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Balance of Payments and Exchange Control

INTRODUCTION

By an extraordinary happenstance, India began the 1980s with a severe balance of payments (BoP) problem and ended it with another. On both occasions, there was at least one common factor: a sudden increase in the price of crude oil. India's foreign exchange reserves were low when the decade of 1980s began. Global economic growth was sluggish and India's exports growth was slow. The imports were burgeoning as the oil import bill was large consequent on a rise in the international price of oil. The current account deficit (CAD) as a per cent of gross domestic product (GDP) rose from 0.5 per cent in 1979–80 to 1.8 per cent in 1980–81. External financing was not enough to meet the CAD as loans obtained under external assistance programme were the main source of capital flows. Therefore, the foreign exchange reserves were drawn down and International Monetary Fund (IMF) was approached for a financial assistance of SDR 5 billion in November 1981 to tide over the BoP difficulties. Quite interestingly, a similar chain of events occurred in 1990–91, of course with higher intensity.

In the 1980s, the Indian external sector scenario, to a large extent, mirrored the global situation, which influenced most of the developing countries. In varying degrees, almost all non-oil developing countries (NODCs) ran into BoP problems with India being no exception. In general, there was a substantial increase in trade deficits, as also sustained inflation in industrial countries along with subdued rates of growth in exports due to recessionary conditions coupled with a rise in protectionism in the industrial world. However, invisibles receipts expanded moderately, which were off-set by an increase in the interest payments on account of borrowings to meet the deficits in BoP. The inflow of larger external assistance was inadequate to meet BoP deficits. In a sense, if one part of the story of the 1980s was financial deregulation in the developed countries, the other part was the external payments crises in the developing world. India's BoP too remained under stress during the 1980s and India put in place several corrective measures, the details of which are given in Appendix 5.1.

The global context for what happened in the early 1980s was that the oil shock induced a slowdown in the overall global economic activity, which deepened into a worldwide recession. Because of the large bank borrowings in the 1970s, the outstanding external debt of the NODCs in the beginning of the 1980s formed 144.0 per cent of their combined exports of goods and services. To make matters worse, the ratio of short-term debt to total debt outstanding increased to 18.2 per cent during 1982. There was a corresponding increase in the indebtedness to private creditors, particularly to banks. The commercial banks had already emerged as the single most important source of non-concessional external financing for the NODCs. The external debt burden of NODCs was also concentrated among a few relatively better developed countries.

The external debt crisis emerged in many developing countries in 1982 fuelled by a host of factors, such as, the higher oil prices in 1973–74 and 1979–80, persistence of high interest rate levels during the period 1980 to 1982, declining export prices and their volumes associated with the global recession in 1981–82, problems of domestic economic management, and risk aversion in the credit markets. Debt had been solidly entrenched in the finances of the developing nations for many years. A sharp spike in international interest rates and plummeting global demand for developing country exports marked the beginning of the debt crisis.

On account of rising debt-servicing, the net external resource flows to the developing countries declined sharply by 12.1 per cent in 1982 due to an absolute decline in both official development assistance (ODA) and non-concessional aid flows. In relative terms, the share of ODA increased marginally from 34.0 per cent in 1981 to 35.0 per cent in 1982, and the share of non-concessional flows showed a corresponding decline during the period. Under the ODA, bilateral assistance declined and the fall was almost entirely accounted for by the reduced flows from the Organisation of the Petroleum Exporting Countries (OPEC). The total external resource flows to developing countries (in nominal terms) increased by 9.3 per cent during 1983. This increase was partly accounted for by an increase in concessional flow of funds. The share of grants by private voluntary agencies remained unaltered at around 2.0 per cent.

The increase in non-concessional flows in 1983 was predominantly on account of bank lending, as after the 1973–74 oil crisis, banks were flush with *petro* dollars and were keen to put these funds to productive use. As a result, the share of bank lending in total flows increased sharply from 26.9 per cent in 1982 to 39.0 per cent in 1983. Between 1981 and 1985, however, the net resource flows to the developing countries shrank by more than 40.0 per cent. The decline in aid flows was accounted for mainly by contraction in export credits and private flows, with ODA and grants from private voluntary organisations showing some increases. It was at this point that the IMF provided assistance and its structural adjustment programmes were framed to address the BoP problems, especially in the debt-stricken third world nations. Towards the mid-1980s, however, when the situation became grim, international banks abruptly disengaged from lending, since the risks became too grave. Financial resources provided to the developing world fell sharply in real terms in 1986, as higher official aid failed to balance out the continued net decline in export credits and bank lending. The flow of financial resources to the developing countries increased marginally in 1987, due mainly to official aid and international bank lending despite export credits showing a marginal decline. The situation of the indebted nations, however, continued to worsen and this led to a shift in focus from debt rescheduling to debt relief during 1988–89.

INDIA'S BALANCE OF PAYMENTS AND EXTERNAL ECONOMIC SITUATION

The 1980s began with a CAD rising sharply to ₹ 2,748 crore (US$ 3,474.0 million) or 1.6 per cent of GDP and, despite a doubling of net aid disbursements (including a trust fund loan), the overall BoP deteriorated from a surplus position to a deficit of ₹ 407 crore (US$ 514.0 million). It was well recognised that though the deficit in the BoP was partly because of transitory influences, such as a rise in the international price of oil and the drought, there were other elements, namely, the deterioration in the terms of trade that were likely to persist over time. Therefore, India approached the IMF for financial assistance to tide over immediate BoP difficulties and began considering a comprehensive programme to promote external adjustment. The medium-term adjustment strategy included, in addition to the traditional focus on demand management, focussed attention on policies to address supply-side concerns. The adjustment strategy, supported by an extended fund facility (EFF) arrangement with the IMF, encompassed the following elements:

(i) to promote strong and balanced economic growth in order to overcome persistent bottlenecks and provide supplies for exports and reduce imports;
(ii) to provide resources for investment by raising domestic savings, especially in the public sector;
(iii) to promote economic efficiency by reducing constraints on private investment and activity and liberalising import restrictions;
(iv) to adopt domestic financial policies which promoted price stability and external payments adjustment; and
(v) to encourage openness and, in particular, export promotion.

The EFF arrangement was based on a programme that included a clear enunciation of the performance criteria, a phased ceiling on the total domestic credit and a sub-ceiling on net credit to the Government; a ceiling on the official contracting or guaranteeing of external debt in the 1–12 year maturity range, with a sub-ceiling for maturities between 1 year and 5 years; and liberalisation of the norms relating to exchange and trade practices.

Thus, the key elements of the strategy underlying the extended arrangement with the Fund during the period 1981 to 1984, in short, included measures to increase agricultural and industrial supplies and thereby stimulate exports and compress imports, supplemented by an increase in public sector resource mobilisation. Financial policies provided for cautious demand management to encourage high rates of domestic savings and low rates of inflation. Structural reforms, particularly directed towards the reduction of administrative regulation in the areas of industrial and trade policies, were aimed at enhancing the efficiency of the domestic economy.

The important objectives of the EFF arrangement relating to higher economic growth, reduced inflation and the avoidance of deterioration in the current account balance were largely achieved. However, export performance remained disappointing. This development could be attributed only in part to the weakness in the overseas demand, and it essentially reflected the persistence of structural inefficiencies in the economy.

A number of new measures were introduced during the programme period 1980–81 to 1984–85 to improve the environment for promoting private investment and production. These included recognition of the need to utilise capacity created in excess of the authorised limits; automatic capacity expansion approvals; relaxation of locational restrictions; relaxation of debt equity norms; debt interest ceilings; and tax concessions, including allowances to encourage capital investment. Special measures were designed as incentives for export industries, including cash assistance to exporters to compensate for relatively high rates of indirect taxes, interest rate costs and product and market development costs, exemption of exports from industrial licensing, anti-monopoly and small scale sector reservation regulations, and introduction of tax and other concessions for 100.0 per cent export-oriented units. Duty-free imports of raw materials in select industries were permitted for exporters in 1980–81. Introducing further relaxations, the commodity restrictions on the use of export replenishment licences were eased and exports of items which were in short supply domestically were in many cases banned or made subject to quantitative limits.

In the area of foreign collaboration, policies were generally applied more liberally and pragmatically. Substantial steps were taken to reduce restrictions on investments in the export sector and to provide exporters with more liberal access to imports. Also, industrial pricing policies were made more flexible than in the past.

Overall, the performance under the EFF arrangement in terms of performance criteria was consistently observed and closely monitored. The CAD came down from US$ 3.4 billion in 1982–83 (1.7% of GDP) to US$ 2.4 billion (1.2% of GDP) in 1984–85. Imports of petroleum, oil and lubricants (POL) declined during 1981–82, both in quantity and value terms. This gradually led to an improvement in the BoP in 1983–84 and the Government terminated the IMF loan with effect from May 1, 1984, which was about six months before the scheduled final period of the arrangement. Amount drawn under the EFF (₹ 4,654 crore or SDR 3,900 million) was less than initially agreed (₹ 5,966 crore or SDR 5,000 million) to be drawn over the three-year period ending November 8, 1984.

In the aftermath of high political uncertainty following the assassination of the Prime Minister in 1984, general elections were held. The elected Government was keen to achieve an accelerated rate of growth and for this, it was necessary to initiate economic reforms. Efforts were made in this direction but, as the events unfolded over the next five years, growth did accelerate due to a combination of internal and external developments but BoP began to come under sustained pressure, especially from 1987. An important reason for this outcome was high government expenditure, resulting in a steep increase in the fiscal deficit from 5.9 per cent of GDP in 1983–84 to 7.3 per cent in 1988–89.

The increase in fiscal expenditure affecting the aggregate demand resulted in a decline in the foreign exchange reserves during 1985–86 and a substantial widening of the trade deficit. As a result, India's external payments position, which showed marked improvement in 1984–85, came under strain. During 1986–87, however, the CAD narrowed somewhat and the ratio of the CAD to GDP — which had reached a high of 2.1 per cent during 1985–86 — declined to around 1.9 per cent. This was primarily on account of a reduction in the trade deficit. The CAD in 1987–88 did not show much improvement as compared with 1986–87, both in absolute terms and as a proportion of GDP. The annual average ratio of CAD to GDP of over 2.0 per cent in three years of the Seventh Plan, as against the targeted average of 1.6 per cent for the Plan period, mirrored the severity of the pressure on the BoP (Table 5.1).

TABLE 5.1

CAD/GDP and Debt-Service Ratio

(Per cent)

Year	*CAD/GDP*	*Debt-Service Ratio**
1981–82	–1.7	9.3
1982–83	–1.7	11.4
1983–84	–1.5	14.0
1984–85	–1.2	15.3
1985–86	–2.1	22.6
1986–87	–1.9	29.6
1987–88	–1.8	29.8
1988–89	–2.7	29.8
1989–90	–2.3	27.7

Note: *Debt-service ratio reflects debt-service payments as per cent of current receipts.

Source: Reserve Bank of India, *Handbook of Statistics on the Indian Economy, 2009–10*; IMF, Article IV Staff Reports.

What caused concern was that despite strong export growth and a softening of international commodity prices, the pressure on the BoP did not ease. There was no let-up even during 1988–89, notwithstanding a robust export performance. The strains persisted since there was a sharp rise in the import bill; and the repayments to the IMF were large and, in fact, peaked during the year. The rise in the import bill was mainly due to an escalation in essential imports necessitated by the preceding year's drought, a rise in the international prices of certain commodities and larger import demand emanating from the recovery in the economic activity during the year. The fiscal profligacy of the Government in the 1980s, particularly in the latter half, led to the expansion of the CAD culminating in a BoP crisis in 1991.

The Reserve Bank expressed serious concern about the persistent deterioration in the BoP position in a letter dated December 23, 1988, addressed to the finance ministry, and suggested certain remedial measures. The letter stated:

> The balance of payments was under considerable pressure since the beginning of the Seventh Plan. The foreign exchange reserves, excluding valuation changes, declined continuously during the first three years of the Seventh Plan by Rs. 707 crore, Rs. 732 crore, and Rs. 954 crore, respectively, despite a sharp increase in the aid flows and commercial borrowings. The order of current account deficit experienced during the Seventh Plan had crossed the comfort zone. This large order of current account deficit was financed partly by drawing down of reserves, but mainly through a large inflow of capital both on concessional and commercial terms and by way of NRI deposits. As a result, India's medium and long-term debt reached high proportions. The debt, which was around Rs. 13,300 crore at the end of March 1980, multiplied to nearly Rs. 55,000 crore by end-March 1988. In addition, the country had also contracted short-term debt, which was estimated to have gone up from Rs. 750 crore at end-March 1980 to Rs. 3,700 crore by end-March 1988. India's total external debt, as a proportion of exports and current invisible receipts, went up from 135 per cent at the end of 1979–80 to 240 per cent at the end of 1987–88. At the same time, the NRI deposit liabilities swelled from Rs. 855 crore at end-March 1980 to Rs. 11,775 crore by end of September 1988.

Consequent upon the increase in external debt, the debt-service obligations registered a consistent uptrend during the period under review. India's debt-service ratio peaked at 30 per cent in 1988–89. If the instalment payments on defence credits from the USSR, which were financed by way of export of goods but not included under debt-service, were also considered, the ratio would become still higher. Similarly, if the interest payments on the NRI deposits and short-term debt were taken into account for computing the debt-service, India's debt-service ratio in 1988–89 would have been 30.8 per cent. The country's debt-service ratio was fast approaching the level of the countries with debt servicing problems as a group, according to the IMF.[1]

The pressure on balance of payments and the mounting burden of external debt was possible to be contained only through a quick reduction in current account deficit. Looking at the developments and trends, more efforts were needed to attain a higher growth in exports and containment of imports in the areas of defence, POL and edible oils. The possibility of raising duties on products covered by the OGL, as a means of restricting their imports, could also be considered.

The trade deficit during 1988–89 was substantially higher than that in the preceding year. As for invisibles, net receipts were higher during the year due mainly to the receipt of ₹ 642 crore (US$ 443.0 million) as compensation for Bhopal gas victims. The ratio of CAD to GDP at current market prices was estimated to have gone up to 2.7 per cent from 1.8 per cent in 1987–88. There was also a continuous depletion of reserves. By end-March 1990, foreign currency assets (FCA) declined to ₹ 5,769 crore (US$ 3,368.0 million), equivalent to 1.7 months of import requirement. India seemed near to a payments crisis which, however, occurred a year later. The main developments under various components of the BoP during the 1980s are given in Table 5.2.

1. International Monetary Fund, *World Economic Outlook, 1988.*

TABLE 5.2

Key Components of India's Balance of Payments

(₹ crore)

Year/Item	*1982–83*	*1983–84*	*1984–85*	*1985–86*	*1986–87*	*1987–88*	*1988–89*
Merchandise							
A) Exports, fob	9,137 (9,490)	10,169 (9,861)	11,959 (10,061)	11,578 (9,461)	13,315 (10,413)	16,396 (12,644)	20,647 (14,257)
B) Imports, cif	15,857 (16,468)	17,093 (16,575)	18,680 (15,715)	21,164 (17,294)	22,669 (17,729)	25,693 (19,812)	34,202 (23,618)
I. Trade balance (A–B)	–6,719 (–6,979)	–6,925 (–6,715)	–6,721 (–5,654)	–9,586 (–7,834)	–9,354 (–7,316)	–9,296 (–7,168)	–13,556 (–9,361)
II. Invisibles, net	3,438 (3,572)	3,610 (3,499)	3,850 (3,238)	3,630 (2,967)	3,524 (2,756)	3,006 (2,316)	1,976 (1,364)
III. Current account (I+II)	–3,280 (–3,407)	–3,316 (–3,216)	–2,873 (–2,417)	–5,956 (–4,867)	–5,830 (–4,560)	–6,293 (–4,852)	–11,580 (–7,997)
IV. Capital account (A to F)	2,010 (2,087)	2,738 (2,655)	3,740 (3,147)	5,514 (4,506)	5,770 (4,512)	6,545 (5,047)	11,678 (8,064)
A) Foreign investment	-	-	-	-	249 (195)	563 (434)	517 (357)
B) External assistance, net	1,125 (1,168)	1,183 (1,148)	1,407 (1,184)	1,676 (1,370)	1,808 (1,414)	2,945 (2,271)	3,210 (2,216)
C) Commercial borrowings, net	732 (761)	785 (761)	1,110 (934)	1,167 (954)	2,513 (1,966)	1,266 (976)	2,743 (1,894)
D) Rupee debt service	-	-	-	-	-	-	-
E) NRI deposits, net	383 (398)	709 (688)	879 (740)	1,767 (1,444)	1,650 (1,290)	1,840 (1,419)	3,636 (2,510)
F) Other capital	–228 (–240)	59 (58)	342 (289)	904 (738)	–450 (–353)	–69 (–53)	1,572 (1,087)
V. Overall balance (III+IV)	–1,270 (–1,319)	–578 (–561)	867 730	–442 (–361)	–60 (–47)	253 (195)	98 (68)
VI. Reserves (increase –/decrease +)	–625 (–649)	–773 (–750)	–926 (–779)	707 (577)	732 (573)	956 (737)	1,449 (1,001)

Notes: 1. -: Nil.

2. Figures in parentheses represent US$ million.

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

EXTERNAL DEBT

The large and recurrent CAD that emerged during this period was financed through inflows of capital from abroad by way of multilateral and bilateral assistance, commercial borrowings and non-resident deposits. As a result, India's external debt rose significantly and the long-term debt (with original maturity of more than one year), which was relatively small at the end of March 1980 (₹ 13,430 crore), rose in the successive years to around ₹ 36,000 crore by end-March 1985, to nearly ₹ 55,000 crore by end-March 1988 and further to ₹ 69,700 crore by the end-March 1989.

As a proportion of GDP at current market prices, the external debt went up from 12.5 per cent at end-March 1980 to 16.6 per cent at end-March 1988. During the same period, the debt-export (export of goods plus invisibles receipts excluding official transfers) ratio rose sharply from 131.0 per cent to 218.0 per cent. The debt-service ratio as per cent of current receipts (exports plus gross invisibles receipts other than official transfers) also escalated from 8.1 per cent in 1980–81 to 15.3 per cent in 1984–85, but showed sharp spurts in the latter years of the decade to 29.8 per cent in 1987–88 and 1988–89, which was substantially higher than the average of 17.6 per cent, postulated in the Seventh Plan document.

DEBT-SERVICING

Total debt-service payments, according to the BoP statistics for the year 1982–83, formed less than 14.0 per cent of the total export earnings during the year and less than 0.8 per cent in relation to the gross national product (GNP). The debt-service payments, including those to the IMF, increased to 16.6 per cent of total export earnings during 1983–84. The CAD was financed increasingly by debt-creating flows. External liabilities as well as debt-service obligations were rising. The debt-service ratio increased sharply from 1985–86 onwards till 1989–90, despite encouraging expansion in exports during the preceding two years. The interest payments on non-resident deposits were treated differently from the usual debt-servicing of external loans because a good part of such interest payments was spent or reinvested in India. Even after allowing for the effect of bunching of debt-servicing relating to the IMF drawings, which peaked in 1988–89, it was necessary to reverse, over the medium-term, the rising trend in the debt-service ratio by a sustained and strong rate of growth in exports. Repayment to the IMF during the fiscal year 1988–89 amounted to ₹ 1,749 crore (which comprised ₹ 1,547 crore under the EFF and ₹ 202 crore in respect of the IMF trust fund loan) as against ₹ 1,389 crore (₹ 1,209 crore under the EEF and ₹ 180 crore on account of the IMF trust fund loan) in the previous year.

NON-RESIDENT INDIAN (NRI) DEPOSITS

An important factor influencing capital flows was the growth in NRI deposits namely foreign currency non-resident accounts [FCNR(A)] and non-resident (external) rupee accounts [NR(E)RA]. With effect from March 1, 1982, at the instance of the Government, current deposits of one year and above under NRI deposits were allowed at rates of interest that were two percentage points higher than the rates permissible on domestic deposits of comparable maturities. Before the introduction of this measure, the Reserve Bank had opposed this move on technical and prudential grounds, but the Government held to its views. The Reserve Bank was, therefore, directed to offer the differential rate of interest.[2]

With the decline in deposit rates abroad, the interest differential proved effective. For instance, outstanding FCNR deposits increased by ₹ 231 crore during the year 1982–83 as against a decline of ₹ 13 crore in 1981–82. The corresponding movements in the NRE accounts were an increase of ₹ 435 crore in the year 1982–83 as against ₹ 265 crore in the previous year.

Between 1983–84 and 1984–85, there was an inflow of ₹ 680 crore and ₹ 635 crore into the FCNR (A) and NR(E)RA, respectively. It is noteworthy that inflows in 1985–86 rose by ₹ 281 crore and ₹ 1,151 crore under FCNR (A) and NR(E)RA, respectively, despite the lowering of interest rates on FCNR (A) deposits twice during the year. Inflows in NR(E)R accounts were substantially higher during 1986–87 than in the previous year, though they were lower than that under the FCNR (A) scheme. Inflows amounted to ₹ 650 crore and ₹ 3,473 crore under NR(E)R and FCNR (A) schemes, respectively during 1987–88. As at end-March 1989, the quantum of non-resident deposits stood at ₹ 14,154 crore — ₹ 5,899 crore under the NR(E) RA scheme, and ₹ 8,255 crore under the FCNR (A) scheme. The inflows under NRI deposits lent a significant measure of support to India's BoP and supplemented the foreign exchange reserves during the 1980s.

The movements in foreign exchange reserves during the period 1981–82 to 1989–90 are set out in Table 5.3.

2. Correspondence with the Government in this regard is placed in the documents section.

TABLE 5.3

Foreign Exchange Reserves: Components

(US$ million)

Year	*SDR*	*Gold*	*FCA*	*Total*
1981–82	473	335	3,582	4,390
1982–83	291	324	4,281	4,896
1983–84	230	320	5,099	5,649
1984–85	145	325	5,482	5,952
1985–86	131	417	5,972	6,520
1986–87	179	471	5,924	6,574
1987–88	97	508	5,618	6,223
1988–89	103	473	4,226	4,802

Source: Reserve Bank of India, *Handbook of Statistics on the Indian Economy, 2010–11.*

Foreign exchange reserves recorded a rise from 1981–82 through 1986–87, but declined sharply from 1987–88 to 1989–90, raising an alarm about the situation. During the 1980s, the optimum level of foreign exchange reserves was broadly considered in terms of number of months of imports. Although there was a perception that the foreign exchange reserves should be adequate to meet 6 months of import requirements, the reserves ranged only between 2.5 and 4.5 months of the import cover through the 1980s (Table 5.4).

TABLE 5.4

Forex Reserves and Import Cover

(US$ million)

Year	*Forex Reserves*	*Imports during the Year*	*No. of Months' Imports*
1981–82	4,390	15,173	3.3
1982–83	4,896	14,786	3.6
1983–84	5,649	15,311	4.1
1984–85	5,952	14,412	4.5
1985–86	6,520	16,067	4.5
1986–87	6,574	15,726	4.4
1987–88	6,223	17,156	3.8
1988–89	4,802	19,497	2.5

Source: Reserve Bank of India, *Handbook of Statistics on the Indian Economy*, various issues.

FOREIGN CURRENCY ASSETS

The FCA of the Reserve Bank, a major component of India's foreign exchange reserves, were US$ 5,850.0 million at end-March 1981, which declined steeply to US$ 3,582.0 million by end-March 1982. During 1982–83 to 1984–85, the FCA progressively rose to US$ 5,099.0 million by end-March 1984, partly due to the IMF's financial assistance and partly because of external adjustment. They broadly remained range-bound between US$ 5,482.0 million and US$ 5,972.0 million from 1984–85 to 1987–88. However, thereafter the FCA declined rather markedly to reach a level of US$ 2,236.0 million by end-March 1991 when the BoP crisis had got fully entrenched.

GOLD HOLDINGS

The Gold Control Act, 1962 prohibited the import of gold other than through licensed dealers, and also barred Indian citizens from holding gold bars and coins. As such, there was a negligible amount of official gold import into the country, though large quantities of gold were smuggled into the Indian territory every year. Gold jewellery for use by the general population was made from recycled gold or smuggled gold. The quantum of gold remained largely constant in the country's foreign exchange reserves. The gold holdings of the Reserve Bank during the 1980s remained in the range of US$ 320.0 million and US$ 508.0 million or ₹ 226 crore and ₹ 274 crore (valued at the statutory holding price of ₹ 84.39 per 10 grams) [Table 5.3].

At 1987–88 prices, India's gold holdings stood at 324.99 tonnes, which did not earn any income for the country. During a review meeting of the Reserve Bank with the finance ministry on deployment of foreign exchange reserves on July 5, 1988, it was suggested that part of the gold reserves, which was not receiving any returns could be leased out to earn income. As a follow-up measure, the Reserve Bank wrote a letter dated September 10, 1988 to the ministry, proposing that gold could be stored with some central banks such as the Bank of England, the Federal Reserve Bank of New York and the Swiss National Bank, who were also acting as depositories. A proportion of the Reserve Bank's gold reserves could be deployed in international gold markets on a lease basis. Further, approximately 48.7 tonnes of gold could be physically transferred to one such depository, which would conform to the statutory requirement that 85.0 per cent of the gold reserves had to remain within the country. The physical movement of gold from Bombay to London involved a one-time cost of US$ 12,900 per metric tonne. Assuming a conservative price of US$ 400.0 per troy ounce, one tonne of gold could have a deployable value of US$ 12.86 million, which would yield an income of US$ 64,300.0 per tonne per annum. The total annual income that could accrue to the Reserve Bank was worked out at ₹ 3.5 crore (US$ 2.5 million). The Bank asked the finance ministry to examine and accord in-principle approval to the proposal, which materialised at a later date.

SPECIAL DRAWING RIGHTS (SDRs)

The SDR holdings had stood at SDR 529 million at end-March 1980, benefiting from the general allocation of SDRs in 1979–80. However, SDR holdings consistently declined thereafter year by year to reach a level of SDR 76 million by end-March 1991.

The SDR balances were generally used for repaying the earlier Fund obligations, payment of charges on various drawals from the Fund and the quota payment to the IMF.

EXTERNAL RESERVES MANAGEMENT

During the 1980s, the foreign accounts division (FAD) of the Reserve Bank continued to manage the external reserves. There was no extensive computerisation or connectivity network. In the absence of an extensive communications network, the division took the help of the State Bank of India's (SBI) New York branch to place funds with certain foreign banks as per a decision by the Reserve Bank — a practice that prevailed until the Reserve Bank established its own dealing room in the early 1980s. Selecting dealers from the existing Reserve Bank staff, imparting extensive training within the country and abroad in dealing rooms of large foreign banks, developing expertise in back-office operations, and instilling confidence among the dealers to take quick and judicious decisions were planned meticulously and executed entirely by the FAD. Specific currencies were assigned to the appointed dealers and they were encouraged to undertake extensive studies on those currencies to develop expertise in their trading. The currency limits were fixed for the individual dealers and their performance (profits earned) was reviewed at the end of each month.

The dealers were encouraged to take a view on the potential of a currency, based on which investment/disinvestment decisions could be taken. Under the guidance of the FAD in charge, the dealers decided on the currency portfolios and exposures like cash balance, Treasury Bills, bank deposits, government securities and institutions with whom to invest. It required continuous alertness and updating with international developments in respect of the currencies and various institutions linked to the dealings. Losses in the individual deals were not important, since the objective was to earn overall profit at the end of the month. On instructions from the Governor, the division began compiling a monthly report containing the currency composition of forex reserves, and changes in the portfolios in terms of currency composition, asset distribution in terms of rupees, dollars, and SDRs as also major receipts and payments. Gradually, the division was fully computerised to facilitate putting in place an effective management information system (MIS).

The division compiled a half-yearly report indicating developments during the period, deployment of reserves, returns thereon, and the overall outlook on each major currency, which was forwarded by the Reserve Bank to the finance ministry. The report was reviewed by a high level committee comprising the Governor, the Deputy Governor, the Executive Director, officials from the concerned department and top officials from the finance ministry. The committee was mandated to regularly take a view on the composition of foreign exchange reserves in terms of currencies for the subsequent half-year.[3]

DEVELOPMENTS IN THE FOREIGN EXCHANGE MARKET AND REGULATION

The objectives and rationale for exchange market regulation and the Reserve Bank's operations in the exchange market were succinctly brought out by the Deputy Governor, Dr C. Rangarajan in a speech on the occasion of the 20th junior international forex seminar on December 13, 1985, New Delhi. The following is an edited summary:

> As the economies of developing countries were not sufficiently diversified and developed so as to permit unrestrained imports, a free operation of the exchange markets was to be ruled out and exchange regulations in one form or the other became a necessity. As such the exchange markets were expected to provide more of service to the import and export trade rather than opportunities for pure exchange trading which was common in developed countries. Exchange rate policy and regulation of exchange markets had

3. Transcript of the interview with Shri P.B. Kulkarni, former Executive Director, Reserve Bank of India.

> therefore to be determined in the context of the overall economic objectives as reflected in the industrial and foreign trade policies. The task of central banks was therefore to steer the exchange markets in such a way as to promote the achievement of these objectives. It was viewed that these responsibilities became more difficult with the abandonment of the fixed exchange rate system.

After abandoning of the Bretton Woods system of fixed exchange rates in 1971, the major currencies floated relatively freely in the world currency markets. The developing countries, including India, did not resort to an independent float and instead pegged their currencies either to one of the major currencies or to a basket of currencies.

The exchange rates of major international currencies had started showing extreme volatility since the mid-1970s causing serious fluctuations in the trade flows. The exchange rate volatility was not only substantial but also showed a tendency to increase over a period of time. Barely 5.0 per cent of the foreign exchange transactions reflected international trade and the remaining 95.0 per cent was accounted for by capital transfers, arbitrage trading and speculation.

Faced with the system of floating exchange rates, the developing countries maintained some form of pegging arrangement for their currencies. This meant that uncertainty in the nominal exchange rates had two components — variability in the rate at which they pegged to the numeraire currency and variability in the relationship between the numeraire and other major currencies. The exchange rate fluctuations and volatility had relatively greater adverse consequences for developing countries than for developed countries. Traders faced greater uncertainty, especially because forward facilities were less readily available or, even if available, were more expensive. Variable exchange rates also posed a serious problem to these countries because of the limited responsiveness of their production capacities and trade to such changes. Nevertheless, governments in the developing countries had to make a choice about the most appropriate regime for determining exchange rates. Most developing countries were not in a position to allow their currencies to float independently. They neither had the institutional arrangements to link the local financial markets with international markets nor would their BoP position permit such a possibility. The choice was, therefore, confined to either pegging to a single currency or to a group of currencies. The choice depended on factors such as the degree of trade concentration and the extent of openness. The choice of currencies and the weights to be assigned to them in the currency basket were again matters on which each country had to decide. Besides the mechanism for exchange rate determination, these countries also needed a specific policy with respect to the exchange rate, which had to be in consonance with their macroeconomic policy objectives.

The role of the central banking authority did not stop with determining the exchange rate regime. The operations in the foreign exchange markets needed to be supervised and monitored. The role of the Reserve Bank in the foreign exchange market in India during the 1980s was in a way typical of the role played by a central bank in most of the developing economies.

The Reserve Bank announced the day's buying and selling rate of the rupee in terms of pound sterling at the beginning of the day, as pound sterling was the intervention currency. The market was free to operate within the prescribed bands of the Reserve Bank Rate, supplemented by exchange margins allowed within the ranges prescribed by the Foreign Exchange Dealers' Association of India (FEDAI) in consultation with the Reserve Bank. The authorised banks were free to deal among themselves in any currency in both spot and forward maturities against the rupee or any other foreign currency. This ensured minimum recourse by market participants to the facilities of sale and purchase provided by the Reserve Bank. The Reserve Bank, on its part, was willing to sell only pound sterling in the spot market against specific demand from an authorised bank. On the purchase side, the Reserve Bank was willing to buy, spot and forward, four major currencies, *viz.*, the pound sterling, the US dollar, deutsche mark (DM) and Japanese yen in order to ensure extending reasonable rates to the exporters.

The guiding principle for the market was that authorised banks could approach the Reserve Bank only after exhausting all avenues for meeting their needs through the market. Also, the specified four currencies that could not be unloaded in the domestic market were required to be necessarily surrendered to the Reserve Bank unless required for cover operations abroad. These regulations, naturally, limited the access of authorised banks to the international markets. The access to international markets was thus confined to covering their currency positions arising out of genuine merchant transactions. While surrendering currencies to the Reserve Bank, the authorised banks were required to declare that the currencies were purchased against genuine trade transactions. The Reserve Bank supervised the market operations through weekly position statements that the authorised banks filed with the Reserve Bank declaring their holdings of open currency positions. The Bank insisted that the currency positions should be either square or near-square at the end of each day.

The regulations relating to foreign exchange trading in India were framed to minimise these risks. Various regulations were logically inter-related to one another. First and the foremost, the Reserve Bank expected the dealers not to resort to outright forward or spot purchases or sales, *i.e.*, transactions that were not related to commercial customer transactions. Dealings in currencies aimed at making profit through the speculation route were to be avoided. Since the resource base of the Indian banks in terms of hard currency was limited, it was imprudent on the part of the Indian banks to maintain overnight open positions in foreign currencies. While prior to 1978 banks were required to maintain square or near-square positions in each foreign currency at all times, subsequently they were required to do so only at the end of the day. Thus, while recognising the need to minimise the open positions at the end of the day, the modifications introduced since 1978 did help to broaden the inter-bank market in India. This also facilitated offering uniform rates to the merchant community.

The Reserve Bank took keen interest in the operation of forward market facilities. The Reserve Bank regulations on forward market operations were extensive and well documented with the objective of making the market a useful tool for covering the exchange risks of importers and exporters in respect of their firm commitments in foreign exchange. The regulations served to ensure that market facilities were need-based and not used for speculative purposes. The Reserve Bank was willing to buy four specific currencies forward in the event that the market was unable to absorb them. The Bank, however, did not sell forward any currency.

The nature and extent of transactions in the foreign exchange market were also determined by exchange controls that were in operation. In relation to exports, the controls ensured that export proceeds were properly accounted for. As regards payments, the same were regulated on the basis of import regulations that were in force. Capital transactions involving borrowings from abroad needed prior approvals and sanction. Thus, the supply and demand in the foreign exchange markets were broadly conditioned by exchange control regulations in force.

With the high degree of volatility witnessed in the 1980s in the foreign exchange markets, the risk attached to carrying open positions in any foreign currency had increased. The second source of risk arose from a mismatch in the maturities of forward transactions. As cover for a forward transaction, dealers normally undertook an opposite transaction to the nearest possible maturity to cover the transaction at a lower cost, instead of waiting for a counterpart with an identical maturity. Later, at a convenient time, the maturities were matched by undertaking swap operations or by primary trade transactions. In this process, however, banks could suffer losses as a result of changes in swap margins for the currencies concerned. The problem was further complicated when the contracts for the merchandise did not carry fixed date maturities. The contracting party was, therefore, given an option period of one month during which delivery could be taken or made. The third risk related to the credit risk arising from the failure on the part of a party to fulfil his obligations. The credit risk could arise in respect of both trade customers as well as bank customers.

The Reserve Bank regulations also required the banks to maintain balances in foreign currencies with overseas branches and correspondents at the minimum level. The objective of this regulation was to ensure that there was no unwarranted draft on the country's foreign exchange reserves for keeping idle balances abroad. To reduce conversion losses to the extent possible, the Reserve Bank expected the banks to clear all their foreign exchange operations through the inter-bank market in India. However, it was recognised and therefore permitted that, under certain conditions; banks could undertake transactions with banks abroad to cover their position.

Regarding open exchange positions, the reputed international banks carried large overnight positions that they were able to circulate among branches operating in different time zones. The international markets did not have any last resort buyers/sellers and naturally some banks had to carry forward the transactions that the market was unable to clear to the next day. In the free-trading countries in the international markets, central banks intervened only to correct exchange rate disturbances and not to provide last resort facilities to banks stuck with positions. In contrast, the Reserve Bank acted as a buyer/seller of last resort in the inter-bank market in India. This enabled the Indian banks to return to square or near-square position at the end of each day, as required under the regulations.

It was the objective of the Reserve Bank to develop an active exchange market at important trading centres in India with wide participation by the authorised dealers (ADs), exporters and importers so that various currencies that entered the country's external market were actively traded, facilitating customers to obtain fine quotes, with rate variations kept to the minimum during a day. The foreign exchange market in India till the year 1990 thus remained highly regulated with restrictions on external transactions, barriers to entry, low liquidity and high transaction costs. The exchange rate during this period was managed mainly to facilitate India's imports and to control and monitor the current account balance.

The foreign exchange market in India came into existence in the true sense in 1978 when the banks in India were allowed by the Reserve Bank to undertake intra-day trading in foreign exchange and were required to comply with the stipulation of maintaining square or near-square positions only at the close of business hours each day. The extent of position, which could be left uncovered overnight (the open position), as well as the limits up to which dealers could trade during the day, were left to the management of banks to decide. The exchange rate regime was characterised by a daily announcement by the Reserve Bank of its buying and selling rate.

The beginning of the 1980s saw the Indian rupee appreciating in real terms as inflation was very high during the period. This period was also characterised by a second steep increase in oil prices and an unfavourable international trade and aid climate. The adjustment in the nominal exchange rate was not commensurate with the inflation differential, which led to an appreciation of the real effective exchange rate (REER) in the early 1980s. However, after 1984, a proactive policy of allowing adjustment in the value of the rupee was followed, keeping in view the inflation differential, and this gathered momentum. To add depth to the foreign exchange market and with a view to making it broad-based, the Reserve Bank started buying US dollars, DM and Japanese yen, both spot and forward, from ADs based on the rates and trends prevailing in the international foreign exchange markets with effect from June 1980.[4] The Reserve Bank followed the same procedure for purchases of foreign currencies under the long-term forward cover scheme.

This regime was activated with the intention of making the Reserve Bank's quotations more realistic and to bring them in alignment with the latest market trends. To bring about an overall reduction in the cost of foreign exchange business to exporters and importers, the Bank decided to regulate foreign exchange rates quoted by banks for the customer telegraphic transfer (TT) business in certain specified currencies.

4. Reserve Bank of India, Exchange Control Department, Central Office, circular no. 20 (AP series), June 4, 1980.

Accordingly, with effect from October 1980, banks were required to quote TT selling and TT buying rates for the US dollar with a spread of one per cent from the mean TT rate and for other currencies, *viz.*, DM, Japanese yen, French franc, Swiss franc, Dutch guilder and Australian dollar, with a spread limit of two-and-a-half per cent. This step was initiated to help not only the exporters and importers but also to further strengthen the inter-bank foreign exchange markets in India.[5] With effect from October 1, 1981, the ADs were allowed to make offers of forward sales to the Reserve Bank without the prior approval of the Exchange Control Department (ECD). Hitherto, all offers for forward sales of pound sterling, US dollar, DM and Japanese yen by ADs to the Reserve Bank, for amounts not less than the specified limits, required prior approval from the ECD.

EXCHANGE RATE DEVELOPMENTS

Throughout the 1980s, the authorities did what in other countries is done by the market: they set the exchange rate practically on a daily basis. To illustrate, the exchange rate between the rupee and the pound sterling was changed 87 times between July 1981 and June 1982. It was changed 113 times in 1983 (July–June). Overall, the policy was aimed at a gradual depreciation of the rupee, both in nominal and real terms, in order to maintain the price competitiveness of the exports sector. This, in fact, was viewed as an integral part of the export strategy and a means of reinforcing trade liberalisation measures. This was achieved in a variety of ways, including changing the weight and components of the currency basket to which the rupee was linked, when necessary.

The movements in the international foreign exchange markets from July 1982 to June 1983 were characterised by long swings and a high degree of day-to-day volatility. For example, in 1982, the volatility in the yen/dollar spot rate, measured as the average absolute value of day-to-day percentage changes, was above 0.6 per cent, the highest in any year since the transition to floating rates in 1973. Apart from the volatility, other prominent feature of exchange rate movements was the continued strength of the US dollar despite deterioration in the current account balance of the United States (US). The pound sterling, which depreciated considerably in the latter half of 1982 and early 1983, primarily because of a decline in oil prices, somewhat improved after March 1983.

5. Reserve Bank of India, Press Release, October 13, 1980.

The exchange value of the rupee continued to be determined in relation to a basket of currencies with the pound sterling as the intervention currency. The value of the rupee appreciated in terms of the pound sterling by 6.8 per cent over the year 1983, following a decline in the middle rate of the rupee per pound sterling from ₹ 16.50 at the end of June 1982 to ₹ 15.45 at the end of June 1983. The maximum appreciation in the exchange rate of the rupee to pound sterling, ever since the rupee was linked to a basket of currencies in September 1975, occurred during the year when the middle rate appreciated to ₹ 14.65 on March 24, 1983. The rupee appreciated against the French franc (5.7%), the Belgian franc (2.6%), and the Italian lira (2.9%). It, however, depreciated against certain other currencies like the US dollar (5.7%), the DM (2.5%) and the Japanese yen (11.5%). The rupee also depreciated against the SDR by 3.9 per cent during the year 1982–83.

The high volatility in the exchange rate movements of the major currencies continued during 1983–84, though on a somewhat lower scale than in the preceding year. As in the previous year, the US dollar remained strong, aided by the hardening of US short-term interest rates, a rebound in the US economy and global political tensions. During 1983–84 (July–June), the annual average rate of appreciation of the US dollar in relation to the SDR was, however, lower than in the preceding year. The Japanese yen, too, emerged stronger, supported by the country's good economic performance; in fact, on an annual average basis, whatever depreciation took place in relation to the US dollar during 1980–1983 was almost neutralised by its appreciation in 1983–84. The pound sterling and the DM weakened further against the US dollar. The pound sterling depreciated by 10.1 per cent during 1983–84, though the pace thereof decelerated. The rate of depreciation of the DM accelerated. Adjustments in the middle rate of the rupee in terms of pound sterling were made on 118 occasions during the year 1983–84 and marginally exceeded the 113 revisions during the previous year, *i.e.*, 1982–83. The middle rate of the rupee moved from ₹ 15.45 per pound on June 30, 1983 to ₹ 15.15 per pound on June 29, 1984 (June 30 being a bank holiday in India and in London), recording an appreciation of 1.98 per cent over the period. The rupee, which also appreciated against the French franc by 0.97 per cent and the Italian lira by 2.45 per cent, depreciated against other currencies, such as the US dollar (9.76%), DM (1.25%) and Japanese yen (10.53%) and also against the SDR (6.62%) during this period.

The volatility of exchange markets increased during the year 1984–85, particularly after February 1985, and continued till the end of the decade. The nominal exchange rate moved by around 51.0 per cent from the financial year average of ₹ 11.89 per US dollar in 1984–85 to ₹ 17.94 per US dollar in 1990–91. The REER with base 1985 declined to 73.33 in 1990–91. Thus the period saw following of the principle of exchange rate management in terms of which the exchange rate moved in line with the movement in the cross-currency exchange rate as well as the inflation differential. Despite gradual depreciation of nominal exchange rate of the rupee and the improved performance on the exports front, the CAD, driven also by internal imbalances, remained high. Thus the adjustment in the exchange rate, though large, was not found adequate to cover the current account gap.[6]

Internationally, the upward trend in the US dollar against most of the major international currencies witnessed since 1980 continued till February 1985, despite a sharp increase in the CAD of the US and a fall in the US interest rates. In fact, the upward movement of the dollar became more pronounced. Strong economic growth in the US, continuing tensions in the Persian Gulf and problems faced by the United Kingdom (UK) in the energy sector encouraged the flow of funds into the US and assisted in the rise in the US dollar value. From late February 1985, the underlying trend in the exchange rate of the US dollar was downwards, but the period was marked by wide fluctuations in exchange rates. Some important factors that contributed to this downturn were the deterioration in the BoP position of the US, greater-than-expected slowdown in the economy and continuation of the fall in interest rates. In 1985, the average rate of the US dollar declined sharply by 7.9 per cent against the pound sterling, by 5.6 per cent against the DM, by 3.8 per cent against the yen and by 3.1 per cent against the SDR. In the same month, the pound sterling rose by 5.1 per cent against the SDR and by 2.4 per cent against the DM.

The rupee value, however, continued to be determined in relation to a weighted basket of currencies of India's major trading partners, with the pound sterling as the intervention currency. The number of rupee–sterling rate adjustments aggregated 164 during 1984–85 (July–June), thus substantially exceeding the 113 changes during 1983–84. The middle rate of the rupee weakened by 5.9 per cent; from ₹ 15.15 per pound on

6. Rangarajan, C. (1998). "Management of the External Sector", *R.N. Malhotra Memorial Lecture*. New Delhi. December 8.

June 29, 1984 to ₹ 16.10 per pound on June 28, 1985. Likewise, the rupee weakened sharply by as much as 10.0 per cent against the US dollar, by 6.9 per cent against the SDR and by 5.6 per cent against the yen during 1984–85. However, the depreciation of the rupee *vis-à-vis* the French franc, DM and Swiss franc was not pronounced. In contrast, the rupee strengthened marginally against the Italian lira over the same period.

During 1984–85, the rupee–rouble exchange rate was changed three times, *i.e.*, on July 29, 1984, October 25, 1984 and February 15, 1985. The exchange rate of the rupee per rouble as at end-June 1985 was ₹ 11.34 as against ₹ 10.33 per rouble at end-June 1984.

As already indicated, a decline in US dollar rate in relation to several major currencies was noticed during the year 1985–86. The downturn in the US dollar, witnessed since end-February 1985, became pronounced after the September 1985 agreement among G-5[7] ministers to strengthen currencies, particularly the yen and the DM, of the countries with large current account surpluses in relation to the US dollar and to actively use official intervention in foreign exchange markets to meet the objective. The Tokyo Summit in May 1986 emphasised the need for relative stability in exchange rates. However, important differences in the direction of the movement of exchange rates of some currencies emerged at the summit. It was agreed that the finance ministers of G-7[8] would meet more frequently to exercise surveillance over each other's economic objectives and policies so as to secure greater stability in the exchange rates of major currencies. However, between September 1985 and June 1986, the US dollar depreciated in terms of average monthly rates by 29.7 per cent against the yen, 21.3 per cent against the DM, 11.7 per cent in relation to the SDR and 9.5 per cent against the pound sterling.

The exchange markets in India continued to be volatile during 1985–86 with occasional periods of subdued trading. The number of adjustments in the rupee–sterling rates aggregated 149 during 1985–86 (July–June) as against 164 during the preceding year. The rupee remained more or less stable in relation to the US dollar, declining only marginally by 0.7 per cent between end-June 1985 and end-June 1986. However, reflecting the strong appreciation of the yen, Swiss franc, DM, pound sterling and the SDR *vis-à-vis* the US dollar, the rupee declined against these currencies.

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7. G-5 is a group of countries, namely, France, Germany, Japan, the UK and the US.
8. G-7 is a group of countries, namely, Canada, France, West Germany, Italy, Japan, the UK and the US.

During 1985–86 (July–June), the rupee–rouble exchange rate was changed six times, *i.e.,* on July 13, September 9 and November 10, 1985 and January 20, February 6 and April 24, 1986. The rupee–rouble exchange rate weakened over the year by 12.5 per cent to ₹ 12.96 per rouble at end-June 1986. In accordance with the Tokyo declaration of May 1986, the G-5/G-7 finance ministers continued their efforts during the year 1986–87 to bring about relative stability in the exchange rates of major currencies. They attempted a consensus on policy adjustments among the group, with appropriate modifications in relative interest rates and concerted intervention in support of an undisclosed range of exchange rates of key currencies. At times the dialogue became restricted to G-3,[9] with overtones of bilateral bargaining and understandings as reflected in the October 1986 pact between the US and Japan. Subsequently, the Paris meeting of February 1987 and the Washington meeting of April 1987 reaffirmed the intentions of the group to ensure a measure of stability in the exchange markets and this was reinforced in June 1987 by the Venice Summit. The instability in the exchange markets, however, persisted.

During the year 1986–87, reflecting the developments in international currency markets, the number of adjustments in the rupee–sterling rate aggregated to 141. The rupee was broadly stable against the US dollar. In view of the weakening of the US dollar against the yen, DM, pound sterling, Swiss franc and French franc, the rupee softened against these currencies and also *vis-à-vis* the SDR.

The rupee-rouble exchange rate was changed four times, *i.e.,* on July 17, September 21, December 4, 1986 and January 23, 1987 during 1986–87 (July–June). As a result, the rupee–rouble exchange rate, which was ₹ 12.96 per rouble at end-June 1986, became ₹ 14.79 per rouble at end-June 1987.

During 1987, the Louvre Accord of February 1987, and active and concerted intervention in support thereof ensured a measure of exchange rate stability in major currencies until the October 1987 crash in the international stock exchanges. The crash led to renewed pressure for further realignment in exchange rates. By December 1987, the exchange markets had steadied, with the US dollar declining further. The co-ordinated readjustment in the interest rates of major industrial countries and the statement by G-7 ministers issued on December 23, 1987, emphasising renewed co-operation among them to stabilise the US currency had a salutary effect on the exchange markets. The policy directives and

9. A free trade agreement entered into by Columbia, Venezuela and Mexico.

commitments set forth in the December statement were reaffirmed by the G-7 countries in April 1988 in Washington DC and again in June 1988 in Toronto. In view of the continued large imbalances, the markets, however, remained volatile and prone to sharp day-to-day fluctuations, at times as a sequel to movement in key economic indicators.

During 1987–88 (July–June), the US dollar continued to weaken against all major currencies and the SDR for the third consecutive year. The pound sterling strengthened against the US dollar, DM and the SDR during most of this period.

Consequently, the number of adjustments in the rupee–sterling rate at 150 during 1987–88 (July–June) was marginally higher than those during 1986–87. In relation to the US dollar and the DM, the rupee declined by 8.4 per cent each between June 1987 and June 1988. Reflecting strong appreciation of the pound sterling and the yen *vis-à-vis* the US dollar during the period, the rupee weakened on a point-to-point basis by 14.1 per cent in relation to the pound sterling and by 16.4 per cent against the yen.

Following the statement by the G-7 ministers in December 1987, then in Washington DC in April 1988 and in Toronto in June 1988, there was a greater degree of co-operation among major industrial countries to stabilise the US currency, which had a positive impact on the exchange markets. During the year 1988–89, the US dollar maintained a firm undertone particularly because of the tightening of the US monetary policy in the wake of fears of the emergence of inflationary tendencies. A substantial weakening of the DM caused concerns about imported inflation in West Germany, while strong domestic demand in Japan led to higher economic growth, assuring the competitiveness of the Japanese manufacturing sector even with a further rise in the yen/dollar level. The pound sterling remained easy during most of the year, except during October to December 1988 when some upward pressure was felt.

The G-7 communique in September 1988 endorsed the prevailing pattern of exchange rate management but was not explicit regarding new initiatives for further stabilisation in exchange rates. The value of the rupee underwent adjustments *vis-à-vis* the pound sterling 229 times during 1988–89 (July–June). Between end-June 1988 and end-June 1989, the rupee weakened by 8.7 per cent against the yen, 14.8 per cent against the US dollar, 9.0 per cent against the DM and by 6.4 per cent against the pound sterling. The rupee–rouble rate applicable for settlement of credit and commercial transactions was changed three times during 1988–89, *i.e.*, on October 10 and 24, and November 20, 1988. Accordingly, the rupee–rouble rate softened by 9.5 per cent; from ₹ 16.39 per rouble at the end-June 1988 to ₹ 18.11 per rouble at the end-June 1989.

The exchange rate of the Indian rupee *vis-à-vis* the SDR, the US dollar, the pound sterling, DM and yen during the period 1981 to 1989 is furnished below (Table 5.5).

TABLE 5.5

Exchange Rate of the Rupee

(Calendar year-annual average)

Year	*SDR*	*Rupee as Per Unit of Foreign Currency*			
		Dollar	*Pound Sterling*	*Deutsche Mark*	*Japanese Yen*
1981	10.2418	8.6926	17.5423	3.8512	3.9600
1982	10.4766	9.4924	16.5954	3.9129	3.8200
1983	10.8310	10.1379	15.3653	3.9760	4.2600
1984	11.6482	11.3683	15.1469	3.9979	4.7900
1985	12.5625	12.3640	15.9904	4.2282	5.2200
1986	14.8083	12.6053	18.4924	5.8414	7.5400
1987	16.7617	12.9552	21.2366	7.2207	8.9800
1988	18.6994	13.9147	24.7729	7.9297	10.8700
1989	20.7906	16.2238	26.5515	8.6438	11.7600

Notes: 1. Exchange rate for Japanese yen is in rupees per 100 yen.
2. Data are based on official exchange rates.

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

THE EXCHANGE RATE: A DISCUSSION

One of the persistent misperceptions about the rupee's external value in the 1980s was that it was overvalued and that is why it had to be steeply devalued in 1991. The REER with base 1985 declined to 73.33 in 1990–91, thus resulting in a depreciation of the rupee value in real terms to the extent of around 27.0 per cent.[10] The rationale behind these adjustments was explained by the Deputy Governor, Dr C. Rangarajan in his speech entitled 'Recent Exchange Rate Adjustments: Causes and Consequences' delivered at the Bombay Management Association in August 1991. The

10. Rangarajan, C. (2000). *Perspectives on Indian Economy: A Collection of Essays*. New Delhi: UBS Publishers.

adjustments reflected the growing internal imbalance in macroeconomic terms. Besides, the cost of financing the CAD had gone up. An adjustment to more sustainable levels of capital flows was imperative. A downward adjustment of the exchange rate of the rupee was one of the instruments, among others, for resolving these problems. A situation of continuing depletion of foreign exchange reserves generated destabilising market expectations. In the immediate short run, exchange rate adjustments helped to reverse market expectations and thereby stem the outflow of capital in the first instance and later encouraged its inflow. In fact, with respect to 20 of India's trade competitors, the REER of the rupee appreciated for a long time — by over 20.0 per cent between 1979 and 1986. It was only from 1987 that the rupee began depreciating in real terms as compared with these countries, and by 1989 was back to roughly the same level of exchange rate that prevailed in 1979.

A question often raised in the above context was whether the Reserve Bank targeted the REER during the period. In a technical sense, REER targeting would mean that the exchange rate is adjusted to an accepted measure of the REER. The rupee value underwent several adjustments over the period from 1985, resulting cumulatively in a one-way movement amounting to real depreciation by about 27.0 per cent. This downward adjustment in the effective exchange rate was on account of real depreciation of the currencies of competitor countries. Thus, it was a creeping depreciation or devaluation in real terms within the framework of the rupee's peg to a secret basket of currencies.

The debate on the issue of India's external sector policies and developments, particularly on managing the exchange rate, brought out the fact that despite the official announcement that the rupee was linked to a currency basket, the IMF, in its classification of the exchange rate arrangement of member countries, included India among the group of 'other managed floating currencies' rather than 'basket-linked currencies'. It was also noted that while most of the basket-linked currencies published their currency components and the method of the basket-related exchange rate adjustment, India did not disclose either the basket or the mode of calculation and adjustment during the period. India, while in principle accepting a basket-related peg, chose to adopt in practice an arrangement that would permit discretionary management of the external value of its currency.

From the early 1980s, the exchange rate was thus actively used as a policy instrument to achieve a sustainable CAD by ensuring improvement in the price competitiveness of exports. At the same time, the gradual withdrawal and rationalisation of quantitative restrictions on imports enabled the import decisions to be increasingly responsive to price signals from exchange rate movements.[11] During the fixed exchange rate regime, the foreign exchange market for all practical purposes was at a nascent stage. The banks were required to undertake only cover operations and maintain a square or near-square position at all times. The objective of exchange control was primarily to regulate the demand for foreign exchange for various purposes within the limit set by the available supply. To overcome the weaknesses associated with a single currency peg and to ensure stability of the exchange rate, the rupee was pegged to a basket of currencies with effect from September 1975. The Reserve Bank of India was required to maintain the exchange rate within a band of +/– 2.25 per cent which was widened to +/– 5.0 per cent in January 1979 on either side of the base basket value. This exchange rate regime can be best described as an adjustable nominal effective exchange rate (NEER) peg with a band and this allowed for the achievement of a medium-term REER objective through changes in the NEER.[12]

REFORMS AND POLICY CHANGES

FOREIGN INVESTMENT POLICY AND DEVELOPMENTS

Foreign investment was considered as a vehicle for transfer of technology, not available indigenously, aiding either export promotion or import substitution. The ceiling for foreign equity participation, even when accompanied by import of technology, stood at 40.0 per cent. There were exceptions, however, and the Government could permit higher levels of foreign equity participation in industries with highly sophisticated technology or for export-oriented units. In fact, the Government could approve cent per cent foreign equity in the case of 100.0 per cent export-oriented units. In the field of technology, the Government was committed to allowing import in sophisticated and high priority areas, for export-oriented and import substitution industries and/or for updating the existing technology. As an exception to the general policy on foreign investment, investment proposals from the oil exporting developing countries (OEDC) were not linked to the transfer of technology clause.

11. Rangarajan (1998) *op. cit.*

12. Ibid.

Such investments could be in the form of equity participation in certain specified industries.

As the BoP came under stress, particularly in the latter half of the 1980s, various possibilities of tapping the savings of NRIs were explored, partly with the belief that they would be irreversible. With a view to attracting remittances from Indian residents abroad, facilities with regard to bank deposits and investment in equity shares of the corporate sector were liberalised. Subsequently, in July and August 1982, these facilities were further enhanced and extended to cover preference shares and debentures issued by Indian companies. The Reserve Bank simplified the exchange control procedural formalities to facilitate such investments. The Government, on its part, decided to encourage borrowing low-cost funds from the international capital markets. In line with this policy, the Indian enterprises, both public and private, were selectively permitted to raise funds abroad. Hitherto, the facilities available for deposits in non-resident accounts and investment in shares of Indian companies were confined to non-resident individuals of Indian nationality or origin. During 1981–82, however, the entire gamut of liberalised facilities was extended to overseas companies, partnership firms, trusts, societies and other corporate bodies, in which at least 60.0 per cent of the ownership or beneficial interest was vested in non-resident individuals of Indian nationality or origin. The overseas bodies owned even indirectly to the extent of at least 60.0 per cent by such non-residents were also brought under the purview of this arrangement during 1983–84.

FACILITIES FOR INVESTMENTS WITHOUT BENEFITS OF REPATRIATION OF CAPITAL AND INCOME

NRIs and overseas corporate bodies were allowed to make portfolio investments through stock exchanges in India in equity, preference shares and convertible/non-convertible debentures without any limit on the quantum or value. They were also allowed to invest in the new issues of public or private limited companies in any business activity (except real estate) up to 100.0 per cent of the issued capital. Payment for purchases either through stock exchanges or for direct investment in new issues could be made by the eligible investors either through fresh remittances from abroad or out of the funds held in NR(E)RA/foreign currencies and non-resident ordinary (NRO) accounts.

In order to facilitate sale and transfer of shares through stock exchanges in India, where the original investment was on a non-repatriation basis by non-residents of Indian origin, and where the other party was a citizen of India or a person of Indian origin, the Government waived the confirmation stipulation by the Reserve Bank, subject to certain conditions.[13]

FACILITIES FOR INVESTMENT WITH BENEFITS OF REPATRIATION OF CAPITAL AND INCOME

Non-residents of Indian nationality or origin and overseas corporate bodies predominantly owned by NRIs were permitted to make portfolio investments in equity preference shares and convertible/non-convertible debentures through stock exchanges in India, provided such investments in shares and convertible debentures in any one company by each investor did not exceed one per cent of paid-up value of the equity/preference shares and convertible debentures issued by the concerned company. The portfolio investment in convertible debentures could be made up to one per cent of the total value of each debenture series. Further, equity shares allotted on conversion were in addition to the shares of the concerned company purchased through the stock exchanges up to the limit of one per cent of paid-up equity capital. No limit, either on quantum or value, was stipulated with regard to purchases of non-convertible debentures. Payment for the portfolio investment was to be made either by fresh remittances from abroad or out of the funds held in NR(E)R/FCNR accounts with a bank in India.

Apart from the purchases of shares and debentures through stock exchanges, NRIs including corporate bodies owned by them were permitted to invest, with repatriation benefits, in the capital raised by a new or existing company (other than a Foreign Exchange Regulation Act [FERA] company) through new issues of equity/preference shares and convertible/non-convertible debentures. Investment in the new issues of non-convertible debentures was permissible without any monetary limit. However, in the case of new issues of shares and convertible debentures through the issue of prospectus, NRIs and corporate entities were allowed to invest up to 40.0 per cent of the new capital raised. The facility of non-resident investment of up to 74.0 per cent in equity capital raised by companies/partnership firms engaged in priority industries was extended

13. Subject to the condition that shares were purchased through a member of a recognised stock exchange in India and proceeds were credited to the transferor's ordinary non-resident account with a bank authorised to deal in foreign exchange in India with no rights of repatriation outside India.

to direct investment in new issues of convertible debentures/preference shares and henceforth covered investment in hotels. The hotels segment was included in addition to abolition of list of industries, which were hitherto not open for direct investment by non-residents. Widening the scope further, in 1982–83, investment in hospitals was approved with full repatriation benefits under 40.0 per cent and 74.0 per cent schemes. Modifications in the list were made with the objective of stimulating growth in industries in the core sector, apart from promoting those with export potential or import substitution. Encouraging the adoption of advanced technologies and reaping economies of scale were some additional benefits assumed to flow from such policies. In 1985, the non-residents were accorded the facility to invest up to 100.0 per cent of equity capital in sick companies in India on a repatriation basis. The lock-in period in such cases was, however, placed at five years. New issues of Indian shipping companies under the 40.0 per cent scheme were next opened up for non-residents. Also relaxations were granted for diagnostic centres under the 40.0 per cent and 74.0 per cent schemes. In addition to the facilities for investment outlined above, NRIs and corporate bodies were permitted to invest freely in 12.0 per cent six-year national saving certificates (NSCs). A significant change made in respect of FERA companies was the enlargement of the list of industries open to them.

The Government, in the first half of the 1980s, permitted the shareholding of foreign investors to be maintained at 51.0 per cent or below, subject to the foreign shareholders bringing in the required foreign exchange in cash to acquire shares at about the market price to maintain the stipulated level of foreign equity holding and further, subject to the passing of the required special resolution under section 81 of the Companies Act, 1956. The quantitative ceiling of ₹ 40 lakh for investments by non-residents in private limited companies under the 40.0 per cent scheme was also removed.

Designated banks were allowed to promptly repatriate sale proceeds of investments of NRIs with the permission of the Reserve Bank, even without producing a no-objection certificate (NOC) or the tax clearance certificate. The amount due for repatriation was, however, limited to the cost of acquisition of investments sold or actual sale proceeds realised, whichever was lower. In respect of the portfolio investments in equity shares, such investments were to be held for a minimum period of one year.

The budget for 1985–86 abolished estate duty, which was a major hurdle for remittances to India by non-residents. Further, the abolition of surcharge on income tax was expected to attract investments in shares and debentures of Indian companies and company deposits by NRIs. The data on approvals granted for such investment registered an increase during the year. Thus, the number of approvals granted by the Reserve Bank for direct investment with full repatriation rights to NRIs rose from 162 in 1983–84 to 211 in 1984–85. The amount of investment involved also went up by 24.6 per cent during the same period; the approvals under the 74.0 per cent scheme, however, declined. The approvals for direct investment on non-repatriation basis showed an increase of 52.9 per cent in 1984–85. The rise in respect of consents for initial issues to non-residents from ₹ 8.3 crore in 1983–84 to ₹ 95.4 crore in 1984–85 was highly impressive and reflected, *inter alia*, the effect of liberalised investment schemes, which were introduced in 1982–83, for attracting investments from NRIs.

With effect from July 31, 1986, to facilitate prompt remittance of dividends, the ADs were granted permission to remit dividends to non-resident shareholders, irrespective of the face value of the equity shares or percentage of issued equity capital held by such non-residents, without the prior approval of the Reserve Bank in respect of non-FERA companies. Only applications of FERA companies were required to be submitted to the Reserve Bank.

The number of proposals approved by the Reserve Bank under facilities available for direct investment with full repatriation rights to NRIs went up by 65.2 per cent, from 264 in 1985–86 to 436 in 1986–87. The amount involved also went up sharply by 65.9 per cent over the previous year. As in the past, approvals for investment under the 40.0 per cent scheme accounted for the bulk of the investment (97.0%) approved during 1986–87. During 1986–87, while consents issued to non-residents for further issues and bonus issues increased over the previous year, this was more than off-set by a drop in approvals for loans, initial issues and debenture issues.

Approvals granted for investment under the 40.0 per cent scheme during 1988 accounted for the bulk (91.0%) of the investments approved; the approvals under the 74.0 per cent scheme also increased during 1988–89. The amount invested by banks on behalf of their non-resident constituents through stock exchanges in respect of approvals granted for portfolio investments was marginally higher. During the year 1988–89, further efforts were made to attract the savings of NRIs. The India Growth

Fund (Country Fund), the second in the series, was launched in the US jointly by the Unit Trust of India (UTI) and Merrill Lynch, which helped mobilise a sum of ₹ 88 crore (US$ 60.0 million). Another investment scheme was launched by the SBI in November 1988 through floatation of seven-year cumulative non-repatriable NRI bonds denominated in US dollars. The inflow under this scheme during 1988–89 amounted to ₹ 138 crore (US$ 92.0 million).

Final orders under section 29(2), FERA 1973, requiring Indianisation/dilution of non-resident equity holdings to a specified level were issued to 389 companies. Of these, 369 companies complied with FERA directives as on March 3, 1989. The remaining 20 companies were at various stages of compliance, such as winding up, and were granted an extension at their request.

The liberal policy of encouraging direct and portfolio investment by the non-residents was continued during 1988–89. In fact, investment by non-residents, particularly in the form of deposits under the NR(E)R and FCNR accounts schemes provided significant support to India's external payments during 1989–90.

EXTERNAL ASSISTANCE AND FUND DRAWINGS

Before liberalisation of external commercial borrowings (ECBs) and foreign investment, external assistance was an important source of financing the CAD. In the 1980s, though ECBs were encouraged during the later part of the decade, foreign direct investment (FDI) was broadly restricted to transfer of technology, while portfolio investment was confined to investment by NRIs only. Therefore, external assistance became an important segment of capital flows. Net loans received under the external assistance programme accounted for roughly 37.0 per cent of capital flows and financed as much as 35.0 per cent of the CAD in the 1980s. The external assistance received by India comprised loans and grants. Loans had the concessional and non-concessional components. Interestingly, concessional loans comprised a significant part. Similarly grants consisted of both cash and commodity grants, the latter being dominated by food grants.

India received external assistance from multilateral as well as bilateral sources. The major part of multilateral loans was received from the World Bank Group (International Bank for Reconstruction & Development [IBRD] and International Development Agency [IDA]). While the loans from the IBRD were at near market terms, the IDA credits were highly concessional, where only a service charge of less than one per cent was applicable. The bilateral donors, who actively lent to India in the 1980s, were West Germany, France, Japan and the erstwhile USSR. The fresh commitments by the World Bank showed an uneven trend during the 1980s. They remained in the range of US$ 1.8 and US$ 2.1 billion during 1980–81 to 1984–85, except in 1983–84 when they declined rather sharply to US$ 1.1 billion due to the combined effect of the lower overall commitment by the IDA in that year and higher IBRD support to Latin American countries. In the second half of the 1980s, the World Bank stepped up aid commitments to India to an annual average of around US$ 2.2 billion. The major portion, however, came from the IBRD.

As far as bilateral aid was concerned, the Aid India Consortium used to meet in June every year to deliberate on India's requirement of concessional flows and effective use of aid already received. The amount of aid pledged remained broadly the same for 1982–83 and 1983–84 at around US$ 3.4 billion. The member countries in the meeting held on June 14–15, 1983, acknowledged the soundness of India's development policies and the prudence with which it had managed the BoP position. For the year 1984–85, the consortium members met on June 19–20, 1984, and pledged an amount of US $4.0 billion. The members appreciated the strong performance of the Indian economy and underlined the need for concessional aid flows to enable India to achieve its development objectives. The Paris Club members met in Paris on June 18–19, 1985 to consider India's aid requirements for the year 1985–86 and pledged a total amount of SDR 4 billion, which was the same as in the previous year. For the years 1987–88 and 1988–89, the consortium pledged an amount of US $5.4 billion and US $6.3 billion, respectively. The amounts pledged in the consortium meetings represented only broad indications of the likely level of assistance in the year and the amounts made available depended upon bilateral agreements concluded during the course of the year.

India's external sovereign borrowing during the 1980s was restricted to loans obtained from multilateral and bilateral sources under external assistance programmes. Neither the central nor the state governments borrowed from the international capital market.

The pick-up in the receipt of gross external assistance evidenced in 1979–80 continued during 1980–81. However, the net loans received during 1981–82 were placed lower at ₹ 746 crore, which was made up of gross loan receipts of ₹ 1,367 crore and repayment of ₹ 621 crore. This, along with the official transfers (grants), financed only 18.0 per cent of trade deficit as against over 27.0 per cent in 1980–81.

During 1982 to 1985, the net loan receipts rose gradually from ₹ 1,124 crore in 1982–83 to ₹ 1,183 crore in 1983–84 and further to ₹ 1,407 crore in 1984–85 mainly due to corresponding increase in gross loan receipts. Official transfers during these years were ₹ 380 crore, ₹ 392 crore and ₹ 574 crore, respectively. Net loan receipts combined with the official transfers financed the trade deficit at an annual average rate of around 20.0 per cent during this period.

The net inflow of external assistance during the second half of the 1980s grew progressively from ₹ 1,676 crore in 1985–86 to ₹ 3,090 crore in 1989–90, owing to larger gross receipts partly due to better utilisation of external loans. In tandem, official transfers too as per BoP statistics rose from ₹ 427 crore in 1985–86 to ₹ 897 crore in 1989–90. As a result, net external aid financed higher proportion of trade deficits in the second half of the decade, which rose gradually from 22.0 per cent in 1985–1986 to 32.0 per cent in 1989–90.

In November 1981, the Government negotiated a loan of ₹ 5,966 crore (SDR 5 billion) from the IMF under the EFF. Under this arrangement, a sum of ₹ 948 crore was drawn up to June 30, 1982. According to the BoP data, purchases (drawals) from the IMF during the fiscal year 1982–83 stood at ₹ 1,896 crore under the EFF. Such drawls had amounted to only ₹ 637 crore during 1981–82. In 1984–85, the drawals from the IMF at ₹ 1,425 crore lent significant support to India's BoP. However, purchases from the IMF were only ₹ 217 crore during 1984–85, and the IMF loan was terminated in May 1984. From 1985–86, outflows began on account of the IMF repayments, which went up from ₹ 264 crore in 1985–86 to ₹ 673 crore in 1986–87. During 1986 to 1990, the repayments to the IMF ranged between ₹ 1,209 crore and ₹ 1,547 crore adding to the pressure on the BoP particularly during 1988–89 and 1989–90 when the CAD expanded respectively to 2.6 per cent and 2.2 per cent of GDP in the respective years.

CONCLUDING OBSERVATIONS

In the early 1980s when a severe BoP problem struck the country following the second oil price shock, the Indian external sector scenario largely mirrored the global situation. In varying degrees, almost all NODCs ran into BoP problems.

The widening CAD in the BoP was, however, only partly because of the rise in the international price of oil. A drought and the deterioration in terms of trade also contributed to the worsening of the CAD. Therefore, India entered into an EFF arrangement with the IMF for financial assistance to tide over the immediate BoP difficulties. The EFF arrangement included a clear enunciation of certain performance criteria and structural economic reform measures. Though the reforms met with political resistance and remained an unfinished agenda, some important objectives of the EFF arrangements relating to higher economic growth, reduced inflation and improvement in the current account balance were largely achieved. This gradually led to an improvement in the BoP position in 1983–84 and the Government took the opportunity to terminate the IMF loan in May, 1984, about six months before the original schedule.

During the period 1984–85 through 1989–90, growth accelerated due to a combination of external and internal developments but BoP came again under pressure, especially after 1987. An important reason for this situation was uncontrolled expansion in government expenditure resulting in a steep increase in fiscal deficit from 5.9 per cent of GDP in 1983–84 to 7.3 per cent in 1988–89, a substantial part of which was monetised through unlimited issue of *ad hoc* Treasury Bills. What caused concern was that despite strong exports growth and softening of international commodity prices, the pressure on the BoP did not ease. The fiscal excesses of the Government in the latter half the 1980s evidently spilled over into widening of the CAD that led to a gradual build-up of a crisis situation by 1989–90.

During the 1980s, the newly created FAD of the Reserve Bank continued to manage the external reserves. The division earlier took the help of the New York branch of the SBI to place funds with certain foreign banks as per the decision of the Reserve Bank. In the early 1980s, however, the Reserve Bank established its own dealing room and evolved its own policy for managing the external reserves through dealers selected from the staff.

After the Bretton Woods system of fixed exchange rates was abandoned in 1971, major currencies floated relatively free in the world currency market. Most developing countries including India, however, could not afford to allow their currencies to float independently for fear of volatility and exchange rate misalignment. The choice was thus confined to either pegging to a single currency or to a group of currencies. The option depended on factors such as the degree of trade concentration and the extent of openness. The choice of currencies and the weights assigned to them in the currency basket were matters on which each country took its own decision. In India, the exchange value of the rupee was determined initially in relation to a secret basket of currencies with the pound sterling as the intervention currency.

The Reserve Bank thus announced the day's buying and selling rate of the rupee in terms of pound sterling. The market was free to operate within the prescribed bands of the Reserve Bank Rate supplemented by exchange margins allowed within the range prescribed by the FEDAI. The authorised banks were also free to deal among themselves in any currency. This facilitated development of an active inter-bank market in foreign exchange. The Reserve Bank also evolved extensive and well documented regulations on forward market operations with the objective of making the market a useful tool for covering the exchange risk of importers and exporters.

Throughout the 1980s, given the need for sustaining external competitiveness, the exchange rate policy was implicitly aimed at a gradual depreciation of the rupee, in real terms, in order to maintain the price competitiveness of the exports sector. The rupee value consequently underwent a series of small adjustments over the period from 1985, resulting cumulatively in a real depreciation of about 27.0 per cent by 1989–90. As a result, despite the official announcement that the rupee was pegged to a currency basket, the IMF, in its classification of exchange rate arrangement of member countries included India among the group of 'other managed floating currencies'.

By 1988–89, there were clear signs of an oncoming external payments crisis. During the second half of the 1980s, non-concessional and short-term external borrowings increased. Between 1984–85 and 1989–90, the total debt to GNP ratio increased from 17.7 per cent to 24.5 per cent and the debt-service ratio increased from 15.3 per cent to a rather unsustainable level of 27.7 per cent during the same period. The difficulty of financing of the widening CAD through external short-term commercial borrowings triggered by loss of confidence remained at the heart of the problem. The foreign exchange reserves shrank dramatically by December 1990. India thus ended the decade as it had started — with a full-blown BoP crisis lurking around the corner.

ANNEX 5.1

Joint Ventures (JVs) Abroad

India continued to pursue its overall strategy of participating in the development efforts of other countries by way of encouraging and promoting JVs abroad. The efforts made by the Indian private enterprise in encouraging and promoting JVs abroad were rather new during the early 1980s. Such ventures, however, were crucial to the development strategies of Indian enterprises. Apart from the private companies, a number of public sector enterprises also showed a keen interest in setting-up JVs in diverse areas such as machine tools, engineering contracts and fertilisers. During 1981–82, there were 228 JVs located in 37 countries, of which 134 were in operation and 94 under various stages of implementation. Prominent among these countries were Malaysia, Singapore, Indonesia, Kenya, Nigeria, Thailand, the UK and the US. During 1982–83, 140 JVs were in operation and 88 proposals were being implemented. By the end of December 1983 the number of JVs in operations reached 154, while 81 proposals were at various stages of implementation. During 1984–85, a number of Indian companies established JVs abroad, particularly in Asia and Africa. Remittances received in India from JVs abroad as at end-December 1984 amounted to ₹ 7.7 crore by way of dividends and ₹ 25.4 crore by way of fees for technical know-how, engineering services and consultancy management. With regard to foreign collaboration in Indian industry, the number of approvals during 1985–86 declined marginally by 5.0 per cent from 979 to 930. Of the approvals granted during 1986–87, 674 or 72.0 per cent were for pure technical collaboration, drawings and designs, and 256 for technical-cum-financial collaboration. However, the number of Indian JVs in operation abroad declined from 156 at end-December 1985 to 150 at end-December 1986. Equity participation by Indian companies in JVs in operation abroad also declined at end-December 1986.

As at end-December 1988, there were 179 JVs abroad, of which 152 were in operation while 27 JVs were at different stages of implementation. Equity participation by Indian companies in JVs which were in operation abroad stood at ₹ 96.78 crore (including bonus shares) as at end-December 1988 compared with ₹ 93.12 crore at end-December 1987. The approved Indian participation in the equity of the JVs under implementation stood at ₹ 16.79 crore as at end-December 1988. Of the 152 JVs in operation, 94 (62.0%) were in the manufacturing sector and 58 (38.0%) in the non-manufacturing sector.

Foreign Collaborations in India

As regards foreign collaboration approvals in Indian industry, the number of approvals granted for foreign collaboration, both technical as well as financial, stood at 389 in 1981, gradually increased to 752 in 1984, posted a jump to 1,024 in 1985 but declined thereafter gradually to 605 during 1989. The financial approvals, which were 57 in 1981, increased gradually to 238 in 1985 but declined to 194 during 1989. A significant shift was noticed in the percentage of technical approvals *vis-à-vis* the financial approvals. The technical collaborations remained close to or above 80.0 per cent of the total approvals granted in the early 1980s, but the mid-1980s witnessed a gradual slowdown to about 70.0 per cent in such collaborations, meaning that the financial approvals were gaining prominence with time. The continued emphasis on technical collaboration was expected to help improve the productivity and efficiency of Indian industries. In the long run, it was expected to impart a competitive edge to the Indian export industries as also to reduce dependence on foreign imports.