Y V Reddy: Overcoming challenges in a globalising economy - managing India's external sector

Lecture by Dr Y V Reddy, Governor of the Reserve Bank of India, at the India Programme of The Foreign Policy Centre, London, 23 June 2005.

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Dear Friends,

I am thankful to the Foreign Policy Centre for giving me this opportunity to be with you this evening and share India's experience in regard to managing its progressive integration with the world economy. I would like to confine myself to the issues relating to the external sector. Perhaps one of the most successful aspects of India's structural reforms is the strength and dynamism in the external sector. The memories of June 1991, when the foreign exchange reserves fell to a level equal to barely a week's imports, are way behind us. Our journey from these problems to the position of comfort that we enjoy today has been exciting.

Today, I propose to dwell on how we have been benefiting from a globalising economy while minimising the attendant risks. The focus is on specific areas relating to the balance of payments and financial integration which transformed a hitherto inward-looking nation into a vibrant, internationally competitive economy, gradually integrating with the rest of the world.

Merchandise trade

A key objective of structural reforms instituted in the aftermath of the crisis of 1991 was to correct for the implicit anti-export bias built up during the first three and a half decades of planning and to reap the competitiveness and efficiency gains for the economy from a more open trade regime. What were the major elements of the reforms?

First, arrangements were put in place for the move towards a market-determined exchange rate. Second, since 1992 the trade policy imbibed a medium-term perspective. Third, a key aspect of the trade reforms has been a substantial reduction in import tariff rates and a drastic rationalisation of the tariff structure, including their dispersion. Fourth, concerted efforts have been made to dismantle the panoply of non-tariff barriers that was predicated upon the balance of payments reasons under the GATT. Fifth, the Reserve Bank of India has undertaken several measures to ensure adequate and timely availability of bank credit for trade finance at competitive interest rates. Sixth, there has been a policy thrust for creating appropriate institutional arrangements for supporting a vigorous export drive. These include export processing zones, special economic zones, overseas banking units and technology parks.

India has engaged herself constructively in multilateral trade negotiations under the WTO. Within its multilateral commitments, India has forcefully articulated its position which reflects the concerns of the developing countries. In tune with the worldwide spread of regional trading arrangements and our belief that such arrangements act as prelude to progressive multilateral trade liberalisation, India has entered into several preferential trade agreements.

These reforms in the trade policy regime have unlocked entrepreneurial energies. India's merchandise exports have been rising at a rate of over 20 per cent per annum, in US dollar terms, in recent years. As a result, the secular decline in India's share in world exports from two per cent in 1950 to 0.5 per cent in the 1980s has been halted. This share began rising in the 1990s and is currently at 0.8 per cent. The export strategy envisages a doubling of India's share in the world merchandise trade by 2008-09.

Services

Trade policy reforms undertaken since the 1990s have shed their traditional focus on merchandise trade and encompassed a wide range of tradable services, reflecting India's competitive advantage in business services, technical and professional services. The EXIM policies of recent years have selected services for special focus. India accepted the obligations under Article VIII of the IMF's Articles of Agreement and instituted current account convertibility in 1994. Besides, there has been a

progressive liberalisation of the exchange control regime. Foreign direct investment (FDI) has been permitted in a host of services in order to take advantage of modern technology, with some restrictions on financial services, taking into account the current stage of development and openness. Further, increasing availability of speedier and cost-effective money transfer arrangements through the banking channels and post offices has resulted in significant increase in the use of formal channels for remittance transfers.

Exports of services have risen consistently by over 20 per cent per annum in recent years. Within services exports, software and IT-enabled services have been growing at an average rate of 46 per cent annually since the mid-1990s. Over the years, skill content of Indian labour has been rising and the traditional markets of the Middle East have given way to the US, Europe and other industrialised countries. For the external sector, this natural advantage has translated into significant inflows in the form of remittances from Indians working abroad. Workers' remittances are nearly four per cent of India's GDP now and have provided considerable and sustained support to India's balance of payments.

Trade and current account

A discussion on the recent trends in trade and current account will perhaps be in order. A distinguishing feature of India's external sector developments during the fiscal year 2004-05 was the expansion of the merchandise trade deficit to more than five per cent of GDP from an average of a little below three per cent of GDP during 1990-2004. Underlying this expansion in the trade deficit was a surge in oil imports on the back of the soaring international crude oil prices and the pick up in investment demand as well as the growing strength of domestic industrial activity. This trend in imports may continue in view of the possible strengthening of upturn of activity in the economy. However, an intrinsic link between merchandise imports and exports has emerged and become entrenched so that the large expansion in imports is also spurring vigorous export growth. Given the recent experience, this order of the trade deficit appears to be manageable at this stage and is consistent with our growth aspirations.

Despite the large trade deficit, the current account recorded only a modest deficit of less than one per cent of GDP in 2004-05 after a continuous run of surpluses over the three-year period, 2001-2004. The high trade deficit during 2004-05 was to a large extent accommodated by the net invisible surplus at five per cent of GDP, supported by buoyant services exports and sustained remittances from migrant workers overseas. In fact, invisible surpluses have traditionally provided valuable support to India' s balance of payments and in recent years, they have taken on the character of a permanent component in the current account. It is in this context that we believe that the current account deficit is sustainable with enough headroom available for accommodating even higher levels of investment activity.

From a cross-country perspective, the Indian experience with managing the current account reveals some unique features. First, the lessons of the 1991 crisis brought forth policies which ensured a low current account deficit in the ensuing years. This approach stood us in good stead in warding off the contagion from the Asian crisis of 1997-98. Second, the sustainability of the current account was ensured by a policy choice for non-debt flows and emphasis on the consolidation and reduction of external debt. Third, the low current account deficit was underpinned by shifts in international competitiveness favouring software, IT exports and workers' remittances over traditional exports. Fourth, although the fiscal deficit remained somewhat inflexible, it was not allowed to spill over into the current account. Finally, the current account deficit being the mirror image of the absorptive capacity, it is best assessed over the business cycle rather than at discrete points.

Capital account

Since the initiation of gradual liberalisation of the capital account in 1991, capital flows have been in excess of current account deficit (CAD) except, in 1992-93 and 1995-96, adding to the reserves. It is interesting to note that the stock of external debt came down steeply from 28.7 per cent of GDP at the end of March 1991 to 17.4 per cent by March 2005. The decline in debt reflected the policy-induced shift in the composition of the capital account in favour of non-debt flows. The level of short-term debt continues to be low at US$ 7.5 billion as at the end of March 2005. As regards the composition of capital flows, there is, of late, almost a total shift in favour of private flows. The foreign direct investment increased from less than one per cent of net capital flows in the 1980s to 20 per cent of net

capital flows in 2004-05. Total portfolio investment flows on account of FIIs, GDRs and others were US$ 8.9 billion in 2004-05 on top of net inflows of US$ 11.4 billion in the preceding year.

In brief, given the adverse international experience with unfettered capital account liberalisation, we have been risk averse and have adopted a policy of active management of the capital account. The compositional shifts in the capital account have been consistent with the policy framework, imparting stability to the balance of payments. The sustainability of the current account is increasingly viewed as consistent with the volume of normal capital flows. The substitution of debt by non-debt flows also gives us room for manoeuvre since debt levels, particularly, external commercial borrowings, have been moderate and can be raised in the event of a sustained pick up in the demand for external resources. There is also the cushion available from the foreign exchange reserves.

Since non-debt creating flows are dominating, the emphasis is on encouraging inflows through foreign direct investment, and enhancing the quality of portfolio flows by strict adherence to what may be described as 'Know Your Investor' principle. Further, in view of entrepreneurial skills in India and evolving synergies in a global economy, overseas investment by Indian corporates has been receiving a positive response. Further, prudential regulations over financial intermediaries, especially over banks, in respect of their foreign exchange exposures and transactions are a dynamic component of management of capital account as well as financial supervision.

Reserve management

The adequacy of foreign exchange reserves is a relevant consideration in the management of the capital account. First, adequacy has to be viewed not only in terms of trade needs but also other short-term liabilities. Second, it is not merely the long-term or short-term debt in terms of original maturity that is relevant for reserves, but the profile of external debt in terms of residual maturity. A trade-related debt which is in the nature of collateralised debt may be less severe on reserve requirements. Third, any addition to portfolio flows may warrant comfort through some additions to reserves. In fact, there is merit in presuming that the flows are temporary till there is reason to judge them to be permanent. Fourth, it is necessary to recognise that reserves provide cushion to manage real and external sector shocks like oil prices. Fifth, there is usually an opportunity cost of maintaining foreign exchange reserves, but this must be weighed against the financial and non-financial costs associated with volatile and adverse exchange rate movements. Finally, while the optimal level of reserves is difficult to quantify, attention to level of reserves as a means of self-insurance is essential. In the final analysis, the adequacy of reserves needs to be assessed in terms of a medium-term perspective taking into account the possible levels of the current account deficits, the composition of capital flows, the level of international confidence in the ability of the country's payment position and pace and quality of growth. Viewed from all these perspectives, the current level of reserves continues to be comfortable.

The essence of portfolio management of reserves by the RBI is to ensure safety, liquidity and optimisation of returns. The reserve management strategies are periodically reviewed by the RBI in consultation with the Government. In deploying reserves, attention is paid to the currency composition, duration and selection of instruments. While there is no set formula to meet all situations, the RBI applies sound portfolio management principles and risk management.

Exchange rate management

A major success in external sector management has been the transition from an administered exchange rate regime to a more flexible, market-based system. Under the new arrangements instituted in early 1993, the day-to-day movements in exchange rates are market determined. India's current exchange rate policy focuses on management of volatility without a fixed target, while allowing the underlying demand and supply conditions to determine the exchange rate movements over a period, in an orderly way. To this end, the RBI monitors closely the developments in the financial markets at home and abroad, and takes such monetary, regulatory and other measures as considered necessary from time to time.

The conduct of exchange rate policy is guided by three major purposes: first, to reduce excessive volatility in exchange rates, while ensuring that the movements are orderly; second, to help maintain an adequate level of foreign exchange reserves and third, to help eliminate market constraints with a view to developing a deep and liquid foreign exchange market. The policy is aimed at preventing

destabilising speculation in the market while facilitating foreign exchange transactions at market rates for all permissible purposes.

There is a wide consensus that India's exchange rate policy has stood the test of time, despite several domestic and external developments, including the severe currency crises which characterised the 1990s. Recent international research on viable exchange rate strategies in emerging markets has lent considerable support to the exchange rate policy followed by India.

Global economy and India

The debate in India has customarily been on the contours of the public policy in the context of increasing global economic integration. More recently, however, a debate in the rest of the world has been in evidence on the challenges likely to be faced by the global economy on account of progressively increasing global integration of the Indian economy. Hence, there is merit in looking at, perhaps illustratively, some of the global challenges of our integration while we move forward in this regard.

Over the next half-century, the population of the world will age faster than during the past half-century as fertility rates decline and life expectancy rises. In Europe, the demographic profile is already tilted towards the higher age group and by 2050, this is projected to accelerate. Projections suggest a turning point between 2010 and 2030 when the European Union, North America and Japan will experience a substantial decline in savings rate relative to investment which may be reflected in large current account deficits. Most of the high performers of East Asia and China are in the second stage of the demographic cycle. Elderly dependency is expected to double in these countries by 2025. Their working age populations will increase modestly first and then shrink. These projections suggest that East Asia could increasingly become an important supplier of global savings up to 2025; however, rapid population ageing thereafter would reinforce rather than mitigate the inexorable decline of global savings. India is entering the second stage of demographic cycle and over the next half-century, a significant increase in both savings rate and share of working age population is expected. The share of the labour force in population in India is expected to overtake the rest of Asia, including China, by 2030. Looking ahead, the rest of the world may increasingly rely on China and India for supplies of both labour and capital and this could significantly influence the evolution of the global economy. It is evident that China and India will have to give high priority to generating employment and both are poised for substantial increases in productivity.

The global economy will have to contend with the implications of these developments on prices, exchange rates, wages and structures of employment in industrialised countries. Over the medium term, it is felt that outsourcing will grow rapidly and may also cover high-end research and development activities. In manufacturing, China has emerged as a leader and India is catching up rapidly. Though agriculture is heavily subsidised in major industrialised countries, such subsidisation would be difficult to sustain from a fiscal point of view, since many of the countries concerned are poised to meet the mounting pension liabilities not to speak of burgeoning health care costs of maintaining the deteriorating demographics. One sector where the industrialised economies continue to show considerable strength and dominance is the financial sector, partly attributable to the confidence factor in financial markets that favours the industrialised economies and traditional international financial centres. It is essential for India to carefully monitor the developments in both real and financial sectors, and to frame the policies in tandem with the global developments so that global integration continues to be a positive sum game for all countries.

Financial integration

On the path of integrating the Indian financial markets with the global financial system, we have chosen to proceed cautiously and in a gradual manner, calibrating the pace of capital account liberalisation with underlying macroeconomic developments, the state of readiness of the domestic financial system and the dynamics of international financial markets.

Unlike in the case of trade integration, where benefits to all countries are demonstrable, in case of financial integration, a "threshold" in terms of preparedness and resilience of the economy is important for a country to get full benefits. A judgmental view needs to be taken whether and when a country has reached the "threshold" and the financial integration should be approached cautiously, preferably within the framework of a plausible roadmap that is drawn up by embodying the country-specific

context and institutional features. In India, we have been adhering to a cautious and sure-footed approach in our reforms so far and there is merit in doing so since it enables us to avoid policy reversals on the one hand and build on the past strengths on the other.

The experience of the 1990s has shown that our approach to financial integration has stood the test of time. Even as we have embarked on a measured pace of financial liberalisation, we have ensured that we have a well-capitalised financial system by international standards, with low levels of loan delinquency. Our financial markets are orderly and smoothly functioning and the ability of our financial intermediaries to deal in various segments of the financial market spectrum is improving almost continuously.

The optimism generated by the recent gains in macroeconomic performance warrants a balanced consideration of further financial liberalisation. Undoubtedly, it contributes to growth through enhancement of allocative efficiency in the use of resources, by promoting financial deepening and by expanding the volume of resource flow to the economy. At the same time it is important to recognise the risks to the financial system emanating from stressed macroeconomic fundamentals such as those associated with fiscal deficit, inflation and uncertainties in international financial markets. Turbulence in the domestic financial systems tends to amplify related distortions and generates undesirable fluctuations in economic activities. Further, it also exposes the economy to external shocks and fluctuations in international business cycles. There could, therefore, be a trade-off in the initial stages while considering financial liberalisation and in policy terms, the trade-off takes the form of a choice between measured and premature financial liberalisation as also appropriate sequencing, the choice being contextual and often judgmental. In general, the downside of a premature financial liberalisation would be in the form of financial instability and associated social costs of disruption which are significantly higher for a developing economy like India.

India has made significant progress in financial liberalisation since the institution of financial sector reforms in 1992 and this has been recognised internationally. External financial liberalisation, in particular, has expanded at a fairly rapid pace. At this stage, the optimism generated by impressive macroeconomic performance accompanied with stability has given rise to pressures for significantly accelerating the pace of external financial liberalisation. It is essential to take into account the risks associated with it while resetting an accelerated pace of a gradualist approach.

First, India’s public debt and fiscal deficit as a proportion of GDP is currently among the highest in the world, but it has been financed almost entirely from domestic savings. There is a commitment to fiscal consolidation in the medium term with the implementation of the Fiscal Responsibility and Budget Management Act, 2003. In the interim, however, before embarking on any faster pace of external financial liberalisation, the possible spill-over effects of fiscal deficits into external sector need to be carefully evaluated.

Second, it is widely recognised that financial instability can lead to high variability in real activity and, as the Asian financial crisis has tellingly demonstrated, even cause interruptions in the growth process. Financial distress has resulted in macroeconomic and welfare losses. Resilience and flexibility in the real sector of the economy are essential to deal with surges of capital flows, large reversals and associated fluctuations in financial prices that become inevitable with accelerated liberalisation of financial sector. At present, some inflexibilities in pricing policies and restrictions on domestic trade constrain the response of the real sector. In general, therefore, low level of system flexibility at the current juncture is a major constraint on economic agents and financial market participants in responding to highly accelerated financial liberalisation and dealing with its downside risks.

Third, the adequacy of foreign exchange reserves is often cited as a consideration for significantly accelerating the pace of financial liberalisation. Foreign exchange reserves are, in the final analysis, a cushion to withstand both cyclical and unanticipated shocks. Therefore, reserve adequacy may be a necessary condition but not a sufficient one for speeding up financial liberalisation. There is a clearer recognition today that the net benefits from financial liberalisation in respect of any developing country would be enhanced only if complementary policies in non-financial sectors are followed.

Finally, the existing international financial architecture is not adequate to prevent or mitigate the domestic and external effects of financial crisis in large economies like India. The impact of instability in times of crisis appears largely to be borne by the home or domestic public sector rather than the global private sector. The issue of setting the pace of financial liberalisation revisits the issue of trade-off between sustained growth and a growth rate that could potentially turn volatile and unstable. While it is necessary to add to the pace of growth, it is also equally important to minimise the risks of

instability and experience shows that more than desirable pace of financial liberalisation was often followed by financial instability and crises.

Thus, the recent experience in many countries shows that periods of impressive macroeconomic performance generate pressures for speedier financial liberalisation since everyone appears to be a gainer from further liberalisation, but the costs of instability that may get generated are borne by the country, the government and the poorer sections. Avoiding crises is ultimately a national responsibility. The approach to managing the external sector, the choice of instruments and the timing and sequencing of policies are matters of informed judgment, given the imponderables.

Conclusion

Over the years, India's commercial and financial linkages with the rest of the world have been increasing with trade liberalisation and openness on the capital account. This is reflected in the transmission of international impulses to the real sector and domestic financial markets. Trends in international prices have now significant influence on domestic prices. Indian corporates and institutions are increasingly accessing international markets with consequent diversification benefits. While this process has provided important opportunities, it has also brought in new challenges and risks, necessitating fine-tuning of macro policies in a much broader canvass and context. India is, thus, moving from a focus on managing external sector to implementing an optimal integration of domestic and external sectors, with the global economy.

Thank you.