13

External Sector Liberalisation

INTRODUCTION

INTEGRATION INTO THE GLOBAL ECONOMY

As brought out in detail in the previous chapter, the unprecedented payments crisis of 1991 was overcome by the concerted policy reforms initiated by the Government and the Reserve Bank in July 1991 onwards, including the depreciation of the Indian rupee by 18.7 per cent against the US dollar. The reforms implemented from 1991 resulted in the opening up of the Indian economy to the global economy. As a result of the policy reforms and successful mobilisation of exceptional financing, there was a marked improvement in the external payments situation and debt indicators. The increase in reserves combined with stabilisation and structural reforms restored international confidence, providing the basis for further liberalisation of trade, tariff, export credit and foreign investment policies during the subsequent period.

Against the backdrop of the policy objective of promoting exports and simplifying import procedures, several measures were introduced during the period. With the initiation of these measures, the trade policy focussed on providing both the institutional and infrastructural back-up to promote exports. The export volume responded to the reforms in trade and balance of payments (BoP) policies. The much needed recovery in export growth commenced from 1993–94 and remained strong during the subsequent two years until 1995–96 though it moderated in 1996–97. The size and quality of foreign exchange reserves also improved significantly.

A new regime of exchange rate management was introduced with the unification of dual exchange rates and the floating of the rupee was announced in the budget of 1993–94. The Reserve Bank set up an expert group (Chairman: Shri O.P. Sodhani) in November 1994 to recommend measures for the growth of an active, efficient and orderly foreign exchange market and to suggest new derivative products. The group made wide-ranging recommendations concerning the removal of market constraints; development of derivative products with suggestions for short-term and long-term measures; risk management; and accounting and disclosure standards. It also dealt with aspects such as information systems and clearing mechanisms relating to the market. The implementation of these measures was expected to create a vibrant but well-regulated foreign exchange market in India that could withstand external shocks successfully. Exchange controls were further liberalised through the amendment of Foreign Exchange Regulation Act (FERA) and other laws.

With industrial recovery strongly under way, imports rose continuously, resulting in the widening of the trade deficit. Growth in invisibles, however, came to the rescue to a considerable extent. Debt-service payments continued to be high, but the debt-service ratio declined with the significant improvement in current receipts. In the medium term, India's BoP situation continued to depend crucially on the export performance. Success in sustaining strong export growth mainly depended on maintaining a competitive exchange rate, overall macroeconomic stability, relative profitability of exports and the competitiveness of the economy.

On account of the positive developments mentioned above, India remained much less vulnerable than most of the East Asian economies when the South-East Asian crisis broke out in 1997. The current account deficit (CAD) had declined to a sustainable 1.25 per cent of the gross domestic product (GDP) in 1996–97. External debt as a proportion of GDP (24.5% in 1996–97) was lower as compared with that of Indonesia (61.3%), the Philippines (59.3%) and Thailand (62.0%). Short-term debt was 7.2 per cent of the total debt in 1996–97. The debt-service ratio fell by 12.3 percentage points from 35.3 per cent in 1990–91 to 23.0 per cent in 1996–97, and the share of concessional credit remained at around 40.0 per cent. The banking sector — of which about 80.0 per cent was state-owned — was also in a better position, with non-performing loans (NPLs) only 8.0 per cent of total loans. The fiscal deficit, although high at 6.4 per cent of GDP in 1996–97, had declined since the early 1990s. All these aspects signified strengthening of the economy further.

CHAPTER OUTLINE

Against the above backdrop, this chapter traces developments in the external sector, including changes in direction of policy in relevant areas, post the BoP crisis between 1992–93 and 1996–97.[1] The broad areas covered are the BoP and its different components, the external debt situation, the reserves position, tapping of gold for external adjustments and exchange rate management.

BALANCE OF PAYMENTS

After the resolution of the BoP crisis of 1991; it was felt that the best way to put BoP on a long-term sustainable path was through comprehensive liberalisation of international trade/finance, capital flows and exchange regime, which was effected during the 1990s. The approach, however, remained cautious. Not only were the reforms sequenced and phased out but the policy also encouraged enduring non-debt-creating inflows as compared with short-term, volatile and debt-creating flows. While foreign direct investment (FDI) and equity flows found favour, capital controls continued on debt flows. Similarly, while capital account was opened to foreign entities, in particular institutional investors, controls continued on residents' investments abroad. Further, any implicit exchange guarantee to borrowers or investors, including through special schemes for non-resident Indians (NRIs), was withdrawn in a phased manner. This paved the way for integration of the foreign exchange market with the money and credit markets.

The process of stabilisation of the BoP was carried forward during 1992–93. The self-balancing mechanism embodied in the liberalised exchange rate management system (LERMS), a dual exchange rate system, and exceptional financing from bilateral and multilateral sources enabled an accretion of US$ 612.0 million to the country's stock of foreign exchange reserves in 1992–93. By the end of March 1993, the Bank's foreign currency assets (FCA) recorded a rise of 14.2 per cent over the previous year. The response of the real sector to the supply-augmenting initiatives of structural reforms was weaker than anticipated, despite the strong recovery in agriculture.

Social disturbances in the country, particularly in Bombay (now Mumbai), which accounted for roughly 60.0 per cent of transportation

1. The critical measures taken as part of crisis resolution immediately following the crisis are covered in chapter 12: Management and Resolution of the 1991 Crisis.

services related to foreign trade, stifled the seasonal upturn in both exports and imports, which usually occurred in the second half of the financial year. The uncertainty surrounding the external transactions with the constituents of the Commonwealth of Independent States (CIS) and the impediments to trade diversification in the context of the continuing recession in industrialised countries were the adverse exogenous factors that had a bearing on the external sector.

During 1993–94, there was a remarkable improvement in the BoP position, reflected in an unprecedented accretion to foreign exchange reserves. A steady build-up of FCA in the first half of 1993–94 was followed by a massive surge from November 1993 onwards. With an increase of 134.2 per cent in 1993–94, FCA reached a historic peak (US$ 15,068.0 million) by the end of March 1994, equivalent to nearly nine months of imports.[2]

The external sector exhibited strength and resilience during 1994–95, consolidating four years of stabilisation and structural adjustment. There was a continued accumulation of reserves, reflecting sustained improvement in the current account balance and strong capital inflows. The CAD in 1994–95, although estimated to be larger than in the preceding year, was clearly justified and sustainable. The export performance during 1994–95 benefited from the recovery in world trade, favourable policy environment and a stable exchange rate. While the exchange rate of the rupee against the US dollar remained steady for the greater part of the year, the weakness of the US dollar against other international currencies offset the adverse inflation differentials between India and the rest of the world.

The large capital inflows witnessed in the second half of 1993–94 continued in the first half of 1994–95. Injection of external liquidity posed problems for the conduct of monetary management. As in the preceding year, the capital flows were dominated by inflows of foreign investment, direct and portfolio, that exceeded the net inflows recorded in 1993–94. Although the capital flows moderated in the second half of 1994–95 in response to the introduction of various policy measures, the absence of an external financing need resulted in a large accretion to the reserves.

Reflecting the strong real output performance, the external trade account showed a larger deficit in 1995–96, with imports recording an increase of 30.0 per cent (in dollar terms) against an export growth of 20.9 per cent. With the invisibles surplus being significantly higher than

2. For details, refer to Table 13.5.

in 1994–95, the external current account showed a deficit of about 1.7 per cent of GDP. The enlarged external financing requirement of the economy coincided with a moderation in external capital flows, resulting in a drawdown of international reserves. As the developments in the external sector signalled easing of the nominal exchange rate, speculative tendencies appeared in the spot and forward segments of the foreign exchange market and the short end of the money market during the period from October 1995 to February 1996.

The Reserve Bank engaged in tactical interventions consistent with the fundamentals. When the rupee weakened sharply against the US dollar in the first week of February 1996, the Reserve Bank announced decisive measures to accelerate the repatriation of export proceeds and moderated the acceleration of import payments. This helped to bring about stability in the market almost immediately and by March 1996; the rupee regained much of its lost ground, achieving in real terms a level consistent with the fundamentals.

The FCA of the Reserve Bank, which were drawn down by 23.4 per cent at the end of February 1996 over that of March 1995 showed a turnaround thereafter and by the end of March 1996, the assets had reached a level equivalent to about five months of imports. At the end of June 1996, the FCA rose further by 2.8 per cent over the previous quarter.

The external sector exhibited distinct signs of stability during the year 1996–97, unlike the turbulence in the foreign exchange market witnessed in the second half of 1995–96. The moderation in the growth of industrial output restrained import demand and, in conjunction with the sluggishness in world trade had the effect of dampening export growth. A surge in net invisibles earnings and a strong resumption of capital flows, after the brief interruption between October 1995 and February 1996, resulted in a large overall surplus in the BoP. Reflecting these developments, surplus conditions prevailed in the foreign exchange market throughout the year. While the spot market saw excess supplies of foreign exchange, premia in the forward market declined significantly, reflecting easing of downside expectations of the future exchange rate of the rupee as well as a narrowing of short-term interest rate differentials *vis-à-vis* the rest of the world. The nominal exchange rate faced considerable upward pressures, which were mitigated by passive interventions by the Reserve Bank. Despite the interventions, the appreciation of the US dollar *vis-à-vis* other international currencies, as well as a continued inflation differential, translated into a large appreciation of the real effective exchange rate (REER) of the rupee by 9.6 per cent by March 1997 over the base period set at March 1993.

TABLE 13.1

Key Components of India's BoP

(US$ million)

		1992–93	*1993–94*	*1994–95*	*1995–96*	*1996–97*
I.	Current Account					
	(i) Exports	18,869 (3.3)	22,683 (20.2)	26,855 (18.4)	32,310 (20.3)	34,133 (5.6)
	(ii) Imports	24,316 (15.4)	26,739 (10.0)	35,904 (34.3)	43,670 (21.6)	48,948 (12.1)
	(iii) Trade Balance	–5,447	–4,056	–9,049	–11,359	–14,815
	(iv) Current Account Balance	–3,526	–1,159	–3,369	–5,912	–4,619
II.	Total Capital Account @	2,936	9,694	9,156	4,690	11,412
	IMF, SDR Allocation	1,288	188	–1,143	–1,715	–975
III.	Reserve and Monetary Gold, Increase–/Decrease+	–698	–8,723	–4,644	2,937	–5,818

Notes: @ Capital Account includes errors & omissions.
Figures in parentheses indicate percentage increase over the previous year.

Source: Reserve Bank of India, *Handbook of Statistics on the Indian Economy, 2008–09*.

FOREIGN TRADE

As described in the previous chapter, the stabilisation measures introduced during 1991–92 in response to the crisis indicated that both the Government and the Reserve Bank had recognised the need for extensive decontrol and delicensing measures to enhance the productive potential of Indian entrepreneurs and raise the underlying growth potential of the economy. Liberalisation was introduced in sectors like exports, imports and customs tariffs for ensuring growth in domestic production and maintaining price competitiveness of Indian goods in the international market.

EXPORTS

The import control measures for exports were primarily directed at providing duty-free access to imported inputs like intermediate goods and reduced duty access to capital goods used in export production. The primary objective of the reform process was to simplify the system while making it as comprehensive as possible. In the trade policy of April 1993, the system of export-oriented units (EOUs) and export processing zones (EPZs) was extended to agriculture and allied exports, with 50.0 per cent domestic tariff area (DTA) sales allowed. Under the export promotion capital goods (EPCG) scheme, the concessional duty on capital goods was reduced to 25.0 per cent and 15.0 per cent, respectively, subject to certain conditions. In April 1994, an electronic hardware technology park scheme was introduced on par with EPZs. The concept of a free trade zone was evolved and finally accepted at the end of the 1990s.

During 1992–93, subdued export performance and a moderate rise in import demand yielded a merchandise trade deficit of US$ 5,447.0 million. This reflected the compressed level of imports during 1991–92. The modest recovery in exports during the first half of 1992–93 was largely offset in the second half of the year on account of dislocation of trade following disturbances in Bombay and weak world demand. These negative factors resulted in very low export growth at 3.3 per cent. Imports, on the other hand, grew by 15.4 per cent during the year (Table 13.1).

Exports to the general currency area (GCA), having a direct bearing on foreign exchange reserves, exhibited resilience. The growth in GCA exports was evident from the beginning of the year up to October 1992; it decelerated in the following two months and veered away from the seasonal pattern (measured in terms of monthly averages of those exports over the preceding three years). By January 1993, however, GCA exports resumed the seasonal uptrend, which reached a peak in the closing month of the year. Given the continued sluggishness in the international prices of tradeables, the volume growth of GCA exports during 1992–93 was placed in the range of 7.0–8.0 per cent.

During 1992–93, exports to the rupee payment area fell over the year by 62.2 per cent in US dollar terms and continued to be a drag on overall export growth. The deterioration in these exports was evident for a third year in succession. The collapse of trade with the erstwhile USSR, one of India's principal markets, led to a marked shift in the destination of exports and sources of imports between the GCA and the RPA. During the subsequent three years between 1993–94 and 1995–96, export performance was robust and recorded a growth in US dollar terms of 20.2 per cent, 18.4 per cent and 20.3 per cent, respectively, over the previous years.

The robust export growth could not be sustained during 1996–97. Exports during 1996–97 registered a modest growth of 5.6 per cent as compared with the very high average growth rate of 19.7 per cent during the three-year period ending 1995–96. The slowdown in export growth during 1996–97 could be attributed, *inter alia*, to the decline in world trade coupled with sluggishness in prices of manufactured goods in the global market, variations in cross-currency exchange rates and a slowdown in domestic industrial activities. The deceleration in exports was spread across major commodity groups. Export growth of agriculture and allied products decelerated (in US dollar terms) to 11.1 per cent in 1996–97 from the 44.6 per cent recorded during the preceding year; items such as tea, coffee and rice even witnessed absolute declines. The export growth of manufactured goods also slid down sharply to 3.6 per cent from 16.3 per cent in 1995–96.

At the disaggregated level, India's major export items that showed considerable deceleration during 1996–97 included gems and jewellery, leather and leather products and readymade garments. These three commodities together accounted for around 25.0 per cent of India's total incremental exports during 1995–96. In 1996–97, however, the export earnings (in US dollar terms) for the first two categories showed absolute declines, while those of readymade garments increased only marginally.

IMPORTS

The import control regime was extremely complex till 1990–91. Significant efforts were made to simplify this complex regime during the 1990s. The existing cash compensatory system was abolished. Quantitative restrictions were gradually eased by moving items from the limited permissible category list to the open general licence (OGL) category. A proactive policy of customs tariff reforms was pursued through the 1990s. The objective was to ease overall protection by reducing the arbitrary distribution of protection among industries through a reduction in the dispersion of tariffs. The peak customs tariff rate at around 300.0 per cent in 1990–91 was gradually reduced to 50.0 per cent in 1995–96 and further to 40.0 per cent in 1997–98.

Following the liberalisation in baggage rules for people of Indian nationality or origin returning from abroad, which was effected in the Union Budget 1992–93, there was an estimated inflow of about 132 tonnes of gold valued at approximately US$ 1.4 billion during 1992–93. In February 1993, similar liberalisation was extended to the import of silver, as a result of which about 650 kg of silver was brought into the country during 1992–93. However, this inflow of bullion was not reflected either under imports or under private transfer receipts in the BoP data for 1992–93.[3]

3. Reserve Bank of India, *Annual Report, 1992–93*.

The rebound in imports from the compression of 1990–91 and 1991–92 was strong in the first half of the year 1992–93, with import growth at 22.3 per cent in US dollar terms during April–September 1992; in the second half of the year, there was a perceptible slowdown in imports. As a result, the import growth for the year as a whole was only 15.4 per cent in US dollar terms, considerably lower than the expected increase from the retrenched level of imports in 1991–92. Non-petroleum, oil and lubricants (non-POL) imports rose by 11.2 per cent in US dollar terms after declining by 22.2 per cent in the preceding year. The impact of extraneous developments and the postponement of some imports in the latter half of the year due to expectations about changes in tariffs altered the seasonal pattern of non-POL imports during the year and resulted in a contra-seasonal downward drift between September 1992 and January 1993.

During 1993–94, import demand remained weak due to the interplay of various factors. With the ongoing liberalisation in trade policy, the need for imports to build up large inventories diminished. The stability of the exchange rate further reduced the anticipatory demand for imports. Sluggish industrial growth as evidenced by decelerating non-oil imports contributed to the weak import demand. Non-oil imports, according to Director General of Commercial Intelligence and Statistics (DGCI&S) data, included aircrafts acquired by Air India and those leased by Indian Airlines and air-taxi operators. If the value of the aircrafts was excluded, non-oil imports would have grown by 5.3 per cent during 1993–94 and overall imports by 9.9 per cent over the previous year.

The significant expansion of imports during 1994–95 and 1995–96 at 34.3 per cent and 21.6 per cent, respectively could be attributed to marked buoyancy in the industrial sector. Both oil and non-oil imports contributed to the high import growth. Reflecting in part the hardening of crude oil prices in the international markets, imports of POL registered a rise of 27.3 per cent during 1995–96. Non-oil imports, on the other hand, increased by 26.8 per cent as against 29.5 per cent during 1994–95. The surge in capital goods imports reflected the buoyancy in investment climate and industrial production during the year. Further, the increase in export-oriented imports, especially for manufactured goods exports, such as chemicals, pearls, precious and semi-precious stones, and iron and steel was also high, reflecting the buoyancy in export growth during the year 1995–96.

Imports rose by 12.1 per cent during 1996–97 compared with the average growth rate of about 27.9 per cent during the previous two years.

Despite the sharp rise in POL imports, the growth in aggregate imports remained subdued during the year 1996–97 on account of an absolute decline in non-oil imports. Non-oil imports were sluggish throughout the year, decreasing by 2.3 per cent during 1996–97 in contrast with a sharp rise of 28.3 per cent during the preceding year. The deceleration in domestic industrial activity and in exports could have, in part, contributed to a decline in non-oil imports. POL imports recorded a large increase of 33.8 per cent during 1996–97 compared with 27.0 per cent during the corresponding period of the preceding year, reflecting shortfalls in domestic production and refinery throughput, coupled with a firming up of international prices.

STRUCTURAL SHIFTS IN MERCHANDISE TRADE

India's exports exhibited substantial structural changes in a longer time horizon. The striking feature that emerged was the declining share of primary products, while manufactured goods exports assumed increasing importance in India's export basket. This was evident from the fact that the share of primary products in total exports declined from around 36.8 per cent in 1980–81 to around 23.8 per cent in 1990–91. In contrast, manufactured goods exports showed a persistent rise from 55.8 per cent in 1980–81 to more than 70.0 per cent by 1990–91. This structural shift in the composition of India's exports continued during the 1990s as well.

Within the primary goods sector, the fall in the relative share emanated primarily from the declining importance of traditional agricultural export categories, such as tea, tobacco, cashew kernels, spices and oilcakes. The decline would have been sharper but for the emergence of non-traditional export items, such as rice, fish and fish preparations, meat and meat preparations, vegetables, fruits, floricultural products and processed items from the 1980s.

A similar trend was discernible in the manufactured goods sector with traditional exports such as cotton fabrics and jute manufactures being overtaken by non-traditional items such as chemicals, engineering goods, readymade garments, gems and jewellery, and leather and manufactures.

The shift in the structure of merchandise imports, on the other hand, was not as perceptible as in the case of exports. Imports of fibres, iron and steel, non-ferrous metals, fertilisers, pulp and waste paper, and paper and paperboards registered a steady decline, with their combined share in total imports shrinking from 19.8 per cent in 1980–81 to 13.2 per cent in the early 1990s. On the other hand, the share of pearls, precious and semi-precious stones registered a continuous increase to 8.5 per cent during the 1990s. The share of capital goods improved from 15.2 per cent in 1980–81 to 24.2 per cent during the early 1990s. The share of POL indicated a sharp rise to 41.9 per cent in 1980–81. Since the 1990s, however, their share had remained at around 24.0 per cent.

INVISIBLES

During 1992–93, the invisibles account recorded deterioration. There was a decline in the rate of growth of tourist arrivals (including nationals of Pakistan and Bangladesh) by 2.2 per cent, reflecting the impact of the disturbances that occurred at the beginning of the tourist season. The rising trend in interest payments decelerated, although outward remittances on account of royalty and technical fees continued to increase. Private transfer receipts, mainly comprising remittances from NRIs, remained broadly at the level of the preceding years, although there were indications of some diversion of remittances to the capital account to avail of the benefit of the full applicability of the market rate of exchange to such transfers which would otherwise have been converted at a composite of official and market rates in the ratio of 40:60. The invisibles account, inclusive of official transfers, yielded a net outflow of US$ 815.0 million. Distinct shifts in inflows under various non-resident deposit schemes[4] occurred as a result of concerted policy efforts undertaken during the year 1993–94. Interest rates prescribed for various maturities under the FCNR (B) and the FCNR (A) schemes were adjusted periodically during the year, keeping in view the movements in the international interest rates. Under the NR(E)RA Scheme, the cap rate of interest for term deposits was revised downwards from 12.0 per cent to 11.0 per cent with effect from October 12, 1993, and further to 10.0 per cent effective May 16, 1994. To mobilise deposits under the NR(NR)RD and FCON schemes, it was, as in the past, left to commercial banks to decide the interest rate structure for different maturities.

The treatment to be accorded to the FCNR (A) scheme as part of the country's external debt statistics was subjected to critical review during 1992–93. Up to the year 1991–92, outstanding balances under

4. FCNR (A): Foreign Currency Non-Resident (Account); FCNR (B): Foreign Currency Non-Resident (Bank) Account; NR(E)RA: Non-Resident (External) Rupee Account; FCON: Foreign Currency Ordinary Non-repatriable Account; FC (B&O) D: Foreign Currency (Bank and Others) Deposit; NR(NR)RD: Non-Resident (Non-repatriable) Rupee Deposits.

the FCNR (A) scheme were included in the debt statistics exclusive of accrued interest, primarily due to the accounting procedure adopted for transactions under the scheme. Interest accruing on FCNR (A) deposits and credited to the accounts, however, impacted on the debt statistics only when it was reinvested as a fresh deposit (inflow) or when it fell due and was paid out (outflow). Interest credited to the accounts but not specifically re-deposited was not placed under debt because it did not involve any immediate purchase or sale of foreign currency. Since it constituted a liability, the statistics relating to the FCNR (A) scheme were recast to add the interest amounts credited to the accounts to the principal amounts to derive the outstanding FCNR (A) liabilities, in line with the recommendations of the policy group/task force on external debt statistics of India (1992) set up by the Government. As a result of the concerted efforts to collect actual information on accrued interest credited to the accounts from the records of transactions between the Reserve Bank and deposit-taking banks, outstanding balances under the FCNR (A) as at end-March 1994 were estimated at US$ 9,300.0 million.

Since the institution of structural reforms, there was an appreciable improvement in the performance of invisibles receipts, which offset the invariant trend in invisibles payments. Since 1991–92, surplus on the invisibles account was financing, to a considerable extent, the deficits on the merchandise account and, as a result, the CAD remained comfortable. In assessing the sustainability of the current account, it was, therefore, necessary to encompass invisibles transactions along with merchandise trade. The ratio of current receipts (excluding official transfers) to current payments moved up appreciably over the three years from 1992–93 to 1994–95. Current receipts financed as much as 94.3 per cent of current payments during 1994–95.

During 1995–96, invisibles receipts maintained a rising trend, spurred by a revival of tourist interest in India and supported by buoyant private transfer receipts as the depreciation in the nominal exchange rate induced switching to repatriation through formal channels. Despite the sharp rise in investment income payments, the net surplus under the invisibles account helped moderate the impact of the expansion in the merchandise trade deficit on the BoP.

The buoyancy imparted to net invisibles earnings with the institution of the market-determined exchange rate system and the introduction of current account convertibility was sustained during 1996–97. A surge in the surplus on the invisibles account was led by burgeoning private transfers, partly reflecting the conversion of India development bonds (IDBs) and a noteworthy improvement in software and other technology-related exports. There was an estimated increase of about 46.0 per cent in exports of software in 1996–97 over the previous year. The increase in gross invisibles receipts more than offset the increase in net investment income payments. Underlying the growing surplus under net invisibles was the relatively stable growth in outflows under travel payments, as well as profits and dividends, contrary to expectations in the aftermath of current account convertibility. The net surplus under invisibles estimated in 1996–97 was significantly higher by 59.0 per cent than that in 1995–96. As a result, net invisibles receipts financed nearly 70.0 per cent of the trade balance compared with 48.0 per cent in 1995–96.

CURRENT ACCOUNT

The CAD for 1992–93 worked out to 2.1 per cent of GDP; it declined to 0.5 per cent of GDP during 1993–94, increased to 0.9 per cent during 1994–95 and went up further to 1.7 per cent of GDP in 1995–96. The CAD during 1995–96 underscored its inherent link with the rate of growth of the economy. CAD financed by capital inflows resulted in an accretion to the country's external liabilities, which required servicing. Accordingly, the size of the CAD needed to be kept at a level that was easily financeable. Traditionally, the debt-service ratio, *i.e.*, the ratio of interest and amortisation payments to current receipts, had been used as a measure of soundness. This ratio declined over the year, underscoring the fact that further slide in this ratio could occur only with a sharper increase in current receipts, especially export earnings. During 1995–96, the widening of the CAD was accompanied by a greater degree of openness of the economy as measured by the ratio of exports and imports to GDP, which rose from 19.5 per cent in 1994–95 to 22.8 per cent. Underlying the increasing global integration of the Indian economy was an improvement in the export to GDP ratio, which rose from 8.9 per cent in 1994–95 to 10.0 per cent in 1995–96. Current receipts were higher by 21.1 per cent over the preceding year. The import dependence also rose as evident from the sharp increase in imports during the year, causing deterioration in the ratio of current receipts to current payments to 89.1 per cent.

Drawing lessons from the crisis of 1991, the high level committee on BoP (Chairman: Dr C. Rangarajan) recommended that the CAD should be contained at 1.6 per cent of GDP, which could be financed with normal capital flows. Structural reforms launched in the wake of the 1991 crisis helped on two fronts. First, there had been a deliberate policy shift towards encouraging non-debt-creating flows to finance the CAD. Second, the current receipts — both merchandise and invisibles — had shown robust performance since 1990–91, largely as a result of the reforms process. The ratio of current receipts to GDP saw a perceptible rise from 8.5 per cent in 1990–91 to 15.6 per cent in 1996–97. The combined outcome of these two factors was reflected in the decline in the debt-service ratio from 35.3 per cent in 1990–91 to 25.4 per cent in 1996–97, despite the fact that 1996–97 was marked by one time repayment of the IDBs. With the downtrend trend in the International Monetary Fund (IMF) repayment obligations, the debt-service ratio was expected to record a steep decline from 1997–98 onwards.

CAPITAL ACCOUNT

During 1992–93, in the capital account, the net inflow of external assistance declined by 38.8 per cent from that in the preceding year, despite the mobilisation of exceptional financing from donors. Access to commercial markets was not attempted in view of the country's rating. Disbursements of commercial borrowings largely took the form of trade-related credits. There was a turnaround in the trend of net outflows under the FCNR (A) scheme and net inflows began to occur from October 1992 onwards. Drawals under the stand-by arrangement negotiated with the IMF were in the form of purchases of US$ 663.0 million in July 1992, US$ 643.0 million in December 1992 (of which US$ 295.0 million or SDR 212 million was held in the reserve position in the Fund as India's quota subscription towards the increase in quotas under the ninth general review of quotas), US$ 319.0 million in February 1993 and US$ 325.0 million in June 1993. Net purchases from the IMF amounted to US$ 1,288.0 million in 1992–93 as against US$ 781.0 million in the preceding year.

Net external assistance declined steadily from a level of US$ 775.0 million during 1992–93 to US$ 52.0 million during 1996–97 (Table 13.2). This was attributable to the slower pace of utilisation and a steady increase in repayments. India had refrained from seeking access to markets in Japan and the US since 1990–91 due to its low credit ratings. The Euro market had, however, been accessed by corporate entities, both for bonds and equity. Mobilisation of commercial borrowings had mainly been in the form of trade-related credits, with a small component of bank loans.

TABLE 13.2

External Assistance

(US$ million)

Year	*Authorisation Loans and Grants*	*Utilisation Loans and Grants*	*Debt Service Payments*	*Net Inflow of Aid*
	(1)	*(2)*	*(3)*	*(2–3)*
1992–93	4,606	3,589	2,814	775
1993–94	4,490	3,769	3,055	714
1994–95	4,302	3,478	3,315	163
1995–96	3,649	3,307	3,699	–393
1996–97	4,826	3,372	3,320	52

Note: Figures of authorisation have been arrived at by applying the average exchange rate of the rupee with individual donor currencies. Figures of utilisation are at current rates applicable at the date of transaction. Figures of authorisation and utilisation include loans and grants on both government and non-government accounts.

Source: Reserve Bank of India, *Handbook of Statistics on the Indian Economy, 2008–09.*

TABLE 13.3

Foreign Investment Inflows

(US$ million)

Year	*Direct Investment*	*Portfolio Investment*	*Total*
1992–93	315	244	559
1993–94	586 (86.0)	3,567 (1361.9)	4,153 (642.9)
1994–95	1,314 (124.2)	3,824 (7.2)	5,138 (23.7)
1995–96	2,144 (63.2)	2,748 (–28.1)	4,892 (–4.8)
1996–97	2,821 (31.6)	3,312 (20.5)	6,133 (25.4)

Notes: 1. Data from 1995–96 onwards include acquisition of shares of Indian companies by non-residents under Section 6 of FEMA, 1999.

2. Figures in parentheses represent percentage of increase or decrease over the previous year.

Source: Reserve Bank of India, *Handbook of Statistics on the Indian Economy, 2008–09.*

FOREIGN DIRECT INVESTMENT

In India's traditional policy framework, FDI was treated more as a source of transfer of technology. In the post-reform approach, its many other advantages such as infrastructure financing, trade and investment were fully recognised. After the crisis, FDI policy reforms formed part of a package of industrial reforms. The attempt to decontrol FDI took the form of an automatic route that was monitored and implemented through the Reserve Bank. FDI with up to 51.0 per cent foreign equity was allowed for 34 priority industries and international trading companies. The newly created Foreign Investment Promotion Board (FIPB) in 1992 ensured the speedy approval of FDI proposals outside the ambit of the automatic route. The scope of 51.0 per cent FDI was widened to cover other industries during the 1990s. A study by a private international consultancy organisation showed that both the FDI policy and its implementation through the Reserve Bank automatic route and the FIPB were comparable with those in South-East Asia and China.[5]

The capital account was dominated by foreign investment inflows that met more than half the financing needs. A welcome development was the spurt in direct foreign investment from 1995–96. During 1995–96 and 1996–97, it nearly equalled the net inflows of portfolio investment for the first time since 1992–93 and emerged as an important item in the capital account. There was a steady improvement in inflows arising from investment proposals by NRIs. The US continued to be the largest direct investor, followed by the UK. Industry-wise, financial companies accounted for the largest share of FDI flows, followed by engineering, electronics and electrical equipment.

PORTFOLIO INVESTMENT

Among emerging economies, India was one of early openers of the equity market to foreign portfolio investments.[6] In addition to the general objective of raising equity flows, there were two other considerations. Though the domestic saving rate was relatively high, the availability of risk capital in the equity market was low. It was envisaged that the flow of foreign equity would help develop the domestic equity market by bringing in the world's best practices and stimulating competition. Second, foreign equity investors were expected to come to India quickly to assess and disseminate the opportunities available in India, which would bode well for FDI.

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5. Virmani, Arvind (2003). "India's External Reforms: Modest Globalisation Significant Gains", *Economic and Political Weekly* 37(32): 3373-3390. August 9-15.
6. The World Bank (2001). *A Review of Financial Sector Issues.*

Portfolio investment inflows, which were placed at US$ 244.0 million during 1992–93, increased during the next five years and the inflow averaged US$ 3,056.0 million (Table 13.3). During 1995–96, the inflow of portfolio investment was adversely affected by a slump due to global depository receipts (GDRs) of Indian corporate in the Euro markets. The bearish domestic market conditions coupled with the restrictions on utilisation and placement of the proceeds of Euro issues, which remained in force up to November 1995, had a dampening influence on corporate that were accessing funds from overseas markets.

With effect from November 25, 1995, however, companies were allowed to bring issue proceeds into the country in anticipation of end-use, while ceilings on the use of funds for corporate restructuring, including working capital, were raised from 15.0 per cent to 25.0 per cent of the GDR issue. Further, the condition relating to the approval of GDR issue of a track record of good performance for a minimum of three years was relaxed in the case of companies in the infrastructure sector. In response to these policy shifts, several Indian companies launched GDR issues. The total amount repatriated to the country against GDR issues, however, was only US$ 149 million during 1995–96. Monetary tightening and rising interest rates in the US, beginning in February 1994, the Mexican crisis in December 1994 and bullish stock markets in the Organisation for Economic Cooperation and Development (OECD) countries, particularly the US, had the effect of lowering the flows to emerging markets. Among the emerging markets in Asia, a tendency to rotate funds away from the markets of Hong Kong and Singapore was driven by an appetite for higher risk-adjusted returns. In India, however, low stock prices tended to dampen foreign institutional investors' (FIIs') investment. FII investments surged on the perceptions of overcorrection in the stock and foreign exchange markets.

INDIA'S EXTERNAL DEBT

A cautious policy towards debt flows was outlined in 1992–93. This included tight control on short-term borrowings and a cap on total external commercial borrowings (ECBs). Until 1992–93, ECBs had a minimum maturity period of five years and could only be used to purchase capital goods abroad. Priority was given to infrastructure, exports and small and medium enterprises (SMEs). The policy was gradually liberalised through the 1990s. The stringent short-term debt policy resulted in the closing of the FC(B&O)D scheme in July 1992, the FCNR scheme of less than one year in May 1993 and the FCNR account scheme of less than two years in October 1993. As a result of this policy, short-term debt declined from 6.1 per cent of the total external debt at the beginning of the 1990s to 3.5 per cent at the end of March 2001. Other elements of this policy were eliminating ECBs, rigorous scrutiny of borrowings by public sector companies and increasing the share of private sector in ECBs. This resulted in a gradual decline in the share of the Government in external debt, while external private debt increased over the years (Table 13.4).

TABLE 13.4

India's External Debt (End-March)

(US$ million)

	1993	*1994*	*1995*	*1996*	*1997*
Total Long-term Debt	83,683	89,068	94,739	88,696	86,744
Short-term Debt	6,340	3,627	4,269	5,034	6,726
Total External Debt	90,023	92,695	99,008	93,730	93,470
Concessional Debt as % of Total Debt	44.5	44.4	45.3	44.7	42.2
Short-Term Debt as % of Total Debt	7.0	3.9	4.3	5.4	7.2
Debt Stock-GDP Ratio %	37.5	33.8	30.8	27.0	24.5
Debt-Service Ratio %	27.5	25.4	25.9	26.2	23.0

Notes: 1. Short-term debt does not include suppliers' credit of up to 180 days from 1994 to 1997.
2. Debt-service is calculated on cash payment basis except for NRI deposits for which accrual method is used. The estimates, therefore, differ from BoP data compilation methodology.
3. Debt to GDP ratio derived from ₹ figures.

Source: Government of India, *India's External Debt: A Status Report, 2001.*

OVERALL POSITION

The highlights of India's external debt position were:

(i) India's external debt recorded moderate growth of 3.0 per cent and 6.8 per cent during end-March 1994 and end-March 1995, respectively over the previous years. However, the external debt slowed subsequently, with negative growth of 5.3 per cent during 1996 and 0.3 per cent during 1997, compared with that of the respective earlier years.

(ii) As per cent of GDP at current market prices, India's external debt declined from the peak of 37.5 per cent in 1993 to 33.8 per cent in 1994, 30.8 per cent in 1995, 27.0 per cent in 1996 and 24.5 per cent in 1997.

(iii) Short-term debt (of maturity within one year) as a proportion of total external debt declined from 7.0 per cent at end-March 1993 to 4.3 per cent at end-March 1995, and thereafter increased to 5.4 per cent during 1996 and 7.2 per cent at end-March 1997.

(iv) A large part of the external debt, especially debt to multilateral (excluding the IMF) and bilateral agencies had a high degree of concessionality, *i.e.*, grant element of at least 25.0 per cent. The share of concessional debt in total debt varied from 44.5 per cent at end-March 1993 to 42.2 per cent in 1997.

(v) Debt in rupee terms owed to the former Soviet Union, rupee-denominated non-resident deposits and debt in the form of foreign currency convertible bonds (FCCBs) moderated the degree of concern about the level of external debt because of their special characteristics. The relatively high grant element in India's external debt translated into downsizing the nominal value of the debt by about one-third in present value terms.

(vi) The debt-service ratio stood at 27.5 per cent in 1992–93, 25.4 per cent in 1993–94, 25.9 per cent in 1994–95 and 26.2 per cent in 1995–96, and declined to 23.0 per cent during 1996–97.

THE POLICY GROUP

The policy group and task force on external debt statistics of India recommended a new definition and classification of external debt. The new classification was exhaustive and included, in addition to the components already covered, the interest credited to the accounts under the FCNR (A) scheme, convertible debentures, revalued balances under the International Bank for Reconstruction and Development (IBRD) pooled loans and exchange adjustments in respect of pre-1971 International Development Association (IDA) credits.[7] It would exclude lease transactions and rupee-rouble credits from the main debt statistics (the latter appear as memo items). Under the short-term debt, all credits up to six-month maturity were excluded. The group also recommended that the data on non-civilian debt be disclosed in view of the need for greater transparency of the debt statistics.

In relation to GDP at current market prices, the total debt excluding under memo items rose from 28.7 per cent at end-March 1991 to 35.7 per

7. IBRD pooled loans were excluded due to technical problems.

cent at end-March 1993. The debt-service ratio (*i.e.*, ratio of debt-service payments exclusive of defence-related debt-service payments to export of goods and services excluding official transfers) was estimated to have declined fractionally, from 35.3 per cent in 1991–92 to 27.5 per cent in 1992–93.

CONSOLIDATION

During 1993–1996, significant developments in the country's external transactions enabled a consolidation of external debt. As a result, at end-March 1996, the total debt recorded a decline of 5.3 per cent over the previous year and continued at the same level till end-March 1997. However, the reduction in external indebtedness during 1995–96 mainly reflected the appreciation of the US dollar *vis-à-vis* other major international currencies during the year, which more than offset the accretions in various important components of the debt stock.

The extent of indebtedness needed to be assessed, keeping in view the concessional element in the total debt. Bilateral debt and debt owed to multilateral institutions, both with a large element of concessionality, ranged between 42.0–44.0 per cent during 1993–1997. The share of ECBs comprising trade credits, bank loans and various types of securitised borrowings though remained range-bound between 13.0 and 18.0 per cent of the total debt between 1993 and 1997, there was a decline in the absolute level of bank loans as well as in their share in the total stock of debt. There was a perceptible decline both in terms of share and absolute level of short-term debt. Short-term debt declined from 7.0 per cent of total debt at end-March 1993 to 5.4 per cent at end-March 1997. This reflected the abolition of the short-term maturity slab under the FCNR (A) in May 1993 and the liquidation of liabilities due on account of public sector undertakings (PSUs).

Interestingly, according to the Global Development Finance 1997, India ranked sixth among the developing countries in terms of the magnitude of debt stock, which showed an improvement as compared with its fourth position in 1991.

RUPEE–ROUBLE DEBT

According to the agreement reached in the beginning of 1993, the amount of debt outstanding in Russian roubles as on April 1, 1992 was to be converted into Indian rupees and repaid in rupees as set out below:

(i) The outstanding debt expressed in roubles as on April 1, 1992 would be converted into rupees as per the rupee-rouble rate of exchange (in accordance with the provisions of the protocol dated November 25, 1978) prevailing on January 1, 1990 (₹ 19.9 per rouble).

(ii) The same rouble debt-stock would be converted into rupees at the exchange rate prevailing on April 1, 1992 (₹ 31.8 per rouble).

The difference between the two amounts, called rescheduled debt, would be repaid with no interest in equal annual instalments over a period of 45 years starting from April 1, 1993. There was no protection against any fluctuation in the value of the rupee for five years from April 1, 1992. Thereafter, this would be reviewed once every five years and, if there was more than 3.0 per cent depreciation of the rupee per year on an annual average basis *vis-à-vis* the SDR, the payment due on this account could be indexed to the rupee value of the SDR for the next five-year period. The debt, converted at the rate of exchange prevailing on January 1, 1990 (rupee equivalent of rouble debt as at (i) above), was called principal debt and would be repaid with interest in accordance with the payment schedule in force for each loan agreement. In case the value of the rupee *vis-à-vis* the SDR changed on any day after April 1, 1992 by more than 3.0 per cent either way compared with the base value of the rupee (which was ₹ 35.3637 on April 1, 1992), the amount of principal and interest to be paid would be readjusted proportionately to the change.

With this agreement, the advantage derived was that the increase in debt between January 1, 1990 and April 1, 1992 due to variation in the exchange rate of the rupee *vis-à-vis* the rouble as per the protocol would be repaid in 45 years without any interest.

FOREIGN EXCHANGE RESERVES

India's foreign exchange reserves as at end-March 1993 recorded an increase of 6.6 per cent over the previous year, *i.e.*, end-March 1992 (Table 13.5). Exclusive of gold revaluation and transactions with the IMF, the foreign exchange reserves declined by 5.3 per cent during 1992–93 against an increase of 30.3 per cent during 1991–92.

The international reserves increased significantly by 95.8 per cent as at end-March 1994. Excluding gold revaluation and transactions with the IMF, the foreign exchange reserves increased by 4.5 per cent as against a decline of 5.3 per cent during 1992–93. The reserves further rose by

30.8 per cent as at end-March 1995. Exclusive of gold revaluation and transactions with the IMF, the foreign exchange reserves increased by 18.3 per cent during 1994–95.

India's foreign exchange reserves stood lower by 13.8 per cent at the end of March 1996. By the end of June 1996, however, there was a modest build-up in the reserves. The movement in the reserves closely reflected the developments in the BoP and external sector polices pursued during the year. The reserves rose by 21.8 per cent during 1996–97, despite large payments on account of redemption of the IDBs and net outflows under the FCNR (A) scheme.

TABLE 13.5

Foreign Exchange Reserves

(US$ million)

End of Financial Year	*SDRs*	*Gold*	*FCA*	*Total*	*No. of Months' Import Requirement*
1992–93	18	3,380	6,434	9,832	4.9
1993–94	108	4,078	15,068	19,254	8.6
1994–95	7	4,370	20,809	25,186	8.4
1995–96	82	4,561	17,044	21,687	6.0
1996–97	2	4,054	22,367	26,423	6.5

Source: Reserve Bank of India, *Handbook of Statistics on the Indian Economy, 2009–10.*

FOREIGN CURRENCY ASSETS

The Reserve Bank's FCA rose by 14.3 per cent as at end-March 1993 over the previous year. The balancing mechanism of the dual exchange rate system under LERMS was evident in the broad correspondence between foreign currency purchases from and sales to authorised dealers (ADs). A sharp decline in aid receipts and large debt-service payments resulted in a net outflow from the stock of foreign currency assets. The foreign currency assets were bolstered by an inflow of exceptional financing (in the form of aid receipts) and net accruals from the IMF drawals. There was a turnaround in the net outflows under the FCNR (A) scheme. Large inflows under the FC(B&O)D scheme in the first four months of 1992–93 were counterbalanced by withdrawals in succeeding months, so that the year ended with a net inflow of FCA.

The Reserve Bank's FCA rose by a substantial 134.0 per cent at the end of March 1994 over the previous year, reflecting an excess supply of foreign exchange in the inter-bank foreign exchange market. The Bank's gross purchases of foreign currencies amounted to US$ 13,940.0 million during 1993–94. As a result of the cost-effective accretions to the FCA through purchases from the market, liabilities in the form of swaps that had been incurred during 1991–1993 could be completely settled. There were outflows under the FCNR (A) scheme and under the FC(B&O)D scheme (which was discontinued). In addition, aid receipts net of debt-service payments and transactions with the IMF yielded outflows resulting in a reduction in medium-term debt obligations. Further, there was a liquidation of the overhang of short-term liabilities incurred on behalf of PSUs during the payments crisis of 1991.

The increase in the reserves during 1994–95 was largely in terms of the Bank's FCA, which rose by 38.9 per cent at the end of March 1995 over that of March 1994. Unlike in 1993–94, the accretion to the FCA was uneven. Reflecting the surge in capital flows, FCA rose sharply between May and October 1994. In November and December 1994, moderation set in as several measures were taken to stem the inflow of elements of foreign capital that were responding to interest rate differentials aided by a stable exchange rate. In January 1995, FCA began to rise again as large purchases of foreign currency were undertaken from the market. While the Bank's purchases of foreign currency fell sharply in February and March 1995, the sharp rise in the FCA in these two months was propelled by the inflow of aid receipts. Despite augmented demand in relation to the preceding year, the inter-bank foreign exchange market faced conditions of excess supply of foreign exchange. The Reserve Bank had to resort to gross purchases of foreign currencies amounting to US$ 10,304.0 million during 1994–95. As in the preceding year, accretions to the FCA were utilised to reorganise the reserves by divesting them of costly liabilities. Liabilities under the FC(B&O)D scheme were completely paid-off during the year. There were also large outflows under the FCNR (A). In addition, debt-service payments of US$ 2,868.0 million and repurchases of US$ 1,146.0 million from the IMF yielded outflows, resulting in a reduction in medium-term debt obligations.

The increase in the foreign exchange reserves during 1996–97 was primarily in the form of accretion to FCA. If the effect of valuation loss resulting from the depreciation of non-dollar currencies *vis-à-vis* the US dollar was excluded, the increase in the FCA would be still higher. The perverse demand conditions and the leads and lags prevailing in the exchange market during 1995–96 completely reversed in 1996–97 under the impact of the strong policy response and market-driven corrections in the exchange rate. Excess supplies of foreign exchange, however, imposed pressure on the rupee to appreciate. Apart from the Reserve Bank's purchases of US$ 7,801.0 million, aid receipts of about US$ 1,705.0 million were the other important source leading to accretion to FCA. There were several large payments obligations to be met directly from the reserves during 1996–97. Under repayment of the IDBs, the actual depletion in the FCA was US$ 1,234.0 million. Besides, withdrawal of deposits under the FCNR (A) scheme of US$ 2,276.0 million and purchase of SDRs through the IMF for an amount of US$ 1,019.0 million for effecting various payments to the IMF also constituted major outflows from the reserves.

Following the decision in July 1995 in respect of routing debt-service payments on government account increasingly through the market (the Government's aid receipts continued to accrue to the account of the FCA of the Reserve Bank), the outflows from the reserves under debt-service payments remained low during the year. The FCA at the end of the year were sufficient to cover around six months of imports. A large stock of volatile/short-term foreign exchange liabilities, however, necessitated the holding of reserves higher than what is conventionally suggested in terms of months of import cover. It was perceived that in the Indian context, the need for a higher level of FCA than the conventional rule of thumb of three months' import cover was justified in the face of large short-term debt and portfolio investment by the FIIs.

RESERVES ADEQUACY

From the standpoint of achieving the goal of ensuring orderly conditions in the foreign exchange market as also to deal with situations arising on account of unanticipated and sudden reversals of capital flows, a level of reserve assets that could be considered as adequate needed to take into consideration a host of factors, such as the cover for sufficient months of current payments, the stock of short-term and volatile external liabilities, a shift in the pattern of leads and lags in payments/receipts during exchange market uncertainties along with the conventional norm of cover for sufficient months of imports. The gross foreign exchange reserves stood at US$ 26.4 billion at end-March 1997, equivalent to more than six months of imports. Even after taking into account short-term debt of US$ 5.0 billion, FII investment of US$ 8.5 billion and GDRs of US$ 6.0 billion, this level of reserves was considered adequate to deal with any external imbalances arising from fluctuations in capital flows. Though there was no specific policy on the quantum of reserves to be built up, the Reserve Bank, through various measures, accumulated a comfortable level of reserves by the end of the 1990s.

TABLE 13.6

Movement of SDR Transactions

(SDR million)

Year	*Nature of Transactions*	*Receipts*	*Payments*	*Balance (3–4)*
(1)	*(2)*	*(3)*	*(4)*	*(5)*
1992–93	Net acquisition	225	--	--
	IMF drawal	446	--	--
	Repurchase	54	--	--
	Payment of charges/interest	--	227	--
	Sale of SDRs	--	231	--
	Payment to IMF towards increase in India's Quota	--	212	55
1993–94	Acquisition	263	209	255
	IMF drawals	105	--	--
	Repurchase	96	--	--
	Payment of charges/interest to IMF			
1994–95	Payment of charges to IMF	--	7	–7
1995–96 (June 1995)	Acquisition of SDR	95	--	95
1996–97	Payment to IMF (charges and valuation effects)	--	764.59	--
	Acquisition from IMF	651	--	–112.23
	Interest received	1.36	--	--

Note: --: Not applicable/not available.

Source: Reserve Bank of India, *Annual Report*, various issues.

Besides the size of reserves, their quality also assumed importance. Unencumbered reserve assets[8] must be available at any point of time to the authorities for fulfilling various objectives assigned to reserves. In India, the only encumbrance is forward sales net of purchases. The Reserve Bank's accumulated forward liabilities, which were US$ 40.0 million at the end of August 1997, rose to a peak of US$ 3,190.0 million or the equivalent of 13.0 per cent of the corresponding gross reserves by the end of January 1998. As a matter of prudent management of external liabilities, the Reserve Bank's policy was to keep forward liabilities at a relatively low level as a proportion of gross reserves.

SPECIAL DRAWING RIGHTS

Holdings of SDRs remained small and showed two-way movements between 1992–93 and 1996–97. However, at the end of March 1997, they fell to a level of around SDR 1 million. The details of transactions are given in Table 13.6.

TAPPING GOLD FOR EXTERNAL ADJUSTMENT

As part of resolving external payments problems and shoring-up reserves, at various stages, the Reserve Bank considered tapping its gold resources and earning some income from gold holdings.

VALUE OF GOLD RESERVES

The Reserve Bank, in its letter (from the Governor, Shri R.N. Malhotra) to the Finance Minister dated August 16, 1990, had suggested, *inter alia*, revaluation of the gold assets held by the Reserve Bank closer to international prices by amending the Reserve Bank of India (RBI) Act, 1934, to increase the flexibility in the use of gold reserves, and to keep 15.0 per cent of these reserves outside India as already permitted under the Act. In about two months' time, the Government initiated action on the suggestion.

The holdings by the Reserve Bank of gold coin and gold bullion were being valued at 0.118489 grams of fine gold per rupee; accordingly, prior to October 1990, these holdings were valued at ₹ 280.67 crore in terms of section 33(4) of the RBI Act, 1934. The Government, by formulating an

8. The unencumbered reserve assets are reserve assets net of encumbrances, such as forward commitments, lines of credit to domestic entities, guarantees and other contingent liabilities.

ordinance dated October 15, 1990, amended the provisions of this section. Consequently, the Reserve Bank revalued its gold holding as on October 17, 1990 at the average of London market prices during the three-month period ended September 30, 1990, reduced by 10.0 per cent and the gold holdings stood at ₹ 6,623.44 crore. Further, the Reserve Bank decided to revalue the gold holdings at the end of each month based on the average daily London market prices during the month, keeping a margin of 10.0 per cent. This change to market-based valuation of gold helped over time to reflect the appropriate value of gold reserves. The details of the gold holdings (monetary gold) during the period 1992–93 to 1996–97 are given in Table 13.7.

TABLE 13.7

Movement in India's Gold Holdings

	1992–93	*1993–94*	*1994–95*	*1995–96*	*1996–97*
I. Stock of Gold (end-March)					
(i) Qty. (tonnes)	354	367	396	398	398
(ii) Value (US$ mn.)	3,380	4,078	4,370	4,561	4,054
II. Addition					
a) Interest on gold holdings kept abroad					
(i) Qty. (tonnes)	0.2	0.1	0.03	–	–
(ii) Value (US $ mn.)	2.5	1.4	0.3	–	–
b) Purchases from Central Government					
(i) Qty. (tonnes)	3.1	12.6	28.9	1.6	–
(ii) Value (US$ mn.)	29.4	139.3	315.0	17.9	–

Notes: '–': Not available.
mn.: million.

Source: Reserve Bank of India, *Annual Report*, various issues.

PROPOSAL TO ISSUE GOLD BONDS TO NRIs

In December 1990, the Finance Minister received several suggestions from NRIs to augment the foreign exchange reserves, one of which was to issue gold bonds to NRIs (and residents) with tax benefits and, in the case of residents, no questions were to be asked about the source of the gold. The bonds were repayable in gold or at the bidder's option in rupees at the prevailing domestic price of gold and to cover the gold price risk; the Government was to buy 10-year gold options in the international markets that might turn out to be cheaper than the best terms which any

Government could get in the international markets. The Reserve Bank was not much impressed with the proposal (as indicated to the Government in a letter dated December 17, 1990). The 'option' price suggested was seen as uneconomical since sizeable upfront premium was immediately payable in foreign currency. However, NRIs could be permitted to import or send out gold subject to the payment of a special customs duty of 30.0 per cent of the value of gold at international prices even though ultimately it might not result in any additional inflow of foreign exchange from the NRIs. This was because what they would have otherwise sent in the form of foreign currency remittances would in part come in the form of gold and thus diminish the inflow of forex remittances. Nevertheless, the Reserve Bank was prepared to allow the import of gold by NRIs for a limited period and the response was expected to be good.

In that connection, the Reserve Bank worked out two schemes, one for residents and the other for NRIs. For residents, gold bonds would be issued at the international price of gold converted into rupees at the prevailing exchange rate at an attractive interest rate consistent with immunity from disclosing the source of gold and tax concessions. These could be redeemed in rupees at the international price of gold and the rupee exchange rate then ruling, thus offering the investor the benefit of possible rupee depreciation and gold appreciation. On the other hand, NRIs were allowed to import gold for subscribing to the gold bond, by paying a special rate of 30.0 per cent customs duty, which would be added to the rupee value of the bond, thus making it attractive for them. The bonds were repayable only in non-convertible rupees and on the same terms as those for resident investors. Compared to deposits in an FCNR account, NRIs would get the added advantage of possible appreciation in the dollar price of gold with the tax benefits of the FCNR scheme, but at a somewhat lower rate of interest and without repatriation rights.

SETTING-UP OF A NATIONAL GOLD BANK

As part of economic restructuring after the 1991 crisis, a proposal to mobilise gold deposits from residents as well as NRIs for productive use at the hands of the Government was internally examined by the Reserve Bank. The total private gold holdings in the country were estimated at 7,000 tonnes (as against the monetary gold holdings of 350 tonnes). Besides, the estimated substantial gold holdings with NRIs, especially those living in the Middle East and African countries, were also kept in view. It was expected that efforts to mobilise gold through a gold bank from both residents and NRIs could generate wider support for three reasons:

(i) Chastened by the gulf war experience and seeking protection from the undercurrents of tensions in countries like South Africa, NRIs were showing interest in such a proposal.

(ii) A gold bank scheme that could provide liquidity against idle stocks of gold at a reasonable cost was expected to receive support within the country from the business community against the background of the credit squeeze and high interest rates.

(iii) The successful honouring of gold delivery commitments under the last scheme (issue of gold bonds by the Government at the time of the external aggression in the early 1970s) and, more importantly, the well-publicised sale and redemption of government gold in the recent past, were seen to have lent considerable credibility to any proposal from the Government involving gold.

In the aftermath of the crisis, a gold bank scheme was viewed as an arrangement to source external funds at low cost and as an off-balance sheet borrowing for the country. It was considered a safety net for procuring external resources at short notice to bridge any unforeseen gap arising from trade liberalisation. The scheme would substitute for a stand-by loan facility that many countries, like Indonesia, that were undertaking structural reforms, lined up with the international banks to safeguard against uncertainties in movements in the BoP.

It was proposed by the Reserve Bank that the gold bank would be a newly created entity under the Companies Act, jointly owned by the Reserve Bank and a few public sector banks (PSBs) that had overseas operations. The essential charter of the company would be to seek and obtain deposits in the form of gold or its equivalent value in dollars from residents and NRIs with a view to pledging such stocks with external agencies to raise funds and on-lend to the owners of the institution. It could seek and obtain the sovereign guarantee to the extent necessary in furtherance of the above objectives.

The Reserve Bank would issue gold certificates against the deposits, which would be redeemable at the end of five years by physical delivery of gold of international purity. Meanwhile, depositors would receive interest at 2.5 per cent per annum payable annually in dollars (or equivalent rupees for domestic residents). The Bank would be at liberty to pledge the gold abroad. On the then-quoted terms in the London market, a 5-year gold deposit with the international banks would fetch a return of about 1.3 per cent per annum. The depository would have the right of usage of the gold until redemption. The Reserve Bank would raise loans and lend to Indian banks at a matching cost.

Borrowings against gold were available at extremely fine rates. A 5-year loan against the pledge of gold stocks could be raised at LIBOR less 60.0 basis points per annum. Lenders normally lent up to 80.0–85.0 per cent of the gold value. They returned physical gold of the same purity at the end of the period of the loan. There was thus no price risk in the account of the borrower.

The gold certificates would be honoured either by delivery of gold abroad or, at the option of the subscriber, delivery of an equivalent quantity to a resident within the country. The local restrictions, if any, at major overseas centres to market such gold certificates would need to be examined. Besides, a mechanism to provide liquidity to such bonds by way of loans within and outside the country would need to be drawn.

In view of the likely larger measure of support from NRIs to the gold certificates than domestic residents and the likelihood of NRIs opting to direct gold delivery on maturity to residents in the country, a probable criticism against the scheme could be that it would amount to backdoor import of pure gold without any tariff. However, such a criticism needed to be viewed against the mandatory lock-in (maturity) period of five years during which the country made full use of the gold. There would be no prepayment or early redemption option under the gold certificates.

To sum up, it was considered viable to constitute a gold bank and issue gold certificates to residents and NRIs with a view to raising low-cost funds against the pledge of gold to support the economic restructuring. Besides providing a safety net for BoP requirements, such a scheme would help monetise a modest portion of the private gold holdings within the country and provide a cost-effective avenue to raise external funds away from traditional funding sources.

Accordingly, the Governor, Shri S. Venkitaramanan, in his letter dated February 9, 1991, suggested to the Finance Ministry to set up a gold bank to mobilise the idle gold holdings of the public and to raise foreign exchange resources against long-term deposits. The National Gold Bank was to mobilise gold from the public in the form of 5 to 7-year deposits, repayable either in gold or dollars at the international prices ruling at the time of maturity. Under an amnesty scheme drawn for the purpose, no questions were to be asked about the sources of gold so deposited. A token interest of 2.5 per cent was payable at the time of maturity of the bond on the value of the deposited gold. The national gold certificates issued against such deposits could be gifted without attracting gift tax and were exempt from wealth tax. The gold so mobilised was to be converted into foreign exchange through a variety of mechanisms to be utilised for providing foreign currency loans to Indian entities and would thus play a useful role in putting to effective use an asset that was remaining idle in the hands of the public, while ensuring a safe haven of investment to the holders of gold.

The Finance Secretary responded (letter dated April 16, 1991) that since the regular budget had been postponed and only the interim budget was to be presented, no new proposals involving the amendment to the tax laws could be finalised and that this proposal might be taken up afresh when the regular budget was presented.

Subsequently, the Government introduced only a gold bond scheme in 1993 that opened for subscription on March 15, 1993 and closed on June 14, 1993. The scheme mobilised 41.12 tonnes of gold from the public. At the domestic market prices (as on June 29, 1993), it was valued at about ₹ 1,807 crore (or ₹ 1,558 crore at international prices).

SUGGESTION TO EARN INCOME FROM GOLD RESERVES

In January 1994, the gold reserves of the Reserve Bank were 356 tonnes, valued at about US$ 4.45 billion at international prices. Further accretion of about 40 tonnes of gold was expected under the gold bond scheme, 1993 of the Government in terms of the arrangement to sell back the gold to the Government on maturity of the gold bonds. Thus, the Reserve Bank's gold holdings were expected to be close to 400 tonnes, equivalent to about one-third of the aggregate gold and foreign exchange reserves. Of this, about 65 tonnes of gold were being held abroad.

The Reserve Bank, in a letter dated January 11, 1994 to the Finance Secretary, proposed that it would be desirable to earn some income on at least a part of its gold holdings. For this purpose, the Reserve Bank of India Act had to be amended to authorise the Reserve Bank to have a reasonable degree of flexibility in its gold operations so as to enhance the returns without undue undertaking risks. The draft bill to amend the Reserve Bank of India Act prepared by the Legal Department was: (i) to authorise the Reserve Bank to place deposits with commercial banks and financial institutions (FIs) abroad; (ii) to provide gold loans to the institutions that were approved by the Central Board of Directors for promoting jewellery exports; and (iii) to deal in derivatives in respect of assets in which the Reserve Bank was permitted to invest under the Act. Investments in derivatives were envisaged since the Reserve Bank had been deploying its foreign exchange reserves in a range of foreign currencies in the form of high-quality money market instruments and bonds, which were in the nature of cash instruments, and a foray into new derivative transactions would enable the Reserve Bank to optimise returns without increasing the element of risk.

EXCHANGE RATE MANAGEMENT

The dual exchange rate arrangement instituted on March 1, 1992 under LERMS enabled an orderly transition from a managed float regime to a market-determined system. During the 12-month period of the operation of LERMS, the officially determined exchange rate held steady except for a downward adjustment of 1.12 per cent effected on December 4, 1992. The official exchange rate equilibrated between 40.0 per cent of current receipts surrendered to ADs and in turn to the Reserve Bank and payments for purposes designated under LERMS. An even volume of transactions passed through market operators and, as a result, the market-determined exchange rate was stable (Table 13.8). The spread between the official and the market rate moved in a narrow range, except in the month of February 1993, when speculative activity resulted in some turbulence in the inter-bank exchange market.

With the introduction of unified market-determined exchange rate system in March 1993, the Reserve Bank's obligation to sell foreign exchange at the official rate for essential purposes, such as oil, food and fertiliser and defence imports, was discontinued and purchases of foreign currency for such transactions were made at the market rate. A part of the Government's debt-service payments were also being put through the market. In consonance with the ongoing efforts to reform the exchange markets in India so as to better reflect the demand and supply position of foreign exchange, the process was carried forward and the debt-service payments of the Government were increasingly routed through the exchange market. The repurchase obligation to the IMF, however, continued to be met through the Reserve Bank.

TABLE 13.8

Spread between Official and Market Exchange Rates

(₹ *per US$*)

Month	*Official Rate*	*Market Rate*	*Spread*	*Weighted Rate*
(1)	*(2)*	*(3)*	*(4)*	*(5)*
March 1992	25.8901	29.4551	13.77	28.0291
April 1992	25.8900	30.9253	19.45	28.9112
May 1992	25.8900	30.3407	17.19	28.5604
June 1992	25.8900	30.2361	16.79	28.4977
July 1992	25.8900	30.2524	16.85	28.5074
August 1992	25.8900	30.0885	16.22	28.4091
September 1992	25.8900	30.0584	16.10	28.3910
October 1992	25.8900	30.0471	16.06	28.3843
November 1992	25.8900	30.0824	16.19	28.4054
December 1992	26.1540	30.7005	17.38	28.8819
January 1993	26.1986	30.8833	17.88	29.0094
February 1993	26.1986	32.6456	24.61	30.0668

Source: Reserve Bank of India, *Annual Report, 1992–93*.

LERMS as a system in transition performed well in terms of creating conditions for transferring an augmented volume of foreign exchange transactions on to the market. It imparted stability, resulted in a significant deceleration in the rate of inflation and a healthy build-up in the level of foreign exchange reserves. At this point, the Reserve Bank evaluated three options for modifying LERMS: (i) to maintain the status quo; (ii) to change over to a 80:20 ratio; and (iii) to have a unified exchange rate regime with one or more purposes for the official rate and no requirement for ADs to surrender any part of their foreign exchange receipts to the Reserve Bank. The implications of these options are detailed below:

Option I : Status Quo

(i) The Government would have to allocate the total foreign exchange that would be sold by the Reserve Bank in 1993–94 at the official rate for various purposes for which it was considered necessary.

(ii) Any change in the list of purposes would require a suitable order to be issued by the Government.

(iii) The Reserve Bank needed to change its instructions to ADs only if there was a change in the list.

Option II : 80:20 Scheme

(i) The list of purposes would have to be modified, specifying the purposes for which foreign exchange would be sold by the Reserve Bank at the official rate, since only 20.0 per cent of the current receipts would be pre-empted by the Reserve Bank.
(ii) Instructions to ADs would have to be issued regarding the modifications in LERMS.

Option III : Unified Exchange Rate

The Reserve Bank was in favour of a market rate-based official rate with the following clarifications:

(i) The Government would have to specify at least one purpose for the sale of foreign exchange at the official rate under section 40, as per the opinion of the Reserve Bank's Legal Department.
(ii) The market-based reference rate would be used for all transactions with the IMF, Asian Clearing Union (ACU), international credit and aid agencies, revaluation of Russian debt, revaluation of rupee balances of some of the banks in the former bilateral group, valuation of foreign exchange reserves, making provisions for balances held under various exchange protection schemes, debt-service payments and aid receipts on behalf of Government.
(iii) Since the holders of Exim scrip, advance/imprest licences and other special licences would be deprived of the benefit of a favourable exchange rate, they would have to be advised by means of a press release by the Reserve Bank that arrangements would be made to compensate them at the rate of 20.0 per cent of the value of the licence eligible for foreign exchange at the official rate. For this purpose, consultations between the Reserve Bank and Ministry of Commerce would be necessary.

UNIFIED EXCHANGE RATE SYSTEM

LERMS comprised a dual exchange rate system. It imposed tax on exports and resulted in rationing the subsidised foreign exchange among certain imports, which distorted resource allocation. As current and capital transactions were subject to different exchange rates, the diversion of remittances (current account) to certain non-resident rupee deposit schemes (capital account) became unavoidable. Therefore, eventually the merger of dual rates was effected on March 1, 1993.

The unified exchange rate arrangement operated within the overall framework of the exchange control. All foreign exchange transactions were put through ADs who had no obligation of surrender to the Reserve Bank. While foreign exchange transactions were effected at market rates, the Reserve Bank's own rate of exchange reflected market conditions and could move within a margin of 5.0 per cent on either side of the market rate. It could, at its discretion, buy US dollars spot and sell the currency for approved purposes and, as such, the Reserve Bank was no longer required to buy or sell foreign exchange; it could undertake, at its discretion, intervention purchases/sales of foreign currencies in the market. Besides its buying and selling rates for transactions with ADs, the Reserve Bank announced its reference rate on a daily basis, which was based on noon rates of a few select banks in Bombay. The Reserve Bank also entered into swap transactions in dollars with ADs for periods ranging from 2 to 6 months.

The market-based Reserve Bank official rate enabled a smooth transition to a regime under which the external value of the rupee was determined by market forces. The unification of the dual rate system into a single, floating exchange rate imparted a significant degree of flexibility in monetary management. The experience with the freely floating market-determined exchange rate system was satisfactory. Contrary to the expectations, there was remarkable stability in the exchange rate of the rupee. The rupee, in fact, strengthened on several occasions after the unification of exchange rates on March 1, 1993 (Table 13.9).

The unification of the exchange rate and the floating of the rupee, besides paving the way for current account convertibility, facilitated the foreign exchange market to develop and mature. The Reserve Bank permitted banks to deploy funds held in the foreign currency accounts of their customers in certain types of overseas investments. Banks were allowed to rediscount export bills abroad without the prior approval of the Reserve Bank with certain interest rate ceilings. Banks were also given permission to write cross-currency options for their customers by resorting to arrangements with their overseas branches or other banks abroad.

TABLE 13.9

Exchange Rate of the Rupee: Monthly Average

(₹ per US $)

Month Ended	*RBI Reference Rate*	*FEDAI Rate*
(1)	*(2)*	*(3)*
1993		
February	-*	32.9244
March	31.5833	31.5858
April	31.2940	31.2921
May	31.3255	31.3253
June	31.4065	31.4105
July	31.3702	31.3689
August	31.3723	31.3720
September	31.3712	31.3722
October	31.3700	31.3713
November	31.3700	31.3706
December	31.3704	31.3704
1994		
January	31.3700	31.3705
February	31.3700	31.3700
March	31.3731	31.3728
April	31.3704	31.3709
May	31.3700	31.3705
June	31.3705	31.3705

Note: * Introduced on March 1, 1993.

Source: Reserve Bank of India, *Annual Report, 1993–94* (compiled from weekly average exchange rate); Foreign Exchange Dealers' Association of India (FEDAI).

EXCHANGE RATE MANAGEMENT: SOME ISSUES

Large capital inflows in the wake of the introduction of a market-based exchange rate system in 1993 far exceeded the CAD and resulted in excess supply conditions in the foreign exchange market.[9] This turn of events posed challenges for the monetary authority in the conduct of both monetary and exchange rate policies. In this scenario, the Reserve

9. For details refer to chapter 16: Financial Markets.

Bank took the opportunity to dwell on the serious dilemmas faced by policymakers in adopting an appropriate strategy.[10]

Under a flexible exchange rate regime, *i.e.*, letting the nominal rate to appreciate in the face of large capital inflows, the Bank propounded, had the virtue of insulating the domestic economy from such inflows and containing inflation on account of a favourable pass-through from exchange rate to domestic prices. These benefits, however, had to be weighed against the cost of deterioration of external competitiveness, reflecting let go of the external balance objective.

Alternatively, if the objective was to prevent the real appreciation of the exchange rate and preserve external competitiveness, the following four options or a combination thereof were envisaged.

(i) The central bank could intervene in the foreign exchange market and sterilise the incremental liquidity thus generated, thereby keeping the monetary expansion under check. This process, however, carried quasi-fiscal costs associated with it and imposed the danger of raising real interest rates, which could induce further capital inflows.

(ii) Trade restrictions could be relaxed to enable capital flows to finance additional imports. These resource flows generally supplemented domestic saving and as such had the potential to foster economic growth. Caution, however, had to be exercised to ensure that investment increased and not the consumption. Otherwise debt servicing would become unsustainable.

(iii) Relax restrictions on capital inflows, which had the advantage of better portfolio diversification for domestic residents as well as improvement in the efficiency of the financial system. Sometimes, it could enhance the international confidence, thereby inducing larger inflows.

(iv) Restrictions could be reintroduced to moderate the pace of inflows, such as, increasing reserve requirements on non-resident deposits, tightening the norms for entities accessing international markets for private capital, higher withholding taxes on interest payments abroad, tightening prudential standards on external borrowing and introducing end-use clauses.

10. Reserve Bank of India, *Annual Report,* various issues; Extracts from the speeches of Governors.

The Reserve Bank was conscious of the fact that an open capital account would not only limit the authorities' independence in the conduct of exchange rate policy, but would also expose the economy to international shocks. More significantly, the Reserve Bank in its Annual Report (1993–94) observed:

> Any strategy of targeting an exchange rate or the money stock may be offset by unexpected inflows which affect the nominal exchange rate as well. Again, free floating of exchange rate may increase volatility and lead to persistent misalignments which could destabilise the financial system, thereby eroding the credibility of an independent monetary policy. To be consistent with the economic fundamentals, it may be imperative to allow short-term nominal appreciation during periods of excess supply, but the authorities would have to be prepared for aggressive intervention supported more often by equally aggressive sterilisation so as to defend the monetary objective. Longer-term measures for preventing deterioration in external competitiveness such as increasing fiscal concessions, softer export credit, etc., should be weighed against the likely amount of losses on account of higher debt servicing burden in the event of depreciation.

The Reserve Bank summed up its exposition by stating that the exchange rate regime, thus characterised, would involve an "activism" in the conduct of exchange rate policy.

CURRENT ACCOUNT CONVERTIBILITY

Current account transactions refer to external transactions in goods and services. In August 1994, India accepted the IMF's Article VIII and thus the rupee officially became convertible on the current account. Further liberalisation of the exchange purchase rules for current account transactions took place in 1995–96. Restrictions relating to the non-trade elements of the current account were also addressed subsequently. The provisions of current account convertibility envisaged:

(i) Indian exporters exporting to ACU countries and receiving the export proceeds in rupees or in Asian monetary units or in the currency of the participating country were permitted to receive payments in any permitted currency through banking channels, provided it was offered by the overseas buyer in the ACU countries.

(ii) ADs were empowered to release exchange without prior approval of the Reserve Bank in certain types of foreign travel, even in excess of the indicative limit, provided they were satisfied about the bonafide of the applicant and the need to release exchange in excess of the prescribed scale.

(iii) Interest income on NR(NR)RDs, which were not eligible for renewal, could be renewed along with the principal for deposit accounts opened on or after October 1, 1994.

(iv) ADs were empowered to allow remittances by a family unit of resident Indian nationals to close relatives residing abroad for their maintenance expenses up to US$ 5000.0 in a calendar year per beneficiary, subject to certain conditions.

(v) ADs were permitted to allow exchange earners' foreign currency (EEFC) account holders to use funds in such accounts to make remittances in foreign exchange connected with their trade and business transactions that were of a current account nature.

(vi) ADs were permitted to export their surplus stocks of foreign currency notes and coins for realisation of proceeds to private money changers abroad, in addition to their overseas branches or correspondents.

DEVELOPMENTS IN THE FOREIGN EXCHANGE MARKET

A detailed account of the developments in the foreign exchange market in India subsequent to the introduction of the market-based exchange rate system in March 1993 is given in the chapter titled: Financial Markets. Nevertheless, certain important aspects relating to the movements in the foreign exchange market are narrated briefly.

Up to 1994–95, there was remarkable stability of the rupee *vis-à-vis* the US dollar even though the Indian currency depreciated sharply against other major currencies and the SDR. Meanwhile, the Reserve Bank intervened in the foreign exchange market whenever there was upward pressure on the rupee or to protect the export competitiveness by preventing appreciation in the value of the rupee. Beginning from August 1995, the rupee came under downward pressure mainly due to widening CAD and pronounced appreciation of the US dollar against major international currencies. This trend was intensified in October 1995 on account of speculative tendencies. The Reserve Bank, in response, intervened in the foreign exchange market and initially tightened the liquidity in the money market. Subsequently, however, the Bank had to lend support to the money market when the rates went up substantially. The foreign exchange market returned to normal conditions after February 1996. Following large capital inflows in 1996–97, the Bank undertook sizeable purchases of the US dollar to protect international competitiveness of the exports.

CONCLUDING OBSERVATIONS

In response to the BoP crisis, concerted policy reforms initiated by the Government and the Reserve Bank in July 1991 onwards resulted in successful mobilisation of exceptional financing and led to a marked improvement in the external payments situation. The increase in reserves combined with stabilisation and structural reforms restored the international confidence in the Indian economy and provided the basis for further liberalisation of trade, tariff, export credit and foreign investment policies during the subsequent period from 1992–93 to 1996–97.

After a subdued performance in 1992–93, India's exports recorded robust growth during the three-year period from 1993–94 to 1995–96. The collapse of trade with the erstwhile USSR, one of India's principal markets, led to a marked shift in the destination of exports. A striking structural change in exports that emerged was the declining share of primary products, while manufactured goods exports assumed increasing importance in India's export basket. This compositional shift in India's exports continued during the 1990s.

Rebound in imports from the compression of 1990–91 and 1991–92 was strong in the year 1992–93. The significant expansion of imports during 1994–95 and 1995–96 could be attributed to marked buoyancy in the industrial sector. The shift in the structure of merchandise imports was not as perceptible as in the case of exports.

Owing to structural reforms, there was an appreciable improvement in the performance of invisibles receipts, which offset the adverse trend in invisibles payments. From 1991–92, surpluses on the invisibles account financed, to a considerable extent, the deficits on the merchandise account and, as a result, the CAD remained comfortable at 1.7 per cent of GDP in 1995–96. Drawing lessons from the crisis of 1991, the high level committee on BoP recommended that the CAD should be contained at 1.6 per cent of GDP, which was financeable with normal capital flows.

The capital account was dominated by foreign investment inflows that met more than half of the external financing needs. A welcome development was the spurt in the FDI from 1995–96. During 1995–96 and 1996–97, it nearly equalled the net inflows of portfolio investment for the first time since 1992–93 and emerged as an important item in the capital account. There was a steady improvement in inflows arising from investment proposals made by NRIs. The US continued to be the largest direct investor, followed by the UK.

The growth of India's external debt slowed substantially to an average annual increase of only US$ 2.2 billion between March 31, 1994 and March 31, 1997. As per cent of GDP at current market prices, India's external debt declined from the peak of 38.7 per cent in 1991–92 to 24.5 per cent in 1996–97. The debt-service ratio also moved favourably during the period.

Foreign exchange reserves expressed in terms of number of months of import requirement showed an uneven trend. From a level of 4.9 months' import requirements at end-March 1993, the reserves sharply rose to more than 8 months' import requirements at end-March 1995. The reserves marginally declined to cover around 6.5 months' import requirements at end-March 1997 and were considered to be comfortable to meet any unforeseen eventualities. Of the three components of foreign exchange reserves, the FCA showed a steady increase over the years from 1992–93 to 1996–97.

The dual exchange rate arrangement instituted on March 1, 1992 under LERMS enabled an orderly transition from a managed floating regime to a market-determined system. The spread between the official and market rates moved in a narrow range, except in the month of February 1993 when the speculative activity resulted in some turbulence in the inter-bank exchange market. LERMS, as a system in transition, performed well in terms of creating the conditions for transferring an augmented volume of foreign exchange transactions to the market. It imparted stability and helped in a significant deceleration in the rate of inflation besides facilitating a healthy build-up of foreign exchange reserves. At that point, the Reserve Bank evaluated three options for modifying LERMS: (i) to maintain the status quo; (ii) to change to a 80:20 ratio; and (iii) to have a unified exchange rate regime.

The unified exchange rate system, which came into force from March 1, 1993, stipulated that all foreign exchange transactions (receipts/payments), both under current and capital accounts of BoP would be put through by ADs at market-determined rates of exchange. The foreign exchange receipts/payments would, however, be subject to exchange control regulations. Foreign exchange receipts should be surrendered by residents to ADs except where residents were permitted to retain them either with banks in India or abroad. Foreign exchange was sold by ADs for permissible transactions. The Reserve Bank's sale of foreign exchange to ADs was only for purposes approved by the Government. ADs were free to retain the entire foreign exchange receipts surrendered to them for being sold for permissible transactions and were not required to surrender to the Reserve Bank any portion of such receipts. The rates of exchange for transactions with countries belonging to the ACU were at rates announced by the Reserve Bank. Such rates were to be determined based on prevailing market rates. The Reserve Bank might also undertake market intervention at its discretion for purchases/sales of foreign exchange in the market. Besides its buying and selling rates for transactions with ADs, the Reserve Bank announced its reference rate on a daily basis, which was based on noon rates of a few select banks in Bombay. The market rate-based Reserve Bank official rate enabled a smooth changeover to a regime under which the external value of the rupee was determined by market forces. The unification of the dual rate system into a single, floating exchange rate imparted a significant degree of flexibility to the exchange rate regime in BoP adjustment.

After the crisis of 1991, the foreign exchange market in India was at an important stage of evolution as it was liberalised from a regime of exchange control to fulfil its principal function of price determination in its various segments. Quantitative controls and barriers to entry were progressively dismantled to allow a greater volume and diversity of transactions to be cleared by the market. The regulations relating to the provision of forward exchange cover by ADs were relaxed. Following the success of the unified market-determined exchange rate system introduced in 1993 and the large accumulation of foreign exchange reserves, it was possible for the Reserve Bank to further simplify the procedures and delegate greater autonomy to ADs in respect of a number of current account transactions. While the linkage between the money market and foreign exchange market was weak in the pre-LERMS period, the introduction of a market-determined exchange rate and the growing importance of the forward market for foreign exchange transactions strengthened the conduits of transmission of impulses between the short end of the money market and the foreign exchange market. Several measures were taken by the Reserve Bank to deepen the foreign exchange market in India. From March 1992, banks were allowed to offer forward cover not merely for trade transactions but also for all genuine transactions as long as the amounts and the maturity dates were identifiable. In order to create liquidity in the foreign exchange market and to give market participants operational freedom and manoeuvrability, the corporate were permitted to cancel and rebook forward contracts.