Monetary Policy and Prospects for Investment in India*

Y.V.Reddy

It gives me great pleasure to be here in your midst. Dr.C.Rangarajan, Governor, Reserve` Bank of India was originally slated to address this seminar but could not do so due to compelling circumstances. I shall try and partly make up for his absence, by drawing heavily from his speeches, in making this presentation. I thank the Adam Smith Institute, and in particular, Professor Carlos – Alberto CAMPOS, for giving me this opportunity to be with you and participate in the discussions on Monetary Policy and the Prospects for Investments in India.

2. I shall initially give a brief review of the factual account of the performance of the Indian economy during the last three years, to illustrate the positive impact of economic reforms in India. I would set out the broad contours of conducting monetary policy in India, i.e., the objectives, the instruments used; the transmission mechanism; and the relevant institutional framework. I will then go over to the recently announced Monetary and Credit Policy for the first half of 1997-98 and the developments in the securities market. I would conclude with the investment climate and the emerging opportunities for foreign investments, especially in the context of capital account liberalisation that we have been contemplating.

Indian Economy : review and Outlook

3. The growth in real Gross Domestic Product (GDP) in the last three years ranged from 6.8 to 7.2 per cent, and the current year (1997-98) should, from all indications, be no exception. While growth in industry averaged 10.4 per cent in the last three years, that of agriculture was 2.5 per cent inspite of negative growth in 1995-96. Investment rate has been on the rise, largely on account of sharp improvement in the domestic saving rate, in recent years. The latest data available for 1995-96 indicate that the saving rate was 25.6 per cent and investment was as high as 27.4 per cent. Given the improvement in real GDP, there have been productivity gains. The overall macro picture on the real side of the economy is highly positive.

4. Gross Fiscal Deficit of Government of India as a percentage of GDP has come down from 6.1 per cent to 5 per cent in the last three years and is estimated to go down further to 4.5 per cent in 1997-98. The liabilities of the government in relation to GDP is also down correspondingly. The rate of inflation as measured by the Wholesale Price Index moved down from 10.4 per cent in 1994-95 to 5.0 per cent in 1995-96, but has edged up to 7.3 per cent in 1996-97. In the current year, we would like to contain it at around 6.0 per cent. Consistent with this, broad money growth is targeted to grow only by 15 to 15.5 per cent in 1997-98, slightly lower than the growth achieved in 1996-97. Growth in non-food credit, however, was sluggish at 10.1 per cent in 1996-97 but we expect it to move towards a figure of over twenty per cent, closer to the very high actuals in 1994-95 and 1995-96.

5. Growth of exports and imports in SDR terms averaged 13.4 per cent and 17.6 per cent, respectively, in the later three years, but the performance last year was below the average at 9.5 and 11.6 per cent. The current account deficit relative to GDP has averaged at a little over one per cent. The exchange rate has been under pressure on occasions but overall, while the nominal exchange rate vis-à-vis the US dollar exhibited a steadily depreciating trend, the real effective exchange rate has been appreciating during the last three years. Foreign currency reserves are currently over $24 billion, implying an import cover of about seven months.

6. There has been a significant structural transformation in the economy that holds a promise for maintaining a strong and sustained performance. These include, the expanding role of the private sector and private investment; the commercialisation of agriculture, especially the opening up of agriculture for exports; the liberalisation of financial sector coupled with strengthened regulatory framework; the public-private sector interface to improve physical infrastructure; and the gradual empowerment of State or Provincial Governments vis-a-vis the Federal Government in the process of economic reform.

Monetary Policy : Objectives and Analytical Framework:

7. The broad objectives of monetary policy in India have been (a) to maintain a reasonable degree of price stability and (b) to ensure adequate expansion in credit to assist growth. The relative emphasis as between the two objectives depends upon the conditions prevailing in the year in question. Price stability as an objective is viewed not just as an end in itself but as a means to promote sustainable and more important, equitable growth. This leads us to the inter-relationship between money, output and prices. Empirical evidence, as far as India is concerned, is clear that the demand for real money function is reasonably stable. It is this function that helps us in estimating the appropriate growth in money supply, given the expected increase in real output and the tolerable level of price increase. An increase in money supply not only results in an increase in demand but also influences output through the availability of credit.

8. We have been targeting broad money expansion as an intermediate target to achieve the ultimate objectives. The concept of monetary targeting that we have been using is, however, a flexible one which takes into account the various feedbacks. Monetary aggregates as intermediate targets are appropriate in the Indian context for two reasons: First, since the money demand function for India has remained reasonably stable, it continues to predict price movements with reasonable accuracy at least over a period of years. Second, the money stock target is relatively well understood by the public at large. With the money supply target, the stance of monetary policy is unambiguously defined and gives a clear signal to market participants.

9. Monetary authorities in India do not confine their attention to just one aggregate. A range of aggregates including aggregate credit are continuously monitored. In the literature, the alternative to monetary targeting is the interest rate. This, however, is more appropriate when various segments of financial markets are

closely integrated, with interest rates in the various markets influencing one another. This is hardly the case in India, even though one does see in the last few years, the beginning of such a financial market integration. Under these circumstances, it is better to target money rather than interest rate, although the monetary authority watches the behaviour of interest rates in the various markets and intervenes appropriately. This, we feel, is not necessarily inconsistent with an overall monetary target.

Instruments of Monetary Policy and Transmission Mechanism

10. It is well-recognised that the two major indicators of effectiveness of monetary policy are : output growth and price stability. Data in the Indian context show that, in the recent past, real growth rate went up sharply during the last five years while price increases were contained. No doubt, the monsoon conditions have been, by and large, favourable and stable, ensuring impressive performance of agriculture, thereby influencing the growth of the economy. But, industry too performed well, responding positively to the economic reforms unveiled since about the middle of 1991. The propitious circumstance of relatively high growth with reasonable price stability has contributed to a gradual move towards indirect instruments of monetary policy. Alongside, there were refinements in interest rate structure, greater autonomy in policy making, effected by changes in fiscal-monetary relationship, and quick and appropriate response to developments in the external sector.

11. In the last five years, monetary policy in India has sought to carefully modulate the liquidity in the system by a combination of measures – direct and indirect methods of control. Reserve requirements and open market operations are the main instruments of action in this regard. Institutional changes have also been effected in the Indian financial system, which helped, in the Indian context, in shifting from direct to indirect instruments. Financial reforms have been undertaken on a wide front in the last five years to improve the allocative efficiency of resources, and to integrate the various segments of financial markets. The latest monetary and credit policy for the first half of 1997-98 went a step further – it has paved the way for the re-emergence of the Bank Rate as a signaling mechanism, thereby providing a potential support to the efficacious use of open market operations.

12. The interest rate developments in the transition to financial market integration would emit important signals for the conduct of monetary policy. The monetary authorities would need to influence market rates through their actions relating to not only quantity but also rate variables. One of the ways to effect this is to make refinements in the lending rate structure. Lending rates which were determined till 1990 have been gradually freed. They are now totally freed except for two concessional rates of interest for small borrowers in recognition that the credit markets in India are imperfect. Progressively, as in many other countries, the Reserve Bank should be able to influence the level of economic activity by actions that impinge on the cost of funds and the overall liquidity in the system.

13. The Reserve Bank has also taken some significant steps to bring about a greater degree of flexibility in the operation of monetary policy. Recently we moved away from a system of automatic monetisation of budget deficit to a loan system, widely known in India as the system of 'Ways and Means Advances'. The Reserve Bank, however, will continue to hold Government paper, of course at its own discretion. While the direct support to budget will over time be limited, there are aspects of fiscal policy which will continue to have a bearing on the conduct of monetary policy. For example, a high level of fiscal deficit can come in the way of effective use of open market operations as an instrument of monetary control. At a time when the Government borrows heavily in the open market, sale of securities by the Reserve Bank as part of open market operations, would result in interest rates rising to unduly high levels. Hence, there is a continued need for monetary policy to take into account the stance of fiscal policy.

14. With the progressive opening of the economy, monetary policy is being increasingly co-ordinated with policies relating to the external sector, in particular, the exchange rate policy. To the extent the capital inflows add to net foreign exchange assets of the Reserve Bank of India, it will have a monetary impact. On the other hand, if capital inflows are not taken into reserves, it may result in an appreciation of the domestic currency. There is here a policy dilemma, faced by many countries including India, which have received substantial capital inflows. The recent surge of capital inflows in our country has been absorbed into the country's foreign exchange reserves, even though it has a monetary impact; this has been done essentially with a view to maintaining the competitiveness of our exports, although some portion of the asset accretion was sterilised through open market operations. But, there are limits to sterilisation, both in terms of costs and availability of stock.

Transmission Mechanism:

15. The financial structure can have an important bearing on transmission of monetary policy. Some of the aspects that have an impact on the transmission are the nature of balance sheets of entities, viz., banks, financial institutions, households, firms, etc., the extent of interest rates deregulation, the substitution between foreign currency and local currency denominations in the composition of loans and deposits, the access to finance from outside the banking system, the extent of disintermediation and the depth and liquidity of secondary markets for debt and equity. In this regard, there are some characteristics of the Indian financial structure which need to be reckoned. A substantial part of financial intermediation is still occurring in the informal sector. Non-banking financial companies have been only recently brought under regulatory framework. Banking sector is still dominated by public sector banks which have significant quantum of non-performing assets. Debt markets have just begun to develop. Insurance sector is still a Government monopoly and most of long-term savings, especially contractual savings in household sector are pre-empted by public sector. Significant progress has been made to reform, liberalise and modernise the structure, but some of the rigidities persist. But, we realise that market integration is essential to reduce transaction costs and to help improve the transmission mechanism

of policy. If this integration is not rendered possible, monetary policy will have to continue to depend heavily on direct control (such as reserve requirements) for policy effectiveness. So, we need to monitor market conditions in order to get at an interest rate structure that is 'optimal', in the equilibrium sense of demand for and supply of funds.

16. There are generally four channels of transmission of monetary policy viz., credit availability effects, interest rate effects, wealth effects and exchange rate effects. Financial deregulation with greater emphasis on competition would help integrate financial markets and promote the effectiveness of interest rate in the monetary transmission mechanism in general. There is, however, a concern that interest rate may not have a significant impact, if the corporate sector relies more on internal resource generation and equity finance for its financing requirements than on bank borrowings. In India, a recent RBI study on selected Financial Ratios of the Private Sector in India revealed that debt to equity ratio of firms in the private corporate sector in India was in the range of 110 to 120 per cent in the early 1990s. Interest cost to value of production in private corporate sector was below 7 per cent in early 1990s but as a percentage to gross profits it was as high as 60 per cent. These facts imply that firms in the private corporate sector in India are highly leveraged and could be susceptible to interest rate shocks.

17. The wealth channel effect is very important in industrial countries where the mortgage market is the prime mover of financial markets and mortgage is the main collateral for borrowings of households and firms. But in the Indian context, the real estate market has a dynamics of its own, which at the present stage, is only loosely and indirectly connected with the mechanisms that form part of the conduct of monetary policy.

18. The importance of exchange rate effect channel depends on how open the economy is; the more open the economy, the more important would this channel be. Judging by this criterion, the share of foreign trade sector (exports plus imports) in India is not substantial. But with the major policy initiatives in respect of trade and payments including the market determined exchange rate mechanism and convertibility on current account, this channel has been assuming increasing importance in recent years. In the second half of 1995-96, the foreign exchange market in India experienced considerable volatility, and the Reserve Bank of India had actively intervened in the forex market. The exchange market intervention (net sales) by the Reserve Bank in the spot market led to withdrawal of a fairly large amount of liquidity from the money market leading to sharp increase in call rates. Another issue relating to this channel is how far the balance sheet position of players in forex market (banks and corporates) limit the scope of monetary action in defence of a pegged exchange rate. The answer to this question depends on the nature of openness of the economy and the exposure of domestic firms to external markets.

19. It is clear from our presentation so far that financial markets in India are not yet fully integrated and that the economy is 'open' only to a limited extent. Given

these elements, the interest rate and exchange rate channels may not be as powerful at the present stage of Indian development as the credit availability channel. Viewed thus, monetary targeting would gain in importance in the conduct of monetary policy.

Institutional Framework for Monetary Policy:

20. As already alluded to, significant changes have occurred and are occurring in the institutional framework in India within which monetary policy acts. These are in the areas of : fiscal-monetary relationship; pre-emption of resources through reserve requirements; structure of interest rates; growth of the non-bank financial sector and changes in exchange rate policy.

21. A historic reform relating to the fiscal monetary relationship was the abolition of the system of automatic monetisation of fiscal deficit taking place through the issuance of ad hoc Treasury Bills by the Government and the introduction, in its place, of the system of the Ways and Means Advances effective April 1, 1997. Under the new system of Ways and Means Advances (WMA), financial limits have been fixed to accommodate **temporary** mis-matches in Government receipts and payments. Interest rates on WMA would be market related. Moreover, for two years beginning April 1997, overdrafts would be permitted for periods beyond ten consecutive days, but at a cost. After these two years, no overdraft will be permitted beyond ten consecutive days. The new system is expected to give more autonomy to the central bank to conduct its monetary policy.

22. Historically, two direct monetary policy instruments, namely, the Cash Reserve Ratio (CRR) and the Statutory Liquidity Ratio (SLR) had to be maintained at very high levels because of high fiscal deficits and a high degree of monetisation of deficits. This 'external constraint' had a bearing on the profitability of the banking system. Easing of these constraints has formed a major agenda for the reform of the financial sector since mid-1991. Progressive reduction in reserve requirements has been effected. The Statutory Liquidity Ratio has been brought down from 37.5 per cent to 25 per cent on an incremental basis and the Cash Reserve Ratio including incremental CRR has been scaled down from 25 per cent to 10 per cent. These changes in the reserve requirements have implications in relation to both CRR and open market operations as instruments of monetary policy.

23. For long, the Indian financial system has been characterised by an administered structure of interest rates. This was aimed at directing implicit subsidy to certain sectors enabling them to obtain funds at concessional rates of interest. In the process, an element of cross-subsidisation got built into the system whereby concessional rates provided to some sectors were compensated by higher rates charged to other borrowers. The regulation of lending rates, *ipso facto,* led to the regulation of deposit rates mainly to keep the cost of funds to banks in reasonable proportion to the rates at which they could lend. The reform of the interest rate structure has, therefore, constituted an integral part of the financial sector reform. Since September 1990, the process of simplification began with the reduction in the number of slabs for which

lending rates had been prescribed. In a major move, the minimum lending rate was abolished and the lending rates were freed in October 1994 for credit limits of over Rs.2,00,000. We are now having only two concessional rates on the lending side (one for credit limits up to Rs.25,000 and the other one for over Rs.25,000 and up to Rs.2,00,000), apart from prescribed ceilings for interest rate and export finance, and only one administered rate on the deposit side, i.e., the maximum rate, which applies to term deposits of maturity up to one year. Banks, however, will be required to lend to priority sectors to a stipulated extent.

24. Three changes in the structure of financial institutions, markets and products that have been witnessed in recent times, carry significant implications for the conduct of monetary policy. First, the growing prominence of capital markets as seen in the increasing mobilisation of resources directly; secondly, the reduction in the barriers to capital mobility leading to increased linkages between domestic and foreign financial markets; and thirdly, a spurt in financial innovation resulting in emergence of new financial products and services and blurring of the distinction between banks and non-banks. Clearly, the issue that arises in this context is as to how the monetary transmission mechanism will get altered as non-banks and capital market begin to play a larger role in the financial system and how the channels of policy need to be rendered effective.

25. The far-reaching changes in the external sector of the Indian economy witnessed in recent years, as reflected in the substantial elimination of quantitative controls on imports, the reduction in tariffs, a market determined exchange rate system, the convertibility on the current account, the encouragement to foreign direct investment and the greater access to external capital markets, have contributed to a closer link between the domestic markets and external markets and made the traditional transmission channels more complex to operate. This is especially because exchange rate is now determined by demand for and supply of foreign exchange in the market. The RBI intervention in the market is limited to reducing rate volatility and to ensuring that the market rate is not too divergent from what the economic fundamental dictate. Besides, greater access to international capital markets also means that the corporates are able to access funds at rates lower than the domestic interest rates. These new set of factors arising out of external sector liberalisation would need to be reckoned in working out the desired rate of expansion of money and credit as well as the optimal level of interest rates.

Monetary Policy – An Update:

26. The recent Monetary and Credit Policy for the first half of 1997-98 went beyond these principles and has, therefore, come to be described as a ‘big bang’ by several observers of the markets. The policy contained significant features in the area of institutional and structural reforms. There are elements of continuity, contextual response and important structural changes. I would like to highlight some of the changes that were ushered in through this policy.

First, the policy seeks greater market orientation in the financial sector by empowering banks with greater operational flexibility. The RBI has moved out of microregulation. Now banks are given total freedom on consortium arrangements and methodology of assessing working capital requirements. No doubt, prudential guidelines will continue to be prescribed by the RBI. These measures signify changes in the relationship so far developed between the RBI and banks.

Secondly, borrowers have also been empowered to reinforce marketisation. These measures have changed the relationship between the banker and the borrower. Borrowers can choose to go through a single bank or multiple banks or take the syndication route. Access to commercial paper is freer now.

Thirdly, macromanagement by the Reserve Bank has, perhaps for the first time, emphasised the need to recognise the rate variables as the potential instruments of influencing the liquidity situation. The Bank Rate will emerge as a signal of the stance of monetary policy and determined the rate at which funds will be available to the system from the RBI.

Fourthly, integration of the money market, the Government Securities Market and the Forex Market is sought to be furthered. Measures towards this end include exemption of CRR/SLR on inter-bank liabilities, permission to Authorised Dealers (Ads) to borrow from and lend in overseas market, permission to ADs to book forward cover on the basis of past performance, permission to undertake rupee/forex currency swaps, allowing repos in all Government Dated Securities, reverse repos for all SGL account holders, reducing the minimum period of Commercial Paper (CP), etc.

Sixthly, to signal continuing consultations with market participants, a Committee for Money Markets has been constituted soon after the policy announcement. This would be similar to the Technical Advisory Committees on Forex and Government Securities Markets which were established in early 1997. Significantly, it signals a difference in the relationship that has hitherto been in existence between the Reserve Bank and market participants and has placed it at an informal level.

Government Securities Markets:

27. The authorities have sought to make the Government securities market an active segment of the Indian financial system so that the conduct of monetary policy could be rendered effective. A number of reforms have been initiated in recent years. These include: (I) the setting up of a comprehensive system of primary Dealers (PDs) – six PDs have already begun to operate (ii) licensing of Satellite Dealers (iii) the provision of liquidity support by the RBI to mutual funds exclusively dedicated to Government securities to the extent of 20 per cent of their holdings of Government securities, which is expected to facilitate the emergence of the retail segment of the Government Securities market, (iv) a progressive movement towards a mark-to-market system for valuation of Government securities which would impart depth to the market

by encouraging trading, (v) adoption of the Delivery versus Payments System (DVP) which ensures that transactions in Government securities are secure, (vi) insistence of greater transparency of operations rendered by dissemination of information to market, and (vii)introduction of indexed linked bonds (viii) abolition of tax deduction at source on Government Securities (ix) allowing FIIs to invest in Government Stock, and (x) introduction of Treasury Bills of various maturities. All of these changes, both in relation to interest rate and government securities market, open up opportunities for using open market operations as an instrument of monetary control.

Investment Climate

28. The contribution already made and efforts underway, in the conduct of monetary policy and reforms in financial sector as a whole to the investment climate, is noteworthy. I will highlight a few facts here:

First, growth, at around 7 per cent per annum in real terms, with a large size of the domestic market, is an attractive feature.

Secondly, price stability has been demonstrated.

Thirdly, exchange rate management is characterised by the absence of undue volatility.

Fourthly, fiscal stability and consolidation is being assured.

Fifthly, transparent regulatory framework in both real and financial sector has been mounted.

Sixthly, large and critical market for Government securities is being improved with access extended to domestic retail investors and foreign institutional investors.

Seventhly, capital markets are rapidly evolving – in terms of size, depth, infrastructure and quality. The institutional framework for regulating both debt and equity markets is firmly in place. Access is provided liberally and on a transparent and assured basis to foreign investors.

29. Investments in India have been growing in recent years. From 23.4 per cent of nominal GDP in 1991-92, gross aggregate investment rate has gone up to 27.4 per cent in 1995-96. In general it has been a gradual rise, with a minor exception in 1993-94 when the rate slid down slightly. The domestic saving rate was lower than the investment rate by an average of 1.18 percentage points over the five year period 1991-92 through 1995-96, representing capital inflows.

30. As a result of economic reforms and change in foreign investment policy, there has been a shift in the structure of capital flows in favour of non-debt creating capital flows. The total inflows of foreign investment, which includes both direct and

portfolio investment, has arisen from a mere US $ 154 million in 1991-92 to US $ 5,561 million in 1996-97. As a result, the share of investments in **net** capital flows which accounted for less than 1 per cent in 1990-91 has gone up to close to 50 per cent in 1996-97.

Foreign Investments : Policy and Structural Changes:

31. The development of domestic institutional structure in the financial sector from the view point of foreign investment is aimed towards availability of reliable information to prospective investors in a relatively low-cost manner; appropriate monitoring of transactions; and transparent guidelines for participation of foreign investors in the domestic economy, including the stock market. In this direction, a series of policy initiatives have been taken since 1991 regarding the approval procedures, the investment restrictions, the limitation on foreign equity participation, the restrictions on acquisitions and take-over by foreign investors, the local content requirement, the restrictions on remittance of funds abroad and the special incentives to the foreign investors, especially in direct investment.

32. In respect of approval procedure regarding foreign direct investment (FDI), a transparent framework is followed under which all the sectors have been opened, with full repatriation benefit, to foreign investors except in the case of agriculture and plantation. The Reserve Bank provides automatic approval in the case of foreign direct investment up to 74 per cent equity in the case of 9 high priority sectors industries and 51 per cent equity in the case of 51 priority sector industries and export/trading/star trading houses. The proposals involving higher equity participation are cleared by the Secretariat of Industrial Approvals/Foreign Investment Promotion Board. In the case of Non-Resident Indians (NRIs)/Overseas corporate bodies (OCBs) this equity limit can be extended up to 100 per cent. Wholly owned foreign subsidiaries are allowed in the power sector, 100 per cent Export Oriented Units (EOUs) and units in Free Trade Zones (FTZs) and Export Processing Zones (EPZs). Similarly, approvals are given in mining and telecommunication industries up to 50 per cent and 49 per cent of the equity capital, respectively.

33. The policy towards foreign portfolio investment too has been substantially liberalised. Portfolio investment in any of the listed companies of Indian stock exchanges/over the counter exchange can be made by foreign institutional investors as well as NRIs/OCBs subject to the condition that the aggregate holding of shares/debentures of the FIIs/NRIs/OCBs put together does not exceed 30 per cent of the voting equity capital of the company. They are also permitted to invest in the public sector/private sector mutual funds and Government Dated Securities. Dedicated debt funds up to 100 per cent from FIIs have been permitted recently. There is no lock-in-period for the remitting of the funds brought in, even in the case of preference shares acquired by the foreign investors. The taxation guidelines are also transparent with capital gains tax of 10 per cent and 30 per cent on long term and short term, respectively and exemption of withholding tax on the dividend earned.

34. The impact of these measures was clearly evident from the spurt in the value of foreign investment approvals as well as inflows since 1991. The amount of foreign direct investment approved during the year 1996 has been US $ 11,142 million which gives an indication of the likely volume of future inflows under direct investment. As against a direct investment of US $ 150 million, US $ 341 million and US $ 586 million during 1991-92, 1992-93 and 1993-94, respectively, the actual foreign direct investment flows for the year 1994-95 has been US $ 1,313 million which further leaped to US $ 2,133 million which further leaped to US $ 2,133 million during 1995-96 and US $ 2,695 million during 1996-97. Since 1992-93, most of direct investments has come from the USA, followed by the UK, Japan and Germany. The direct investment has mainly been garnered towards the engineering industries, the financial services sector, the electronics/electrical equipments and the chemical/allied products, in that order. Still, the proportion of direct foreign investment in our country is low at around 3 per cent of the overall FDI flows to developing countries during 1995 and, therefore, in keeping tandem with the overall structure of the economy efforts are made to raise the amount of FDI to around US $ 10 billion every year. Keeping this in view, a Foreign Investment Promotion Council has been set up while FIPB has been reconstituted to approving and encouraging FDI flows.

35. Similarly, portfolio investment has taken quantum leap in recent years. Not only have the Indian corporates raised funds abroad through Global Depository Receipts (GDRs) and Offshore funds, FIIs and NRI/OCBs have also remained bullish on the Indian market during this phase. The inflows into India arising from GDR were of the order of US $ 1,602 million and US $1,839 million during 1993-94 and 1994-95, respectively. While GDR issues were somewhat subdued in the first half of 1995-96, the same has picked up during 1996-97 with the amount repatriated to India by the Indian corporates from the GDR proceeds amounting to US $ 920 million. Portfolio investment flows on account of FIIs have been encouraging with an average of around US $ 1,687 million coming during 1993-94 to 1995-96. Moreover, the total FII inflows during 1996-97 were US$ 1,926 million. The dimension of the flows should be assessed in the light of the overall slump in global portfolio flows to developing countries witnessed during 1995 and 1996 following monetary tightening and rising interest rates in the US from February 1994, bullish stock markets in the OECD particularly in the US, and the Mexican crisis in December 1994.

Foreign Investments and Emerging Opportunities

36. An expert committee set up to lay out the road map towards Capital Account Convertibility (CAC) has come to the conclusion that based on the assessment of the current macroeconomic situation, the time is now appropriate to initiate a move towards CAC. The Committee has stated that fiscal consolidation, a mandated inflation target and strengthening of the financial system should be regarded as crucial preconditions/signposts for CAC in India.

37. Successful efforts to liberalise the capital account have typically been preceded by a strategy of fiscal reforms which significantly reduces the fiscal deficit

and finances the remaining deficit with a minimum recourse to inflation tax. Accordingly, the committee has recommended a reduction in the GFD/GDP ratio from the budgeted 4.5 per cent in 1997-98 to 3.5 per cent in 1999-2000. On the inflation front, a mandated rate of inflation for the three-year period 1997-98 to 1999-2000 has been placed at 3-5 per cent by the Committee. This would break the inflationary expectations in India and bring inflation rates in close alignment with international inflation rates. The Committee has also recommended full interest rate deregulation in 1997-98 and reduction in the non-performing assets of the banking system. Quite clearly, the load of a high level of NPAs cannot be borne by the banks if the financial system is opened up fully to the forces of competition. In addition, the Committee has suggested that the conduct of exchange rate policy, the balance of payments and the adequacy of foreign exchange reserves should be assessed on an on-going basis.

38. In the current situation, one way of assessing the emerging opportunities could be on the basis of the recommendations of the Committee. It would be reasonable to expect that it provides a basis for what needs to be done by the authorities in future.

---

[*] Address by Dr.Y.V.Reddy, Deputy Governor, Reserve Bank of India, at the Adam Smith Seminar on "The outlook for emerging markets : The Middle East/The Indian Ocean", Paris on June 11, 1997.