-96 or from 32.3 per cent of GDP to 28.3 per cent of GDP, not only on account of valuation changes but also due to the path-breaking policy changes that occurred during the period. In fact, it will be interesting to note the difference between gross and net capital flows during the period (see Table 2). Furthermore, the decline in debt reflected the policy-induced shift in the composition of the capital account in favor of non-debt flows.

As regards composition of capital flows given in Table 3, private flows which averaged about 47 per cent the in the 'eighties, rose to 89 per cent in 1997-98. The most significant vehicle of private capital was Foreign Direct Investment which increased from US $ 47 million, i.e, less than 1 per cent of net capital flows in the 'eighties to 3.7 billion or 28 per cent of net capital flows in 1997-98.

Total portfolio investment flows on account of FIIs, GDRs and others have averaged around US $ 2.6 billion during 1995-96 to 1997-98 despite a sharp drop in flows during

1997-98 to $ 1.8 billion from $ 3.3 billion in 1996-97. The dimension of these flows should be assessed in the light of the overall slump in global portfolio flows to developing countries witnessed during 1997-98. Net Disbursements of commercial borrowings have roughly been close to $ 3 billion during the last three years, reflecting the policy of restraining commercial borrowings within sustainable limits. The level of short-term debt, which was US $ 8.54 billion in 1990-91, was reduced to US $ 5.03 billion by the end of March 1998. Outstanding net forward exchange liabilities of RBI, which rose to 3.2 billion in January 1998 declined to US $ 1.2 billion in September 1998. In brief, the level of current account deficit and compositional shift in capital flows turned out to be broadly in conformity with the policy framework adopted.

Tools of Management

The process of liberalisation of capital account has been very gradual. The appended Statement shows the landmarks in regard to liberalisation of current account, capital account, and exchange rate management bringing out clearly how the sequencing and complementarity were addressed.

Based on the policy frame and the projected financing requirement for each year, management of the capital account is operationalised through procedures for foreign direct investment, portfolio investment, external commercial borrowings, NRI deposits, and outflows.

The broad approach to targeting of foreign direct investment has been through a dual route, i.e., automatic and non-automatic, differentiated on the basis of sector and size and extent of ownership. For infrastructure and export-oriented units, 100 per cent of foreign ownership is generally permitted. Where the approval is automatic, activities and extent of ownership are listed while in regard to the rest, a case by case approval by a high powered Board is adopted.

Portfolio investments are restricted to select players, viz., FIIs. They could, subject to some restrictions, operate in equity and debt markets. FIIs are, permitted to invest in equity subject to a ceiling of 10 per cent for individual FIIs in a single company and 30 per cent collective FII investment ceiling in a single company. FIIs are also subject to higher short-term capital gains tax of 30 per cent as compared to 20 per cent for local investors. The long-term capital gains tax for FIIs is at the same level of 10 per cent as for local investors. Indian corporates are permitted, again through a process of approval of individual cases satisfying general guidelines, to access funds through Global Depository Receipts and Euroconvertibles.

External commercial borrowings are also subject to a ‘dual route’, viz., a small component of automatic and a major part through case-by-case approval, based on the size and sector. Short-term debt, including trade-related payments beyond 180 days, is subject to strict case-by-case approval of purpose, amount and terms. An overall annual ceiling is kept for all debt flows - both for short-term and medium to long-term.

In respect of NRI deposits, control over inflows is exercised through specification of interest rates or interest rate ceilings for different maturities in respect of deposits in select schemes, while, more generally, variable reserve requirements are stipulated for encouraging or discouraging such flows. In the recent period, there has been a decline in the policy recourse to the interest rate instrument. Most interest rates have been freed or have been linked to international rates. The reserve requirement, however, continues to be operated flexibly as a tool for managing capital flows in relation to the needs of the underlying conditions.

As regards external assistance, both bilateral and multilateral flows are administered by Government of India.

In respect of capital outflows, the approach has been to facilitate direct overseas investment through joint ventures and wholly owned subsidiaries and provision of financial support to promote exports, especially project exports from India. There are dual routes, namely automatic and case-by-case and there is an aggregate annual ceiling for such approvals. All exporters and exchange earners can have the option of crediting 50 per cent of their export proceeds to foreign currency accounts with banks in India. Exporters and exchange earners have also been given permission, on a selective basis, to maintain foreign currency accounts outside India and use them for permitted purposes which facilitate their overseas business promotion and growth.

However, there are occasions when large capital inflows do take place, in spite of recourse to all the tools of management. As will be explained later, recourse was taken to sterilisation through open market operations, changes in reserve requirements, foreign currency swaps, direct purchase and sale of foreign currencies in spot market, management of liquidity through repos, signalling through interest rate changes, i.e., bank rate, reporting requirements for larger forex operations and open positions by banks, interest changes rates changes applicable to export finance, and moral suasion.

While fiscal measures, mainly taxes, have been taken to discourage short-term flows in addition to quantitative restrictions, variable reserve requirements have been used as an instrument only for foreign currency denominated non-resident deposits. Transaction tax has not been considered appropriate. Holding of reserves in foreign currency for short-term flows was considered cumbersome and not worthwhile. In any case, reserve adequacy is continuously monitored to safeguard against sudden reversals of short-term flows.

Link with Current Account and Dollarisation

When India adopted current account convertibility in 1994, it was recognised, as emphasised by the Rangarajan Committee, that there could be capital outflows in the guise of current account transactions. Hence, certain safeguards were built into the regulations relating to current account transactions.

First, the requirement of repatriation and surrender of export proceeds was continued. Exporters were, however, allowed to retain a portion of their earnings in foreign currency accounts in India which could be used for approved purposes, thereby avoiding costs of conversion and reconversion.

Secondly, all authorised dealers were allowed to sell foreign exchange for underlying current account transactions which could be readily identified and supported by some documentary evidence.

Thirdly, indicative value limits were given for different kinds of transactions so that the amounts sold were reasonable in relation to the purpose. For higher amounts, the banks had to approach the RBI. This operational framework for current account transactions strengthened the effectiveness of management of capital account.

Fourthly, the RBI has been undertaking a leading role in the development and monitoring of money, Government Securities and forex markets. A proactive interest in the development of these markets has also enabled effective management of the current and capital accounts.

Fifthly, while ensuring orderly and cautious deregulation, every effort has been made to improve the information base on major transactions in the forex markets with respect to its nature and magnitude. Constant improvements are made to ensure the appropriateness, timeliness and quality of the information base. The insistence on adequate and timely details from Authorised Dealers in forex markets also helped in fine tuning the management of current and capital accounts.

On dollarisation, it was recognised that large scale dollar denominated assets within a country can disrupt the economy by creating potential for destabilising flows. We do not allow dollar denominated transactions between residents. Exchange earners' foreign currency accounts can be used only for external payments and if such balances have to be used for local payments, they have to be converted into rupees.

The counterpart of dollarisation is internationalisation of domestic currency. For example, there are instances when a currency of a developing country could be officially traded outside the country without any underlying trade or investment transactions. When such currencies are held increasingly outside the country and there is multiplication of such holding, any expectation that there will be a fall in the currency due to fundamentals or contagion leads to widespread sell off which results in very sharp fall in the currencies especially when the local markets are not well developed. India does not permit rupee to be transacted offshore, i.e., Rupee is not allowed to be officially used as international means of payment or store of value. Indian banks are not permitted to offer two way quotes to NRIs or non-resident banks.

A highly conservative approach is adopted with reference to dollarisation of domestic economy and internationalisation of domestic currency.

Exchange Rate Management

The exchange rate is determined by the market, i.e., forces of demand and supply. The objectives and purposes of exchange rate management are to ensure that economic fundamentals are reflected in the external value of the rupee as evidenced in the sustainable current account deficit. Subject to this predominant objective, the conduct of exchange rate policy is guided by three major purposes.

- First, to reduce excess volatility in exchange rates, while ensuring that the market correction of overvalued or undervalued exchange rate is orderly and calibrated.
- Second, to help maintain an adequate level of foreign exchange reserves.
- Third, to help eliminate market constraints with a view to the development of a healthy foreign exchange market.

As a general rule, foreign currency transactions take place for financing defined underlying transactions supported by documentation. Genuine hedging of exposures as well as some flexibility in dynamically reducing the cost of hedging is allowed. Basically, the policy is aimed at preventing destabilising speculation in the market while facilitating foreign exchange transactions at market rates for all permissible purposes.

Reserve Bank of India makes sales and purchases of foreign currency in the forex market, basically to even out lumpy demand or supply in the thin forex market; large lumpiness in demand is mainly on account of oil imports and external debt servicing on Government account. Such sales and purchases are not governed by a predetermined target or band around the exchange rate.

Crisis Avoidance Strategies

It would not be appropriate to conclude that managing capital flows on the above lines, however efficient, will ensure that there would be total stability in the capital flows. In fact, even with a managed capital account, we had to contend with occasional surges in capital flows between 1993 and 1997. In general, the short-term response has taken a number of forms, viz., raising of reserve requirements, reviewing the pace of removal of restrictions on capital inflows, relaxation of end-use specifications, liberalisation of capital outflows, partial sterilisation through open market operations, and deepening the foreign exchange market by routing an increased volume of transactions through the market.

The prolonged stability in the exchange rate of the rupee from March 1993 came under stress in the second half of 1995-96. In response to the upheavals, the RBI intervened in the market to signal that the fundamentals were in place and to ensure that market correction of the exchange rate was orderly and calibrated. Exchange market intervention was supported by monetary policy action to withdraw liquidity. The pressures intensified towards the end of January 1996 and the first week of February 1996. The Reserve Bank undertook a number of measures to encourage the faster realisation of export proceeds and to prevent an acceleration of import payments. The interest rate surcharge on import finance was raised, the scheme of post-shipment export credit denominated in foreign currency was scrapped and the RBI continued to intervene actively in the spot, forward and swap/money markets.

The year 1997-98 and the first quarter of 1998-99 posed severe challenges in exchange rate management in the face of the threat of external contagion and other uncertainties. Distinct phases of exchange rate movements and response of RBI can be identified. During April to September 1997, excess supply conditions prevailed in the market and the Reserve Bank undertook large net purchases of foreign currency. From September 1997 to mid-January 1998, acute exchange market pressure was staved off through sale of foreign currency, coupled with administrative and monetary policy measures. Mid-January to April 1998 marked the return of stability and enabled rolling back of tight monetary measures introduced in January 1998.

When the foreign exchange market was characterised by considerable uncertainties in May-June 1998, several measures were announced by the RBI in June 1998 to reverse the demand-supply mismatches in the market. The market responded positively to these measures, but in August 1998 there were fluctuations in the exchange rate in view of international developments. The RBI once again undertook strong administrative and monetary measures, which included increase in the repo rate and the cash reserve requirement of banks.

A vigilant and proactive policy by the RBI was, therefore, essential to avoid crisis in the highly unsettled environment of international currency markets.

An extraordinary situation arose in 1998-99 consequent upon imposition of sanctions and the issue of Resurgent India Bonds (RBIs) is an interesting example of management of capital account in such a situation. The RIBs were designed to compensate for the extraordinary events in 1998-99, which may have resulted in some shortfall in the normally expected level of capital inflows in relation to the current account deficit which would continue to be well within 2 per cent of GDP. Due to the sudden developments in 1998-99, a temporary disruption in capital flows, especially debt flows was anticipated.

Instead of dipping into currency reserves, which may affect sentiment adversely, or cutting the current account deficit through drastic import cuts which would affect real economic activity, the alternative was to enhance debt flows at the least possible cost. There was a need to offset the adverse negative market sentiment created in the international capital markets due to downgrading of India's sovereign rating to non-investment grade. This could be done by demonstrably raising debt resources at a cost lower than that any organised financial intermediary was prepared to provide in the context of the rating downgrade. Raising resources through sovereign borrowing was considered to be time consuming and in any case inadvisable as a maiden offering under adverse circumstances. At the same time, it was necessary to ensure that amounts so obtained were restricted quantitatively to meet essential needs as a replacement for normal debt flows by keeping an option for premature closure. Furthermore, we had to ensure that the borrowing had an appropriate medium-term maturity, say, five years RIBs, which are essentially in the nature of foreign currency deposits on par with FCNR (B), were devised keeping in view these considerations. It was also necessary for RBI to ensure that these funds do not disrupt the money, forex or Government securities market.

There have been three main points of criticism regarding RIBs, i.e., the cost of raising RIBs, substitution of FCNR-B deposits and exchange rate guarantee.

A total amount of $ 4.23 billion has been mobilised at a moderate cost in a difficult international environment and in the face of recent downgrading of our credit rating. Some have called it the deal of the year. To quote an international investor, "… the cost at which funds have been raised imply a perceived sovereign rating three to four notches higher than current levels. For comparison sake China's 2003 Yankee Bond Issue, rated A3 by Moody's traded at a spread of 280 basis points (on August 21) over the ten year US Treasury implying a dollar yield of 7.90 per cent and the RIB issue is not even sovereign risk."

On the second point, as most of the banks that have actively mobilised RIBs, may be aware by now, there has been limited substitution from FCNR-B deposits and moreover, to the extent there has been substitution, it would result in elongation of the maturity of deposits to five years, while at the same time bringing into the country actual foreign exchange that was being kept unswapped.

In regard to the exchange guarantee extended, it is recognised that under normal circumstances, issuance of such guarantee is inadvisable. It can be, however, legitimately held that the recent times have been far from normal. In return for a specific guarantee on RIBs, the Government can claim benefits in four ways, viz., addition to forex reserves, support to macroeconomic environment and sentiment, indirect support for its own borrowing programme and resources for infrastructure development, including for public sector entities. It can also be argued that Government bears exchange risk in regard to bilateral and multilateral flows for its use or for onlending. Moreover, given the Indian track record on prudent macro economic management, the burden of the exchange guarantee could be said to be manageable.

Liberalisation of Capital Account

As evident from the foregoing analysis, liberalisation with respect to inflow of capital has been substantial but gradual. Having accepted Article VIII status of the IMF with respect to current account convertibility in August 1994, a framework for capital account convertibility was sought to be achieved in a phased manner. The committee on Capital

Account Convertibility, with Dr.S.S.Tarapore as Chairman, submitted its Report in May 1997. The Committee observed that although there were benefits of a more open capital account, international experience showed that a more open capital account could also impose tremendous pressures on the financial system. Hence, the committee indicated certain signposts or preconditions for capital account convertibility in India.

The three crucial preconditions were fiscal consolidation, a mandated inflation target and above all, strengthening of the financial system. The committee recommended a reduction in Gross Fiscal Deficit / Gross Domestic Product ratio from 4.5 per cent to 3.5 per cent in 1999-2000 and a mandated rate of inflation for the period 1997-98 to 1999-2000 at an average of 3 to 5 per cent. In the financial sector, the time frame for signposts that were recommended were in terms of cash reserve ratio (CRR) and non-performing assets (NPAs). The recommendations were to reduce gross NPAs of banks as a percentage of total advances from 13.7 per cent in 1996-97 to 9 per cent by 1998-99 and to 5 per cent by 1999-2000, and the average effective CRR from 9.3 as of April 1997 to 3 per cent by 1999-2000.

The committee then felt that the preconditions could be satisfied in three years, and therefore, it adopted a three-year time frame for CAC. A basic dictum of the Committee was that the timeframe for implementation of the measures could be shortened or elongated in accordance with the performance on the preconditions and that attainment of preconditions and implementation of measures should be considered as a simultaneous process. A significant feature was that the committee did not recommend unlimited or open CAC, but preferred a phased liberalisation of controls on outflows and inflows over a three-year period. It may be noted that as per the committee’s recommendations, even at the end of three-year period, capital account will not be fully open and some flows, especially debt would continue to be managed.

Most of the measures related to removing the controls on outflows more than inflows. Specifically, it addressed issues such as investment abroad by Indian Joint Ventures/Wholly Owned Subsidiaries; retention of earnings by exporters/exchange earners; investment by individual residents in assets in financial markets abroad; and more liberal limits for banks in regard to borrowing and deployment of funds outside India. In addition, the Committee addressed the issue of proper governance and transparency, and the need to develop and gradually enable integration of forex, money and securities markets.

It would be useful to assess the current status with regard to both the measures and the signposts recommended by the committee. The monetary policy of October 1997 implemented some of the recommendations of the committee. These included, increasing the retention portion of exchange earning in the foreign exchange account to 50 per cent, dispension with prior approval from the RBI for execution of projects abroad, permitting ADs to undertake forfaiting of medium-term export receivables, allowing corporate entities to open offices abroad without the need for prior approval from the RBI, providing credit/non-credit facilities to joint ventures abroad and permitting SEBI registered Indian fund managers including mutual funds to invest in overseas markets subject to individual and total overall caps. Permission was also granted to banks fulfilling certain criteria to import gold for domestic sale. Recently, FIIs have been permitted to invest in Treasury Bills. They are also permitted to cover in the forward market their entire exposure in the debt market. FIIs can now to cover up to 15 per cent of their equity exposure in the forward market and 100 per cent of their incremental investments after June 1998.

In respect of the variables identified as signposts, the GFD/GDP is budgeted at 5.6 per cent for 1998-99, inflation is currently hovering around 8.0 per cent, the current level of CRR is at 11.0 per cent (effective level 9.75 per cent), and the gross NPA as a percentage of total advances of public sector banks stood at 16.0 per cent in 1997-98.

Thus, the roadmap for further liberalisation of capital account will have to be built over the progress so far, domestic and international developments. The current approach can be summarised as under:

(a) Between the preconditions and the time frame for CAC recommended by the committee, it is clear that the achievement of preconditions has emerged, as perhaps intended, the more important criterion for liberalising the capital account, while the timetable itself has lesser significance.

(b) In the context of the East Asian crisis, the liberalisation of capital account will also hinge upon the establishment of an appropriate international financial architecture.

(c) The East Asian crisis has vindicated the committee's stand with regard to preconditions and there is need, if at all, to further refine and detail the preconditions to capture the recent experiences.

(d) The measures for liberalising capital account need to be kept under continuous review, would warrant some repackaging and in any case, to be cautiously implemented.

Review and Outlook

We, in India, have cautiously but systematically moved from control regime, out of a crisis, into current account convertibility and market-determined exchange rate. We have managed capital account to ensure growth with stability, consistently adding to our foreign currency reserves. We also experienced and managed phases of excessive capital movements: there were surges of capital inflows during 1993-95, and two major episodes of volatility in flows in the second half of 1995-96 and again during 1997-98. In the periods of exchange rate volatility, there were major imponderables involved, both externally and internally, and contagion and herd behaviour had to be guarded against. In both situations the co-ordinated policy framework and the careful calibration of instruments with market pressures enabled an effective management of capital flows without any distortive shocks on the performance of the economy.

In conclusion, the policy of cautious movement towards capital account liberalisation that has been adopted by us continues to be valid. We in India treat liberalisation of capital account as a process and not a single event; to be embarked upon cautiously as part of overall economic reforms in our country as well as our assessment of the emerging scenario relating to international economic and financial architecture.

Table 1: Macroeconomic Indicators

	1980-85	1985-90	1990-91	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98
Real GDP Growth(%)	5.7	6	5.4	0.8	5.3	6.2	7.8	7.2	7.5	5.1
Saving Rate(%)	19.4	20.6	24.3	22.9	22	22.7	25.6	25.3	26.1	na
Investment Rate	20.9	23.1	27.7	23.4	23.9	23.3	26.9	27.1	27.3	na
ICOR	3.6	3.9	4.8	51.4	4.3	4.7	3.6	4	4	na
CAD(% of GDP)	1.6	2.3	3.2	0.4	1.8	0.4	1.1	1.8	1.2	1.7
Capital Account(% of GDP)	0.6	2.3	2.4	1.5	1.3	3.8	3	1.4	3.1	2.9
Reserves/Imports(Months)	4.1	3.4	2.5	5.3	4.9	8.6	8.4	6	6.6	7.3
External Debt, end-March ($ bn)	28.8	75.86	83.8	85.29	90.02	92.7	99.01	92.98	93.43	94.4
External Debt, end-March (% of GDP)	15.6	28.5	30.4	41	39.8	35.8	32.3	28.3	26.2	26.4
Short term Debt, end-March ($ bn)	na	7.5	8.54	7.07	6.34	3.63	4.27	5.05	6.73	5.03
M3 Growth(%)	17	17.6	15.1	19.3	15.7	18.4	22.3	13.7	16.2	17.6
Domestic Credit Growth(%)	18	16.43	13.2	9.4	17.1	8.0	23.1	17.7	9.2	14.9
Inflation, WPI, Average of Weeks	9.3	6.7	10.3	13.7	10.1	8.4	10.9	7.7	6.4	4.8

Table 2
Capital Flows in India

US $ million

	1980s	1990-91			1991-92			1992-93		
	Net	Inflows	Outflows	Net	Inflows	Outflows	Net	Inflows	Outflows	Net
Foreign Investment	97	113	10	103	151	18	133	589	32	557
(a) Direct	42	107	10	97	147	18	129	345	30	315
(b) Portfolio	55	6	0	6	4	0	4	244	2	242
External Assistance	1487	3397	1193	2204	4366	1335	3031	3302	1446	1856
External Commercial Borrowings	1044	4282	2028	2254	3152	1689	1463	1179	1545	-366
Banking Capital	9.34	2758	3612	-854	3263	2989	274	2810	985	1825
Non Resident Deposits	1237	7347	5811	1536	7695	7405	290	9188	7187	2001
Rupee Debt Service	0	0	1193	-1193	0	1240	-1240	0	878	-878
Short Term Capital	-23.26	1752	677	1075	1898	2413	-515	4190	5269	-1079
Indian Investment Abroad	0	0	0	0	0	0	0	0	0	0
Other Capital (net)	126	3117	1186	1931	2809	2335	474	1359	1399	-40
IMF	76	1858	644	1214	1245	459	786	1623	335	1288
Total	5025	24624	16354	8270	24579	19883	4696	24240	19076	5164

US $ million

	1993-94			1994-95			1995-96		
	Inflows	Outflows	Net	Inflows	Outflows	Net	Inflows	Outflows	Net
Foreign Investment	4611	376	4235	5763	956	4807	5632	1028	4604
(a) Direct	651	65	586	1361	133	1228	2176	233	1943
(b) Portfolio	3960	311	3649	4402	823	3579	3456	795	2661
External Assistance	3476	1580	1896	3193	1675	1518	2933	2066	867
External Commercial Borrowings	3015	2330	685	4249	3125	1124	4262	2977	1285
Banking Capital	2650	1592	1058	1215	1721	-506	1524	1865	-341
Non Resident Deposits	8850	7645	1205	5805	5633	172	4929	3826	1103
Rupee Debt Service	0	1053	-1053	0	983	-983	0	952	-952
Short Term Capital	3480	4249	-769	3488	3095	393	4137	4088	49

Indian Investment Abroad	0	0	0	10	125	-115	14	204	-190
Other Capital (net)	2873	1235	1638	2201	224	1977	748	3285	-2537
IMF	321	134	187	0	1143	-1143	0	1715	-1715
Total	29276	20194	9082	25914	18555	7359	24165	21802	2363

US $ million

	1996-97			**1997-98**		
	Inflows	**Outflows**	**Net**	**Inflows**	**Outflows**	**Net**
Foreign Investment	7699	1861	5838	8906	3913	4993
(a) Direct	2746	220	2526	3333	168	3165
(b) Portfolio	4953	1641	3312	5573	3745	1828
External Assistance	3056	1955	1101	2877	2000	877
External Commercial Borrowings	7579	4723	2856	7382	3372	4010
Banking Capital	1243	2364	-1121	1378	3396	-2018
Non Resident Deposits	6775	3425	3350	7532	6407	1125
Rupee Debt Service	0	727	-727	0	767	-767
Short Term Capital	7085	6247	838	7034	7130	-96
Indian Investment Abroad	8	198	-190	97	134	-37
Other Capital (net)	2629	2883	-254	6263	2463	3800
IMF	0	975	-975	0	618	-618
Total	36066	25160	10906	41372	30066	11306

Table 3: Net Capital Flows in India

(In per cent)

	1980s*	1990-91	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98
	(Average)								
Foreign Investment	1.93	1.25	2.83	10.79	46.63	65.32	194.84	53.53	44.16
(a) Direct	0.84	1.17	2.75	6.10	6.45	16.69	82.23	23.16	27.99
(b) Portfolio	1.09	0.07	0.09	4.69	40.18	48.63	112.61	30.37	16.17
External Assistance	29.59	26.65	64.54	35.94	20.88	20.63	36.69	10.10	7.76
External Commercial Borrowings	20.78	27.26	31.15	-7.09	7.54	15.27	54.38	26.19	35.47
Banking Capital	0.19	-10.33	5.83	35.34	11.65	-6.88	-14.43	-10.28	-17.85
Non Resident Deposits	24.62	18.57	6.18	38.75	13.27	2.34	46.68	30.72	9.95
Rupee Debt Service	0.00	-14.43	-26.41	-17.00	-11.59	-13.36	-40.29	-6.67	-6.78
Short Term Capital	-0.46	13.00	-10.97	-20.89	-8.47	5.34	2.07	7.68	-0.85
Indian Investment Abroad	0.00	0.00	0.00	0.00	0.00	-1.56	-8.04	-1.74	-0.33
Other acapital	2.51	23.35	10.09	-0.77	18.04	26.87	-107.36	-2.33	33.61
IMF	1.51	14.68	16.74	24.94	2.06	-15.53	-72.58	-8.94	-5.47
Foreign Exchange Reserve (US$bn.)	3.96	5.83	9.22	9.83	19.25	25.19	21.69	26.42	29.37
(end of period)									

Major External Sector Policies : 1991-98 (Statement)

Year	Current Account Measures	Capital Account Measures	Exchange Rate Measures	Others Measures
1990-91	• Measures taken to control imports and expedite the repatri-ation of export proceeds • New Trade policy announced in July 1991.	• Access to short term credit to the Indian borrowers, particularly Bankers' Acceptance Facilty restricted. • Negotiated with the IMF for the drawal of loans under the Compensatory and Contingency Financing Facility (CCFF) and First credit tranche of its Stand-by Arrangement. • Foreign Currency Banks and Other Deposits Scheme (FC(B&O)D) introduced.		
1991-92	• Persons of Indian origin permitted to import gold up to 5 kgs.	• Foreign Currency Ordinary Non-Repatriable Scheme (FCON) introduced. • Liberalisation of foreign direct investment of industries in Annexure III of the Statement of Industrial Policy, 1991. • The Scheme of India Development Bonds (IDBs) introduced by the State Bank of India aggregated US $1.6 billion. • Foreign Institutional Investors (FIIs) permitted to invest in all securities traded on the primary and secondary markets subject to a ceiling of 24 per cent of the equity of the company.	• Downward adjustment of Indian Rupees in terms of US dollar by 18 per cent. • Liberalised Exchange Rate Management System (LERMS) through which one leg of the exchange rate, applicable to 40 per cent of all current receipts, essential imports and debt service payments, was determined by the Reserve Bank and the other leg, which applied to all other transactions, was determined by the market.	• Pledging of monetary gold in the international market

Year	Current Account Measures	Capital Account Measures	Exchange Rate Measures	Others Measures
1992-93	• Persons of Indian origin permitted to import silver up to 100 kgs	• Indian company launches the first GDR issue of India. • Non-Resident Non-Repatriable Account Scheme (NRNR) introduced.	• Exchange rate was unified through which the external value of the rupee to be market related.	• Comprehensive amendments to the FERA.
1993-94		• FCNR (B) scheme introduced. • FC (B & O) D scheme withdrawn.		
1994-95	• India accepted obligat-ions under Article 2,3 and 4 of Article VIII of the Articles of Agreem-ent of the IMF. • Interest accrued on NRNRD along with other current account liberalisa-tion measures made eligible for repatriation.	• FCNR(A) scheme withdrawn in a phased manner. • FCNR (A) scheme withdrawn in a phased manner.		
1995-96		• Liberalised Guidelines for Indian investment abroad in Wholly Owned Subsidiaries and Joint Ventures with fast track approvals from the Reserve Bank.	• The Report of the Expert Group on Foreign Exchange Markets in India (Chairman : Shri. O.P. Sodhani) submitted. • ADs allowed to decide their foreign exchange overnight open position limits subject to approval from RBI and their maintaining of Tier I capital funds of 5 per cent of the foreign exchange open position limits.	• Post shipment credit in Foreign currency (PSCFC) scheme withdrawn.

Year	Current Account Measures	Capital Account Measures	Exchange Rate Measures	Others Measures
1996-97		• 100 per cent dedicated debt funds allowed to invest in private debt instruments of Indian companies. • Greater access to investment proposals under the Automatic Approval Route to foreign investors. • Application for raising foreign currency loan under US $ 3 million scheme and short term loan to be considered by the RBI. • RBI appointed a committee on Capital Account Convertibility which submitted its Report on May 30, 1997. • FII allowed to invest in GOI dated securities.	• Aggregate Gap Limit (AGL) left to be fixed by individual banks depending upon their foreign exchange operation, risk taking capacity, balance sheet size and other relevant parameters subject to approval from the RBI. • ADs permitted to offer cost effective and risk reduction option strategies. • ADs permitted to use interest rate swaps, currency swaps, forward rate agreement instruments to hedge their asset liability portfolio. • ADs having the requisite infrastructure, risk control mechanism and satisfying capital adequacy norms, were permitted to initiate cross currency positions in the overseas market.	

Year	Current Account Measures	Capital Account Measures	Exchange Rate Measures	Others Measures
1997-98	• Major revision in the EXIM Policy 1997-2002. • RBI announced detailed eligibility criteria to apply for authorisation as a nominated agency for import of Gold/ Silver/ Platinum.		• ADs were allowed to book forward cover for exporters and importers without the requirement of documentary evidence of a firm order for letter of credit, but on the basis of a declaration of exposure supported by past performance and business projection. • ADs permitted to provide forward exchange cover to FIIs in respect to their investments in debt instruments in India. • ADs permitted to extend forward cover to holders of FCNR/ NRE to enable them to hedge the balance therein. • ADs were permitted to invest/ borrow amounts up to a maximum extent of 15 % of their unimpaired Tier I or US $ 10 million, whichever is higher, capital as against the previous ceiling of US $ 10 million.	• CRR of 10 per cent imposed on incremental liability over April 11, 1997 under FCNR(B) deposit. • Banks including primary co-operatives which are ADs in foreign exchange permitted to fix interest rates on NRE term deposits of 6 months and above. • RBI appointed a Committee on Hedging through internati-onal Commodity exchanges which formally submitted its recommendations on November 21, 1997. • Interest rates charged on rupee loans out of /against FCNR(B) deposits made consistent with lending rates for rupee loans in general. • The incremental CRR of 10 per cent on NRE and NRNR deposit scheme imposed on the increase in the level outs-tanding as on April 11, 1997, was removed, with effect from December 6, 1997.

Year	Current Account Measures	Capital Account Measures	Exchange Rate Measures	Others Measures
1998-99		• FIIs allowed to invest in GOI Treasury Bills.	• ADs permitted to provide forward cover to FIIs in respect of their fresh investment in India in equity and appreciation in the market value of their existing investment in India	