CHAPTER 4

CONCOMITANTS FOR A MOVE TO FULLER CAPITAL ACCOUNT CONVERTIBILITY

4.1 This Chapter reviews some key macro-economic indicators since 1996-97 and against this backdrop, certain steps are set out to enable a move to FCAC. Policies for macroeconomic stability in an open economy environment need greater attention. The fiscal-monetary policies, exchange rate management, prudential, regulatory and supervisory safeguards and measures for development of financial markets all assume importance (some of these issues are discussed in subsequent Chapters). The implementation of these measures and the pace of liberalisation are a simultaneous process.

Macroeconomic Indicators

4.2 Table 4.1 sets out select macroeconomic indicators comparing the position as of 1996-97 and 2005-06. The real sector, monetary and external sectors show improvement while the fisc continues to be of concern. The level of foreign exchange reserves is at an all time high and the net foreign exchange assets (NFA) are well in excess of the reserve money (RM) and are equivalent to one fourth of the money supply. Unlike some countries, which have accumulated their foreign exchange reserves through current account surpluses, the build up of the Indian forex reserves has largely been the result of capital inflows. (Table 4.2)

Table 4.1: Select Macroeconomic Indicators

	1996-97	2005-06
I. Real Sector		
Real Growth Rate (percentage) during the year	7.8 7.5 (Three year average ended 1996-97)	8.4 8.1 (Three year average ended 2005-06)
Rate of Growth of Industrial Production	6.1	8.1

(percentage)		
II. Monetary Sector		
Inflation Rate (measured in terms of WPI) Year on year	5.4 9.0 (Three year average ended 1996-97)	4.1 4.6 (Three year average ended 2005-06)
Reserve Money Outstanding Percentage change during the year	Rs. 1,99,985 crore 2.8 13.3 (Three year average ended 1996-97)	Rs. 5,73,066 crore 17.2 15.8 (Three year average ended 2005-06)
M_3 Outstanding Percentage change during the year	Rs. 6,96,012 crore 16.2 17.4 (Three year average ended 1996-97)	Rs. 27,29,535 crore 21.2 16.7 (Three year average ended 2005-06)
III. Fiscal Sector		
Gross Fiscal Deficit as percentage of GDP		
- Centre	4.9	4.1 (RE)
- States	2.7	3.1 (BE)
- Combined	6.4	7.7 (BE)
Revenue Deficit as percentage of GDP		
- Centre	2.4	2.6 (RE)
- States	1.2	0.7 (BE)
- Combined	3.6	3.4 (BE)
Domestic liabilities as percentage of GDP		
- Centre	45.4	60.3 (RE)
- States	21.0	32.7 (BE)
- Combined	55.7	78.9 (BE)
IV. External Sector		
Current Receipts as a percentage to GDP	14.3	24.5
Current Account Deficit as a percentage of GDP	-1.2	-1.3
External Debt as a percentage of Current Receipts	169.6	64.0
Total External Debt Outstanding (US$ million)	93,470	125,181
Foreign Exchange Reserves (US$ billion)	26.4	151.6
Net foreign exchange assets/Currency Ratio (percentage)	69.1	156.3
NFA/RM Ratio (percentage)	47.4	117.4
NFA/M3 Ratio (percentage)	13.6	24.7
Average US-Rupee $ Exchange Rate	35.5	44.3
REER (6-currency trade based) 1993-94=100	101.0	106.7

RE: Revised Estimates; BE: Budget Estimates

Source: Reserve Bank of India

Table 4.2: Sources of Accretion to Foreign Exchange Reserves Since April 1, 1997

(US$ billion)

	Items	**1997-98 to 2005-06**

A		**Reserves Outstanding as on end March 1997**	**26.4**
B		Current Account Balance	-9.1
C		Capital Account (1 to 6)	130.2
	1	Foreign Investment (I + ii)	73.6
		(i) Direct	30.6
		(ii) Portfolio	43.0
	2	Banking Capital (I + ii)	24.5
		(i) NRI Deposits	17.1
		(ii) Other @	7.4
	3	External Assistance	1.5
	4	External Commercial Borrowings	13.4
	5	Short Term £	7.2
	6	Others #	10.0
D		Valuation Changes	4.1
		Total (A+B+C+D)	**151.6**

@: Comprises foreign assets of banks, foreign liabilities of banks (other than NRI deposits) and movements in balances of foreign central banks and international institutions maintained with the RBI.

£: Does not include supplier's credit of less than 180 days.

#: Comprises mainly the leads and lags in export receipts (difference between the customs data and the banking channel data).

Source: Reserve Bank of India

Concomitants for a Move to Fuller Capital Account Convertibility

4.3 The 1997 Committee had set out certain preconditions/signposts for liberalising the capital account and the actual outcomes *vis-à-vis* the preconditions in a sense determined the pace of capital account liberalisation. While a certain extent of capital account liberalisation has taken place, since 1997, it would be necessary to set out a broad framework for chalking out the sequencing and timing of further capital account liberalisation. The key concomitants discussed below are not in any order of priority.

Fiscal Consolidation

4.4 The Fiscal Responsibility and Budget Management (FRBM) Legislation was enacted in 2003 and the Rules were notified in 2004. Steps are required to be taken to reduce the fiscal and revenue deficits and the revenue deficit was to be eliminated by March 31, 2008 and adequate surpluses were to be built up thereafter. The target for reducing the Centre's fiscal deficit to 3 per cent of GDP and elimination of the revenue deficit has been extended by the Central Government to March 31, 2009.

4.5 The Twelfth Finance Commission (TFC) recommended that the revenue deficits of the States should be eliminated by 2008-09 and that the fiscal deficits of the States should be reduced to 3 per cent of GDP.

4.6 The Committee notes that apart from market borrowings, at the general government level, there are several other liabilities of government – both explicit and implicit - such as small savings and unfunded pension liabilities which are large but not easily quantifiable. As the interest rate conditions and climate for investment and growth are dependent upon the totality of such resource dependence, generation of revenue surplus to meet repayment of the marketable debt should be viewed but as a first step towards fiscal prudence and consolidation. A large fiscal deficit makes a country vulnerable. In an FCAC regime, the adverse effects of an increasing fiscal deficit and a ballooning internal debt would be transmitted much faster and, therefore, it is necessary to moderate the public sector borrowing requirement and also contain the total stock of liabilities.

4.7 The system of meeting government's financing needs is set out in terms of *net* borrowing, i.e., the *gross* borrowing minus repayments. This masks the repayment issue totally as no arrangement is made for the repayment. Over the years, the practice has been that the government determines its *net* borrowing requirement and the repayment is merely added to derive the *gross* borrowing requirement. Till the early 1990s, the difference between the gross and the net borrowing was marginal and with high investment prescriptions for banks/institutions it was reasonable to assume that the repayments would automatically be met out of fresh issuances of government securities. This approach of financing repayments out of fresh borrowings poses the danger of a vicious cycle of higher market borrowings at a relatively higher cost, chasing higher repayments. While repayment obligations financed through gross borrowings would not affect the gross fiscal deficit for the particular year of borrowings, the concomitant interest burden would fuel the revenue deficit as well as the gross fiscal deficit in subsequent years. This development would not only result in higher accumulation of debt but also further aggravate the problem of debt sustainability.

4.8 Over one-third of the Centre's *gross* borrowing in 2006-07 of Rs.1,79,716 crore would go towards repayment. Over the years, on account of higher repayments, the gross borrowings of the Centre have increased significantly. For example, *gross* market borrowings relative to GDP are estimated at 4.5 per cent in 2006-07 as compared with 2.6 per cent in 1996-97. With the progressive move to market determined interest rates on government securities and the dilution of the captive market, there is no certainty that repayments would smoothly and automatically be met out of fresh borrowings without a pressure on real interest rates. Progressively, therefore, it is the *gross* borrowing programme and not the *net* borrowing programme which has to be related to the absorptive capacity of the market as also in gauging potential borrowing costs of the government. With the practice of meeting repayments out of fresh borrowing there has been a ballooning of the government's internal debt. The combined domestic

liabilities of the Centre and States rose from about 56 per cent of GDP in 1996-97 to an estimated 79 per cent of GDP in 2005-06. The large *gross* borrowing of the government has consequential effects of crowding out private sector requirements, particularly, long-term requirements for infrastructure and other investments. More importantly, it has the adverse effect of raising interest rates; this would, in turn, hurt investment, output and employment. At the present time, the comfortable liquidity in the system, following large capital inflows, has resulted in interest rates being moderate. Once these capital flows slow down or reverse, the large *gross* borrowing programme of the government would force interest rates up to undesirably high levels. To obviate such high interest rates, it would be imperative to make arrangements for repayment of loans progressively out of the revenue surplus, while ensuring that the overall fiscal deficit is contained within the parameters laid down by the FRBM/TFC. By 2010-11 the Centre should endeavour to build a revenue surplus of 1.0 per cent of GDP which would amount to an estimated Rs.62,197 crore in 2010-11 (assuming a nominal GDP growth of 12 per cent). The repayment schedule of the Centre's market borrowing (as at the end of March 2006) for 2010-11 amounts to Rs.62,586 crore. The Committee recommends that a substantial part of the revenue surplus of the Centre should be earmarked for meeting the repayment liability under the Centre's market borrowing programme, thereby reducing the *gross* borrowing requirement.

4.9 While the government has brought an element of transparency in fiscal operation, quasi-fiscal deficits still remain. The Committee recommends that as part of better fiscal management, the Central Government and the States should graduate from the present system of computing the fiscal deficit to a measure of the *Public Sector Borrowing Requirement (PSBR)*. The PSBR is a more accurate assessment of the fisc's resource dependence on the economy. Rough indications point to the probability of the PSBR being about 3 per cent of GDP above the fiscal deficit. While an official figure on the PSBR is not available, once a policy decision is taken to move over to a PSBR measure, steps can be taken to effectively implement a systematic compilation of this information and its regular monitoring. The RBI should attempt a preliminary assessment of the PSBR and put it in the public domain which would then facilitate the adoption of the PSBR as a clearer indicator of the public sector deficit.

4.10 There have been some initial moves to functionally separate public debt management from monetary policy operations; the two functions, however, continue to be within the RBI. For an effective functional separation enabling more efficient debt management as also monetary management, the Committee recommends that the Office of Public Debt should be set up to function independently outside the RBI.

Monetary Policy Objectives

4.11 In the context of a progressively liberalised capital account, inflation rates in India need to converge towards internationally acceptable lower levels. Furthermore, interest rates in India would broadly need to realign and reflect inflation differentials. There is a strong social objective in an unswerving policy on inflation control as inflation hurts the weakest segments the most.

4.12 Issues relating to transparency in setting monetary policy objectives and the need to develop effective tools of monetary policy have come to the forefront especially in the context of progressive liberalisation of the capital account. In recent years, there have been significant changes in the formulation and monitoring of fiscal policy with increased transparency of operation. Monetary policy transparency is the obverse of fiscal transparency. The operation of monetary policy and instruments and issues of strengthening the policy tools are discussed in Chapter 6 along with issues relating to exchange rate management.

4.13 In the rapidly changing international environment and the drawing up of a roadmap towards fuller capital account convertibility, the issue of greater autonomy for monetary policy needs to be revisited. This issue has been raised earlier by more than one committee.

4.14 The Committee recommends that, consistent with overall economic policy, the RBI and Government should jointly set out the objectives of monetary policy for a specific period and this should be put in the public domain. Once the monetary policy objectives are set out, the RBI should have unfettered instrument independence to attain the monetary policy objectives. Given the lagged impact of monetary policy action, the monetary policy objectives should have a medium-term perspective. The Committee recommends that the proposed system of setting objectives should be initiated from the year 2007-08. Strengthening the institutional framework for setting monetary policy objectives is important in the context of FCAC.

4.15 The RBI has instituted a *Technical Advisory Committee on Monetary Policy.* While this is a useful first step, the Committee recommends that a formal Monetary Policy Committee should be the next step in strengthening the institutional framework. At some appropriate stage, a summary of the minutes of the Monetary Policy Committee should be put in the public domain with a suitable lag.

Strengthening of the Banking System

4.16 In any significant move towards liberalising the capital account, the state of health of the banking system would be of concern. As the economy moves to a more open external environment, it would be necessary to restructure the banking system and put in place appropriate safeguards.

4.17 India has a set of diversified financial institutions like commercial banks (private and public, foreign and domestic), non-banking financial institutions, urban and rural cooperatives, regional rural banks, micro-finance institutions and an informal money lending sector and each of these groups of institutions have varying strengths. It bears recalling the old adage that a financial system is as strong as its weakest link. These institutions cater to varied needs and are subject to different sets of regulations. Over three-fourths of the business of the financial sector is accounted for by the commercial banks and three-fourths of the commercial banks business is accounted for by public sector banks. The competitive efficiency of institutions needs to be promoted, in the context of liberalisation and FCAC. Initiatives have been taken to develop various segments of financial markets – foreign exchange, money and government securities – and strengthen the financial system and improve efficiency.

4.18 In the light of greater deregulation of the pre-emptions in the banking system, which is likely to increase on the path to a FCAC regime, and with the growing significance of the banking system in the economy, the size of the commercial assets of the banking system is expected to increase. Consequently, the capital requirements of banks in India would increase. Furthermore, in the context of Basel II, capital adequacy requirements would be more risk sensitive and exacting than at present and consequently, banks' appetite for shouldering risks will be reflected in the capital requirements. The present minimum 9 per cent capital adequacy ratio (CAR) may need to be reviewed for banks which have an international presence, on the basis of the risks assumed by them both in the domestic as well as international jurisdictions. The prudential measures would need to be calibrated, simplified and rationalised as the banks are able to manage various types of risks. In addition, capacity-building in the domestic banks would be an imperative to enable them to meet the enhanced needs of a financial system with a liberalised capital account. Inputs towards this, in the form of human resource development, information technology, accessing expert advice for formulating policy on potentially complicated issues such as risk management, financial conglomerates, bundling of services, upgradation of accounting systems in line with international standards such as International Accounting Standard (IAS) 39, would be critical in the area of capacity-building (issues relating to regulation/supervision are detailed in Chapter 7).

4.19 While it is sometimes argued that commercial banks should be classified as international, national, and regional, it is not feasible to use such classification as some of the smaller banks may be more competitive than larger banks. Some of the smaller banks which specialise in certain areas of business or regions may have a comparative advantage over larger banks by virtue of their core competence. As such, emphasis on consolidation to mean larger banks, merely by mergers, may not lead to strengthening of the banking system. In other words, there is no immutable relationship between size and efficiency of operation.

4.20 About three-fourths of the banking system is covered by the public sector. This, by itself, should not be a constraint but the legislative framework is a major handicap and there are embedded disabilities for consolidation and governance. First, within the public sector, the legislative framework for the State Bank of India (SBI) Group is different from the nationalised banks. The major constraint is majority ownership by the Government/RBI in the public sector banks. The capital requirements of banks will go up in the context of Basel II, since they have to maintain capital for certain risks which do not attract a capital requirement under Basel I. In an FCAC context, the banks would be exposed to greater level of risks than at present and hence the capital requirement would go up even further. There is a dilemma here which has to be squared off in the ensuing period: the government is unable or unwilling to provide large additional capital injection into the public sector banks; at the same time, the government has so far not agreed to a reduction in the Government/RBI majority holding in public sector banks. The danger is that there could be a weak resolution in that various types of hybrid loan capital would be used to meet the capital adequacy requirements of banks. The Committee cautions that regulatory forbearance in the case of public sector banks would greatly weaken the system and as such should be avoided.

4.21 In the absence of injection of capital in public sector banks and the reluctance of government to give up majority ownership, public sector banks' share of business would shrink. Either way, there would be a weakening of the Indian financial system. In this context, the issue of majority Government/RBI ownership of public sector banks would come to the fore. The problem needs to be examined separately for the SBI Group and the nationalised banks. All public sector banks should not be on a 'one size fits all' approach. The stronger public sector banks need to be given greater autonomy and the powers and accountability of bank boards of the stronger banks need to be enhanced. Thought also needs to be given to encouraging well-capitalised new private sector banks to be set up preferably with institutional backing. The banking system has only limited time up to 2009 when intense competition from foreign banks is expected and, therefore, urgent action is warranted.

4.22 In this regard, the Committee notes that the RBI proposes to transfer its stake in SBI to the Government of India. If this transfer materialises, the share of nationalised banks in the banking system, will increase from around 50 per cent to around 75 per cent. The SBI, at present, has a greater degree of functional autonomy than the nationalised banks and bringing it under the category of nationalised banks would be a retrograde step. The shareholding of the RBI in SBI, currently 59.7 per cent, is close to the statutory minimum of 55 per cent and the bank may need to raise further capital in the near future to sustain its normal growth and business

requirements. This is expected to place a further burden on the government, if it became the majority shareholder in SBI.

4.23 With a view to further enhance the efficiency and stability of the banking system to the best global standards, a two-track and gradualist approach was adopted by the RBI in March 2005. One track was consolidation of the domestic banking system in both public and private sectors. The second track was gradual enhancement of the presence of foreign banks in a synchronised manner. The second phase, which will commence in April 2009 after a review of the experience gained and after due consultation with all the stakeholders in the banking sector, would consider allowing a greater role for foreign banks. There has been, however, hardly any progress on the first track with regard to consolidation in the public and private sector banks.

4.24 At present, the Indian banking system is fragmented with as many as 85 commercial banks. Going forward, the Indian banking system will be exposed to greater competition. In the context of the greater uncertainties which call for greater focus on the risk management capabilities of banks, it would also be appropriate to envisage the need for development of stronger and professionally run domestic banks which will enable them to compete effectively. A weak and fragmented banking sector cannot co-exist with a system opened to global influences. In addition, with the likely gradual enhancement of presence of foreign banks after 2009, the banking system would be exposed to intense competition from large global banks. In this regard it has been the policy of the RBI not to actively pursue consolidation but to play the role of a facilitator. While respecting this approach of the RBI, the Committee considers that consolidation in the banking sector is an important concomitant to FCAC and hence the Committee recommends that the RBI should formulate its prudential policies in a manner which will favour consolidation in the banking sector. The Committee also recommends that the RBI should facilitate emergence of strong and professionally managed banks and not only large banks. The initial target may be, as recommended by the Committee on Banking Sector Reforms (Narasimham II), to create 4 or 5 large banks with international presence which are equipped with the state of the art skills in banking, risk management and information technology (IT).

4.25 In this regard, it will also be relevant to address the issue of governance. Commercial banks are at present governed by the following six statutes in addition to the Banking Regulation Act, 1949, *viz.,* Banking Companies (Acquisition & Transfer of Undertaking) Act, 1970, Banking Companies (Acquisition & Transfer of Undertaking) Act, 1980, State Bank of India Act 1955, State Bank of India (Subsidiary Banks) Act, 1959, Industrial Development Bank (Transfer of Undertaking and Repeal) Act, 2003 and the Companies Act, 1956. These statutes have embedded provisions which hinder good governance and consolidation. The Committee recommends that one of the first initiatives which the RBI should initiate to promote easier market

driven consolidation within the banking sector is to move necessary legislative amendments to the above statutes to ensure that all commercial banks are registered under a single Act, *viz.*, Companies Act and regulated under the Banking Regulation Act and the voting rights of investors should be in accordance with the provisions of the Companies Act. Early enactment of the proposed amendments of the Banking Regulation Act is imperative.

4.26 On the strengthening of the banking system, the Committee has the following recommendations:

(i) All commercial banks should be subject to a single Banking Legislation and separate legislative frameworks for groups of public sector banks should be abrogated. All banks, including public sector banks, should be incorporated under the Companies Act; this would provide a level playing field.

(ii) The minimum share of Government/RBI in the capital of public sector banks should be reduced from 51 per cent (55 per cent for SBI) to 33 per cent as recommended by the Narasimham Committee on Banking Sector Reforms (1998). There are, admittedly, certain social objectives in the very nature of public sector banking and a reduction in the Government/RBI holding to 33 per cent would not alter the positive aspects in the public sector character of these banks.

(iii) With regard to the proposed transfer of ownership of SBI from the RBI to government, the Committee recommends that given the imperative need for strengthening the capital of banks in the context of Basel II and FCAC, this transfer should be put on hold. This way the increased capital requirement for a sizeable segment of the banking sector would be met for the ensuing period. The Committee, however, stresses that the giving up of majority ownership of public sector banks should be worked out both for nationalised banks and the SBI.

(iv) In the first round of setting up new private sector banks, those private sector banks which had institutional backing have turned out to be the successful banks. The authorities should actively encourage similar initiative by institutions to set up new private sector banks.

(v) Until amendments are made to the relevant statutes to promote consolidation in the banking system and address the capital requirements of the public sector banks, the RBI should evolve policies to allow, on a case by case basis, industrial houses to have a stake in Indian banks or promote new banks. The policy may also encourage non-banking finance companies to convert into banks. After exploring these avenues until 2009, foreign banks may be allowed to enhance their presence in the banking system.

(vi) Issues of corporate governance in banks, powers of the Boards of public sector banks, remuneration issues, hiring of personnel with requisite skills in specialised functions and succession planning need early attention.

(vii) The voting rights of the investors should be in accordance with the provisions of the Companies Act.

(viii) Following the model of the comprehensive exercise undertaken on Transparency, a number of Groups/Committees could be set up for examining each set of issues under the overall guidance/coordination of a High Level Government – RBI Committee to ensure concerted and early action to expeditiously prepare the financial system to meet the challenges in the coming years in the context of Basel II and the move to FCAC. As part of this comprehensive exercise, the proposed Committee should revisit the issue of investments by foreign banks in Indian banking. In this Committee's view, this has relevance in the context of issues relating to bank recapitalisation, governance, induction of technology and weak banks.

External Sector Indicators

4.27 Recent developments in the balance of payment (BoP) indicate continuing resilience of the external sector even as the Indian economy is entering an expansionary phase of the business cycle. There has been an emergence of a current account deficit (CAD) in 2004-05 and 2005-06 after surpluses in the preceding three years (2001-04). For a developing country like India, imports of raw materials, intermediates, capital goods, technology and services hold the key to scaling up growth in the medium-term. It is important to recognise that current BoP has significantly improved over 1990-91.

Current Account Deficit

4.28 Since the crisis of 1990-91, during which a CAD of 3 per cent of GDP turned out to be unsustainable, the appropriate level of the CAD for India has been the subject of considerable deliberation. The appropriate level of the CAD is a dynamic concept and cannot be fixed in time, or cast in stone.

4.29 The openness is based on the increase in the current receipts to GDP ratio to 24.5 per cent in 2005-06, which is substantially higher than the ratio of 8.0 per cent in 1990-91. Current receipts in 2005-06 pay for 95 per cent of current payments, up from 72 per cent in 1990-91.

4.30 Acceleration in the growth of current earnings economises on the need to seek access to international financial markets and strengthens the ability to run a higher CAD (and achieve

higher growth) without encountering a financing constraint. Stepping up the growth of current receipts is essential for sustaining a higher CAD.

4.31 Viability of the CAD is a function of the availability of normal capital flows, as opposed to exceptional financing. Net capital flows have regularly exceeded the CAD requirements by a fair measure, enabling large accretions to the reserves. During 2005-06, the CAD has been comfortably financed by net capital flows with over US$ 15 billion added to the foreign exchange reserves. Compositional shifts in favour of foreign investment have actually strengthened the economy's absorptive capacity. The share of non-debt creating flows in net capital flows has, in fact, risen from 1 per cent in 1990-91 to nearly 50 per cent in 2004-05. The operating ‘viability’ criterion for determining the access to capital flows is the ability to service external liabilities as embodied in a low ratio of debt service payments to current receipts. The debt service ratio (DSR) has fallen to as low as 10.2 per cent in 2005-06 and the ratio of the external debt stock to GDP was a modest 15.8 per cent. The DSR could safely be in the range of 10-15 per cent.

4.32 If the ratio of current account deficit to GDP is regarded as the target variable, the ratio of current receipts to GDP can be regarded as the instrument variable. Accordingly, a sustainable current account deficit is dependent on the current receipts to GDP ratio. A rising current receipts to GDP ratio will enable a higher current account deficit which would enable a higher investment ratio. Given the present CR/GDP ratio of 24.5 per cent, the CR/CP ratio of 95 per cent and a debt service ratio in the range of 10-15 per cent, a CAD/GDP ratio of 3 per cent could be comfortably financed. Should the CAD/GDP ratio rise substantially over 3 per cent there would be a need for policy action.

Adequacy of Reserves

4.33 The adequacy of reserves is regarded as an important parameter in gauging an economy’s ability to absorb external shocks. With the changing profile of capital flows, the traditional approach of assessing reserve adequacy in terms of import cover has been broadened to take into account risk profiles of various types of external shocks to which the economy is vulnerable. In the more recent period, assessment of reserve adequacy has been influenced by the introduction of new measures that are particularly relevant for emerging market countries like India. One such measure requires that the foreign currency assets should exceed scheduled amortisation of foreign currency debt (assuming no rollovers) during the following year. The other one is based on a “Liquidity at Risk” rule that takes into account the foreseeable risks that a country could face under a range of possible outcomes for relevant financial variables such as exchange rates, commodity prices, credit spreads and the like. The RBI has been pursuing a policy of maintaining an adequate level of foreign exchange reserves to meet import requirements, unforeseen contingencies and liquidity risks associated with different types of

capital flows. Adequacy of reserves in the context of consumption and investment smoothing requirements in the event of a shock is assessed in relation to trade needs which cover import payments as well as the broader measure of all current external payments. Liquidity indicators of reserve adequacy are monitored in terms of the preparedness to meet short-term liabilities and to fulfill the need for maintaining orderly conditions in the foreign exchange market in the event of mismatches between supply and demand. Thus, reserves are also required to be adequate in terms of short-term debt obligations and portfolio investments. Broader measures of solvency are assessed in terms of the ratio of reserves to total external debt and to the external liabilities, the latter encompassing direct and portfolio investments and bank claims in addition to gross external debt. Money-based indicators of reserve adequacy help to indicate vulnerability of economic activity to any possibility of massive capital outflows. Finally, reserve adequacy is also gauged in terms of macro indicators, i.e., the ratio of India's reserves to GDP.

4.34 In terms of trade-related reserve adequacy indicators, India's foreign exchange reserves at about 11.6 months of imports at end-March 2006 are comfortable. India's ratio of reserves to short-term debt is also comfortable. The level of reserves well exceed India's overall external debt. In terms of total external liabilities, which include portfolio liabilities, India's reserves cover over one half of the external liabilities. In the context of large non-debt flows in recent years, greater attention is required to the concept of reserve adequacy in relation to external liabilities.

4.35 While the reserves are comfortable in relation to various parameters, the Committee has some concerns about the coverage of data on short-term debt, including suppliers' credit. Again there are concerns whether the flow of private equity capital are fully captured in the data (on FDI). The Committee suggests that the RBI should undertake an in-depth examination of the coverage and accuracy of these data.