Investing in India: Challenges and Opportunities*

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I am extremely happy to be here at the *Pravasi Bharatiya Divas* 2005. Whether in the spirit of the traditional Indian culture of *Vasudaiva Kutumbakam*, or in the context of a globalised world, I would *not* like to treat the *Pravasi Bharatiyas* as 'distant', but close to both our hearts and the economy. We are, of course, very proud of the achievements of the Indians settled abroad. It is, therefore, only befitting that the great Indian family should meet once a year.

The topic chosen for today's discussion, *viz*., finance and growth, is indeed apposite. I propose to cover in my address the role of the RBI in maintaining an environment conducive to investment and growth. These essentially relate to maintaining monetary and financial stability which can be achieved through an appropriate monetary policy framework, sound financial sector policies and strong external sector.

MONETARY POLICY

Structural reforms in the Indian economy since the early 1990s impacted upon the various aspects of monetary policy - its objectives, strategies and tactics. Price stability and ensuring adequate credit to productive sectors of the economy have been the twin objectives of monetary policy since Independence. The relative emphasis between these two objectives depends on the underlying economic conditions and is spelt out from time to time. Although with the introduction of the structural reforms, there has been a shift in the policy from a planned and administered interest rate regime to a market-oriented financial system, credit availability remains an important objective of monetary policy in India.

At the same time, with the opening up of the economy since the early 1990s, financial stability has now emerged as a key consideration in the conduct of monetary policy. Monetary management has now to contend with vicissitudes of capital flows and the resultant volatility in exchange rates. A related difficulty is that whereas the distinction between short term and long term flows is conceptually clear, in practice, however, it is not always easy to distinguish between the two for operational purposes. Moreover, at any given time, some flows could be of an enduring nature whereas others could be temporary and, hence, reversible. More importantly, what appears to be short-term could tend to last longer and *vice versa*, imparting a dynamic dimension to judgment about their relative composition? In a scenario of uncertainty facing the authorities in determining temporary or permanent nature of inflows, it is prudent to presume that such flows are temporary till such time that they are firmly established to be of a permanent nature. The instruments and operating procedures of monetary policy have, therefore, to be constantly refined to meet the challenges thrown up by such capital flows and a market-determined exchange rate. This necessitated a complete recast of the monetary policy operating procedure by moving away from statutory preemptions and direct controls to an array of indirect instruments to modulate liquidity conditions in tune with the process of price discovery. The Reserve Bank is now able to influence the quantum of liquidity through a policy mix of open market (including repo) operations alongside changes in reserve requirements and standing facilities, reinforced by interest rate signals, through changes in the policy rates which impact the price of primary liquidity. Illustratively, in India, existing arrangements to modulate liquidity had to be supplemented with innovations such as the Market Stabilisation Scheme.

BANKING SECTOR REFORMS

As the economy grows and becomes more sophisticated, the banking sector has to develop *pari passu* in a manner so that it supports and stimulates such growth. With increasing global integration, the Indian banking system and financial system as a whole had to be strengthened so as to be able to compete.

Until the beginning of the 1990s, the state of the financial sector in India could be described as a classic example of "financial repression", *a la* MacKinnon and Shaw. While the true health of financial intermediaries, most of them public sector entities, was masked by relatively opaque accounting norms and limited disclosure, there were general concerns about their viability. Scant attention was placed on the financial health of the intermediaries. Their capitalisation levels were low. The lack of commercial considerations in credit planning and weak recovery culture resulted in a large accumulation of non-performing loans.

Starting from such a position, it is widely recognised that the Indian financial sector over the last decade has been transformed into a reasonably sophisticated, diverse and resilient system. However, this transformation has been the

culmination of extensive, well-sequenced and coordinated policy measures aimed at making the Indian financial sector efficient, competitive and stable. These measures covered prudential, competition enhancing institutional and legal and supervisory measures.

An important feature of the move towards globalisation of the Indian financial system has been the intent of the authorities to move towards international best practices. This is illustrated by the appointment of several advisory groups designed to benchmark Indian practices with international standards in several crucial areas of importance like monetary policy, banking supervision, data dissemination, corporate governance and the like. Towards this end, a Standing Committee on International Financial Standards and Codes (Chairman: Dr. Y. V. Reddy) was constituted and the recommendations contained therein have either been implemented or are in the process of implementation. The RBI has recently prepared a Report that reviews the progress, provides the current status on the implementation and captures new developments in the field of international financial standards and codes.

EXTERNAL SECTOR MANAGEMENT

The overall objective of external sector reforms was to achieve higher growth and efficiency without exposing the system to greater vulnerability. The position of the external sector today is in marked contrast to the balance of payments crisis of 1991, when default was perceived as a real threat. As is well known even in these circumstances India did not default on any of its obligations and maintained its excellent track record of debt service. At that time reserves were down to less than US$ 1 billion and external debt was around US$ 85 billion as against the current position where reserves are more than external debt. We Indians can be proud of the fact that even during the worst currency crisis India did not reschedule, roll over or default on its obligations which is unparalleled.

The process of opening up the Indian economy has proceeded in steady steps. First, the exchange rate regime was allowed to be determined by market forces as against the fixed exchange rate linked to a basket of currencies. Second, this was followed by the convertibility of the Indian rupee for current account transactions with India accepting the obligations under Article VIII of the IMF in August 1994. Third, capital account convertibility has proceeded at a steady pace. We view it as a process rather than as an event. At present, the *de facto* full capital account convertibility for non-residents is supported by the calibrated liberalisation of transactions undertaken for capital account purposes in the case of residents. Fourth, the distinct improvement in the external sector has enabled a progressive liberalisation of the exchange and payments regime in India. Reflecting the changed approach to foreign exchange restrictions, the restrictive Foreign Exchange Regulation Act (FERA), 1973 has been replaced by the Foreign Exchange Management Act (FEMA), 1999. It may not be entirely an issue of semantics that the 'Exchange Control Department' of the RBI has been rechristened as 'Foreign Exchange Department'.

WHAT HAVE WE ACHIEVED?

How did these measures get translated into tangible economic results? While assessing the conduct of policies in recent years, one needs to take cognisance of the fact that the Indian economy witnessed a large number of shocks, both global and domestic. These shocks included a series of financial crises in Asia, Brazil and Russia besides September 11 terrorist attacks in the US, border tensions, sanctions imposed in the aftermath of nuclear tests and political uncertainties. From the vantage point of 2005, it seems that our strategy worked and worked reasonably well.

There was a sharp fall in the average inflation rate to 5.8 per cent during 1994-95 to 2003-04, which is far below the long-run average of about 8.0 per cent during the 1970s-90s. While year-to-year inflation may vary depending upon the intensity of supply shocks, monetary policy can stabilise inflation expectations at low levels. It is necessary to underscore that the moderation in inflation has been wrought in an atmosphere of multiple challenges.

- First of all, there have been a number of supply shocks, including the major drought of 2002-03. It is a measure of the improvement in supply management over the years that the inflation rate, at 3.4 per cent during 2002-03, was far lower than 8.1 per cent in 1987-88, the last drought year. Food article prices were, in fact, only marginally higher at 1.8 per cent than 9.0 per cent of 1987-88.
- Secondly, it must be understood that large capital flows, although an indicator of investor confidence, also pose challenges for price stability. The Reserve Bank has been able to put in a carefully crafted monetary policy strategy to maintain orderly conditions in the financial markets, on the one hand and to ensure price stability on the other.
- Finally, it is necessary to appreciate that inflationary expectations in the economy are also coming down.

What had been the impact on the banking sector? The banking sector had been able to withstand various shocks and provided the foundation for a safe and sound financial infrastructure. Among various indicators, let me highlight three basic indicators:

- There has been a significant improvement in the capital position of the banking system. As at end-March 2004 scheduled commercial banks had a capital to risk-weighted asset ratio (CRAR) of 12.9 percent.
- Net non-performing assets of the banking system have come down (as percentage of net advances) to 2.9 per cent by March 2004 from 8.1 per cent in 1996-97.
- Despite the fact that banks were required to follow income recognition and provisioning norms and that there was intensification of competition, the profitability of the banking system has improved to over 1.0 per cent of total assets since March 2003 from 0.2 per cent as at end-March 1996.

No discussion on the achievement of financial sector reforms is complete without a discussion on financial stability in Indian context. Following Governor Reddy, financial stability in the Indian context could be interpreted to embrace: (a) ensuring uninterrupted financial transactions, (b) maintenance of a level of confidence in the financial system amongst all the participants and stakeholders, and (c) absence of excess volatility that unduly and adversely affects real economic activity.[1] The stability of the Indian financial system has been tested on certain occasions and the financial system has proved its resilience.

The management of the external sector is seen as another success story. Before I delve into the details of the impact of reform in external sector, consider the following broad indicators:

- The current account deficit contracted to an average of only 0.6 per cent of GDP during 1994-95 to 2003-04 from 1.8 per cent in the 1980s. It, in fact, recorded a surplus since 2001-02 after a period of 23 years.
- Key indicators of debt sustainability point to the continuing consolidation and improved solvency in the 1990s. The external debt to GDP ratio declined sharply from 38.7 per cent at end-March 1992 to 17.6 per cent at end-March 2004.
- The present Indian regime of market determined exchange rate and focusing on managing volatility without any fixed target has served India well. In line with the policy preference, we have emphasised the need for non-debt flows rather than debt flows in our capital account during the 1990s.
- We now have foreign exchange reserves of over US$ 130 billion, which is the sixth largest in the world, which is a far cry from the situation of August 1991 when foreign exchange reserves dwindled to US$ 0.8 billion. Our foreign exchange reserves are, in fact, larger than our external debt.

It is now well recognised that the Indian approach to exchange rate management with a focus on managing volatility has stood the test of time. The Indian approach to exchange rate management has been even described as an ideal for Asia.

[1] **Reddy, Y. V (2004): "Financial Stability: Indian Experience", Lecture at Zurich University, Zurich, Switzerland, *RBI Bulletin*, July.**

The merits of our cautious approach to capital account convertibility are now well appreciated. Gradualism in liberalisation implies that the mix between controlled, regulated and liberalised capital transactions keeps changing gradually in favour of the latter. We did not have to reverse policies towards the capital account as was the case with some emerging market economies that had followed a relatively rapid liberalisation without entrenching the necessary preconditions. We have repeatedly emphasised that our approach to capital account convertibility is a process rather than an event, contingent on achieving certain preconditions related to health and strength of the financial sector, sustainability in the fiscal sector and containment of inflation. Over the years, the policy regime in regard to capital account inflows and outflows in India has witnessed a significant liberalisation. There are, however, two areas where extreme caution continues to be exercised, *viz*., (i) unlimited access to short-term external commercial borrowing; and (ii) providing unrestricted freedom to domestic residents to convert their domestic bank deposits and idle assets (such as, real estate).

AVENUES FOR INVESTMENT IN INDIA

Having talked of the success story of reforms let me now turn to the avenues of investment in India. Several such options are available, depending on the risk and return profile of the investment in mind. Instead of providing a shopping list, let me give a quick rundown of the menu available.

One of the oldest avenues is the NRI deposit. Since the early 1970s, when the Non-Resident (External) Deposit Scheme was introduced, the Reserve Bank has offered various facilities for non-resident Indians in the form of deposit schemes. Since the 1990s, the Reserve Bank's policy in this regard has been aimed at attracting a stable pool of NRI deposits for providing a support to balance of payments. NRI deposits, at US$ 33.3 billion as at end-March 2004, emerged as a major source of capital inflows during the 1990s. Apart from the size, the success of the policy is also reflected in an increase in the proportion of local currency denominated deposits from around one-fourth in 1991 to almost two-third by 2002. This has been accompanied by a rationalisation of interest rates on rupee-denominated NRI deposits. This apart, we are now linking interest rates on foreign currency denominated deposits to LIBOR. The Reserve Bank has been de-emphasising short-term (up to 12 months) foreign currency denominated deposits in view of its attendant implications. These measures have been counterbalanced by several incentives to accord NRIs operational flexibility. Funds of US$ one million can be remitted through authorised dealers after payment of taxes subject to certain limits in case of property. Authorised dealers (ADs) are now permitted to grant rupee loans to NRIs. Earlier, housing loans availed by NRIs/Persons of Indian Origin (PIOs) could be repaid by borrowers either by way of inward remittances through normal banking channels or by debit to NRE/ FCNR(B)/NRO/NRNR/NRSR accounts or out of rental incomes derived from the property. Since May 2004, borrowers' close relatives in India are allowed to repay the instalment of such loans, interest and other charges directly to the concerned ADs/ housing finance institutions through their bank accounts.

A second avenue is foreign portfolio investment. We now provide an operating environment which is now much more congenial because of procedural changes for investment and facilities for investment in equity securities as well as in debt securities. NRIs and PIOs are also permitted to invest in shares and debentures of Indian companies, government securities, commercial papers, company deposits and mutual funds. An NRI is permitted to purchase/sell shares and/or convertible debentures of an Indian company through a registered broker on a recognised stock exchange provided his/her transactions are routed through designated branch of an AD in India subject to prescribed limits. Although the aggregate paid-up value of shares of the company purchased by NRIs should not exceed 10 per cent of the total paid-up capital and convertible debentures, respectively, the ceiling can be raised to 24 per cent if a Special Resolution to that effect is passed by the concerned company. NRIs are allowed to invest in exchange traded derivative contracts approved by the SEBI out of rupee funds held in India on a non-repatriable basis.

Yet another avenue is foreign direct investment. It will be recalled that a major policy thrust towards attracting foreign direct investment (FDI) was outlined in the New Industrial Policy Statement of 1991. Since then, continuous efforts have been made to liberalise and simplify the norms and procedures pertaining to FDI. At present, FDI is permitted under the automatic route subject to specific guidelines except for a small negative list. To put this in perspective, let me mention the so-called negative list: There are just six[2] sectors where investments are prohibited. There are twelve[3] sectors where investments require prior approval of the Government. Further, under the automatic route, investments only in six[4] sectors are subject to sectoral caps.

Until recently, acquisition of shares from residents by non-residents through private arrangement required Government approval. Such acquisition of shares, except in financial services sector, by private arrangement no longer requires Government approval. This implies that FDI is virtually welcome in a number of sectors without any prior approval. Non-residents are permitted to enter into forward sale contracts with ADs in India to hedge the currency risk arising out of their proposed FDI in India. Non-resident shareholders were allowed to apply for issue of additional equity shares or preference shares or convertible debentures over and above their rights entitlements. Allotment is subject to the condition that the overall issue of shares to non-residents in the total paid-up capital of the company does not exceed the sectoral cap. FDI by NRIs, however, continues to be negligible.

So far I have not mentioned about the role of remittances. During 2003-04, remittances amounted to around US$ 22.8 billion. In fact, of the Asian countries, apart from India it is only the Philippines that is receiving remittances in excess of 3 per cent of GDP. I compliment the Indian Diaspora for being such a source of resilience to the Indian economy. This apart,

in view of demographic challenge facing the Western countries, remittances have an additional dimension. To the extent that they are essentially in the nature of family maintenance transfers they are surely funding a non-trivial population of the aged. For the recipient countries, remittances have the potential of reducing the pressure of dependency ratios and increasing growth. It is also good for the remitting countries, facing the old-age challenge, through augmentation of their work force.

CONCLUDING OBSERVATIONS

India has come a long way from the days of crisis of the early 1990s. Our pragmatic and gradual approach to reform seemed to have paid reasonably well. We emerged almost unscathed from various crises like East Asian crisis, drought or sanction-like situation. While I am not being complacent, there are reasons to believe that India would be on a higher growth trajectory in the coming decades. This is echoed in the assessment of international agencies as well.

What are the opportunities and challenges? There are business opportunities in the traditional sector – such as power generation and roadways – as well as in the sunrise sector – such as information technology. The Tenth Five Year Plan targets, among others, agriculture, and construction for high growth in view of their potential for employment generation with relatively low capital intensity. It also plans to fill the existing shortfalls in investment in power generation and communication by a significant improvement in private investment, and by removing fiscal constraints as well as generation of internal resources by the public sector. There is a particular accent on developing infrastructure which is often recognised as a major constraint on growth. Power sector reforms are energising power generation to meet the rising demand for electricity.

The aggregate of remittances and non-resident deposits is quite significant. We now look for greater contribution in this national metamorphosis for mutual benefit. There is no doubt that the emergence of the Indian economy on a high growth path provides ample scope for the entrepreneurial abilities of the NRIs. It is only appropriate to conclude that this session will be very fruitful in discussing investment opportunities available in the Indian economy.

[2] **These are: Retail trading, atomic energy, lottery business, gambling and betting, housing and real estate business and agriculture (excluding floriculture, horticulture, development of seeds, animal husbandry, pisiculture and cultivation of vegetables) and plantations (excluding tea plantations).**

[3] **These are: Domestic airlines, petroleum sector, investing companies in infrastructure and services sector, defence and strategic industries, atomic minerals, print media, broadcasting, postal services, courier services, establishment and operation of satellite, development of integrated township and tea sector.**

[4] **These are: Private sector banking, insurance, telecommunications, trading, exploration and mining of diamonds and precious stones and airports.**

* **Keynote Address by Smt. Shyamala Gopinath, Deputy Governor, at the sectoral session on finance for the *Pravasi Bhartiya Divas* on January 8, 2005 at Mumbai. The assistance of Janak Raj, Indranil Sen Gupta, Ashok Sahoo and Partha Ray in preparing this address is gratefully acknowledged.**