Mr. Reddy reports on the recent performance of the Indian economy Speech by Dr. Y.V. Reddy, a Deputy Governor of the Reserve Bank of India, entitled, "Managing Capital Account" in Hyderabad on 01/10/98.

On behalf of the Reserve Bank of India, I would like to convey my warm greetings to all the delegates from various South Asian countries. I have special pleasure in welcoming our chief guest, Governor A. S. Jayawardhene.

The forex markets in many parts of the world are going through a turmoil due to currency crises, which are intensively affecting more and more countries. Many of these crises are characterized by volatile capital flows – though the underlying causes for such crises may vary. Currently, there is a raging debate on the issues relating to managing capital flows, incidentally reopening many issues such as the merits of capital controls, and the adequacy of the international financial architecture. There are references to India also in this debate and interest has been expressed on how we are managing our capital flows. I will, therefore, share with you our perceptions on the following issues.

First, why is it that India has remained relatively unaffected by the Asian crisis?

Second, what role did policy relating to capital flows play in imparting stability? To put it differently, what was the policy and operational framework in managing capital flows? How was the current account handled to ensure effective management of the capital account? What were the strategies for crisis avoidance? What were the means adopted to meet extraordinary situations?

Third, in view of emerging global developments, can India continue to be what has been described as an island of tranquility amidst a sea of turbulence in the emerging economies? To put it differently, what are the immediate prospects for India in the external sector?

India and Asian Crisis

The performance of the Indian economy, by all accounts, has been by and large impressive both in terms of growth and stability. During the period 1992-97, the annual average real GDP growth rate was 6.8 per cent. Our annual average growth rate during this period was higher than the developing countries' average at 6.4 per cent. Our inflation during the period 1992-97 was 8.7 per cent, which compares favourably with the developing countries' average. Our current account deficit as a percentage of GDP was only 1.3 per cent during this period. Foreign exchange reserves went up from US$ 9.2 billion in 1991-92 to US$ 26.4 at end-March 1997.

The data that I have just presented will show that our fundamentals are strong, making us less vulnerable to contagion, and this is clear from our performance in 1997-98 also, when the crisis struck East Asia. During 1997-98, real GDP growth has been estimated at 5.1 per cent, a decline from the previous year's growth of 7.5 per cent, mainly attributable to a significant decline in agricultural output. The rate of inflation as measured by the wholesale price index declined in 1997-98 to 5.3 per cent on a point-to-point basis. In 1997-98, the current account deficit continued to be low at 1.7 per cent of GDP and there was accretion to foreign exchange reserves to the tune of US$ 3 billion.

The reason as to why we escaped the contagion can be analysed in terms of the policies that we have been pursuing in areas where serious concern has been expressed in the context of the Asian crisis. Investment as a percentage of GDP has been reasonably steady in the recent past

at around 27 per cent on average, and about 95 per cent of this was financed by domestic savings. In managing our external account, we ensure a sustainable current account deficit, strictly control reliance on short-term external debt, limit access to external debt, and emphasise productive use of such debt. We do encourage Foreign Direct Investment and portfolio investments through foreign institutional investors as the main sources of non-debt-creating capital inflows. Also, the exchange rate is market determined. The RBI closely monitors it, and when warranted makes purchases and sales of foreign currency to ensure orderly conditions in forex markets. We undertook, early in the reform period, financial sector reforms - especially banking reform, which included strengthening the regulatory framework, imposing prudential norms and reducing non-performing assets. We discourage banks' investments in real estate and stock markets. Corporates' exposure to debt, especially external debt, is within reasonable limits. As compared with other central banks, there is widely recognised transparency in operations of the Reserve Bank of India. There is, therefore, reason to believe that it is not just chance but sound macroeconomic management which saved us from the South-East Asian contagion. It is nonetheless necessary for us to learn from the experience of the Asian crisis.

Policy Frame

The broad approach to reform in the external sector after the Gulf crisis was laid out in the Report of the High Level Committee on Balance of Payments chaired by Dr. C. Rangarajan, currently the Governor of Andhra Pradesh. It recommended, inter alia: liberalisation of current account transactions, leading to current account convertibility; compositional shift in capital flows away from debt to non-debt-creating flows; strict regulation of external commercial borrowings, especially short-term debt; discouraging volatile elements of flows from non-resident Indians; gradual liberalisation of outflows; and disintermediation of the Government in the flow of external assistance. The Committee also recommended the introduction of a market-determined exchange rate regime while emphasing the need to contain the current account deficit within limits. The policy framework for the external sector based on the Rangarajan Committee Report was implemented along with policy changes in the trade, industrial and financial sectors.

Under trade policy, there has been a virtual elimination of licensing, a progressive shift of restricted items of imports to Open General Licence (OGL) and a lowering of tariff barriers. Industrial policy has been characterised by delicensing, removal of monopoly clauses defining large industrial houses and removal of most reservations for public sector enterprises. The reforms in the area of the financial sector were guided by the recommendations of the Narasimham Committee. Alongside the deregulation of the banking industry, including entry for new private sector banks, the general thrust of monetary policy has been towards reduction in pre-emptions, greater recourse to open market operations, deregulation of interest rates and widening and deepening of financial markets. Simultaneously, measures have been undertaken to strengthen the institutional framework in banking, non-banking financial companies, financial institutions and stock markets through prudential norms, capital adequacy stipulations, improvements in payments and settlement mechanisms and strengthening of the supervisory framework. Institutional measures have also included recapitalisation of banks, improvements in debt recovery and, most important, the setting-up of the Board for Financial Supervision and strengthening Bank's supervisory mechanisms. A second Narasimham Committee has given a road map for further reform of the banking sector.

We have taken various measures to ensure that the banking system does not get into a maturity mismatch bind. With a view to encouraging banks to mobilise longer-term deposits, we increased the interest rate ceiling on FCNR-B deposits above one year while simultaneously reducing the ceiling on such deposits below one year. Banks have been asked to monitor unhedged

foreign currency exposures of their clients. Draft guidelines for asset-liability management have been prepared and after discussion with banks will be put in place. We are monitoring the liquidity position in the economy very closely.

Fiscal adjustment has been undertaken and a very significant measure is that the system of automatic monetisation of the fiscal deficit was replaced by a system of ways and means advances.

In brief, reform in the external sector was meshed with reform in other related sectors and, within the external sector reform, capital flows were managed, keeping in view the needs of efficiency and stability. There was a fairly smooth movement from an administered exchange rate system to a market-determined exchange rate, and the Reserve Bank always ensures that volatility and speculative elements are curbed through both direct and indirect measures.

Operational Framework

Based on the policy frame and the projected financing requirement for each year, management of the capital account is operationalised through procedures for foreign direct investment, portfolio investment, external commercial borrowings, NRI deposits and outflows.

The broad approach to targeting of foreign direct investment has been through a dual route, i.e. automatic and non-automatic. Where the approval is automatic, activities and extent of ownership are listed, while in regard to the rest, a case-by-case approval by a high-powered board is adopted.

Portfolio investments are restricted to select players, viz. FIIs. They could, subject to some restrictions, operate in equity and debt markets. FIIs are permitted to invest in equity subject to a ceiling of 10 per cent for individual FIIs in a single company and 30 per cent collective investment ceiling in a single company. Indian corporates are permitted, again through a process of approval of individual cases satisfying general guidelines, to access funds through global depository receipts and euroconvertibles.

The approach to external commercial borrowings has been one of prudence, with self-imposed ceilings on commitments and a careful monitoring of the cost of raising funds as well as their end use. External commercial borrowings are subject to a ‘dual route’, viz. a small component of automatic and a major part through case by case approval, based on the size and sector. Short-term debt, including trade-related payments beyond 180 days, is subject to strict case-by-case approval of purpose, amount and terms. An overall annual ceiling is kept for all debt flows - both for short-term and medium to long-term.

In respect of NRI deposits, control over inflows is exercised through specification of interest rates or interest rate ceilings for different maturities in respect of deposits in select schemes, while, more generally, variable reserve requirements are stipulated to encourage or discourage such flows.

As regards external assistance, both bilateral and multilateral flows are administered by the Government of India.

In respect of capital outflows, the approach has been to facilitate direct overseas investment through joint ventures and wholly owned subsidiaries and provision of financial support

to promote exports, especially project exports from India. There are dual routes, namely automatic and case-by-case and there is an aggregate annual ceiling for such approvals. Exporters and exchange earners have also been given permission, on a selective basis, to maintain foreign currency accounts and use them for permitted purposes which facilitate their overseas business promotion and growth.

Current Account Management

When India adopted current account convertibility in 1994, it was recognised, as emphasised by the Rangarajan Committee, that there could be capital outflows in the guise of current account transactions. Hence, certain safeguards were built into the regulations relating to current account transactioins.

First, the requirement of repatriation and surrender of export proceeds was continued. Exporters were, however, allowed to retain a portion of their earnings in foreign currency accounts in India which could be used for approved purposes, thereby avoiding costs of conversion and reconversion.

Second, all authorised dealers were allowed to sell foreign exchange for underlying current account transactions which could be readily identified and supported by some documentary evidence.

Third, indicative value limits were given for different kinds of transactions so that the amounts sold were reasonable in relation to the purpose. For higher amounts, the banks had to approach the RBI. This operational framework for the current account enabled effective management of the capital account.

Fourth, the RBI has been taking an active interest in the development of money, government securities and forex markets. A proactive interest in the development of these markets has also enabled effective management of the current and capital accounts.

Fifth, while ensuring orderly and cautious deregulation, every effort has been made to improve the information base on major transactions in the forex markets with respect to its nature and magnitude. Constant improvements are made to ensure the appropriateness, timeliness and quality of the information base. The insistence on adequate and timely details from authorised dealers in forex markets also helped in fine tuning the management of the current and capital accounts.

It must be noted that we insist as a general rule that foreign currency transactions take place for financing defined underlying transactions. No doubt, genuine hedging of exposures under specified conditions is allowed. Transactions merely involving currency exchange or with purely speculative motives are viewed with serious disfavour. This consistent approach has lent credibility to the management of both current and capital transactions.

As explained by Governor Jalan, the objective of the current policy in regard to the foreign exchange market is to maintain orderly conditions in the financial markets. The policy is aimed at preventing any destabilizing speculation in the market while at the same time facilitating foreign exchange transactions at market rates for all permissible purposes.

Crisis avoidance

It would not be appropriate to conclude that managing capital flows on the above lines, however efficient, will ensure that there would be total tranquility in the capital flows. In fact, even with a managed capital account, we had to contend with occasional surges in capital flows between 1993 and 1997. In general, the short-term response has taken a number of forms, viz. raising of reserve requirements, reviewing the pace of removal of restrictions on capital inflows, relaxation of end-use specifications, liberalization of capital outflows, partial sterilization through open market operations, and deepening the foreign exchange market by routing an increased volume of transactions through the market.

The prolonged stability in the exchange rate of the rupee from March 1993 came under stress in the second half of 1995-96. In response to the upheavals, the RBI intervened in the market to signal that the fundamentals were in place and to ensure that market correction of the exchange rate was orderly and calibrated. Exchange market intervention was supported by monetary policy action to withdraw liquidity. The pressures intensified towards the end of January 1996 and the first week of February 1996. The Reserve Bank undertook a number of measures to encourage the faster realization of export proceeds and to prevent an acceleration of import payments. The interest rate surcharge on import finance was raised, the scheme of post-shipment export credit denominated in foreign currency was scrapped and the RBI continued to intervene actively in the spot, forward and swap markets.

The year 1997-98 and the first quarter of 1998-99 posed severe challenges in exchange rate management in the face of the threat of external contagion and other uncertainties. Distinct phases of exchange rate movements and response by the RBI can be identified. During April to September 1997, excess supply conditions prevailed in the market and the Reserve Bank undertook large net purchases of foreign currency. From September 1997 to mid-January 1998, acute exchange market pressure was staved off through sales of foreign currency, coupled with administrative measures such as restricting certain forward contracts and monetary policy measures. Mid-January to April 1998 marked the return of stability and enabled the rolling-back of tight monetary measures introduced in January 1998.

When the foreign exchange market was characterised by considerable uncertainties in May to June 1998, several measures were announced by the RBI in June 1998 to reverse the demand/supply mismatches in the market. The market responded positively to these measures, but in August 1998 there were fluctuations in the exchange rate in view of international developments. The RBI again undertook strong administrative and monetary measures, which included an increase in the repo rate and the cash reserve requirement of banks.

A vigilant and proactive policy by the RBI was, therefore, essential to avoid crisis in a highly unsettled atmosphere in international currency markets.

Managing Extraordinary Events

An extraordinary situation arose consequent upon the imposition of sanctions, and the issue of Resurgent India Bonds (RIBs) is an interesting example of management of the capital account in such a situation. The RIBs were designed to compensate for the extraordinary events in 1998-99, which may result in some shortfall in the normally expected level of capital inflows - though the current account deficit would continue to be well within 2 per cent of GDP. Due to the sudden developments in 1998-99, a temporary disruption in capital flows, especially debt flows, was

anticipated. Instead of dipping into currency reserves, which might affect sentiment adversely, or cutting the current account deficit through drastic import cuts, which would affect real economic activity, the alternative was to enhance debt flows at the least possible cost. There was a need to offset the adverse negative market sentiment created in the international capital markets due to the downgrading of India's sovereign rating to non-investment grade. This could be done by demonstrably raising debt resources at a cost lower than that any organised financial intermediary was prepared to provide in the context of the rating downgrade. Raising resources through sovereign borrowing was considered to be time-consuming and in any case inadvisable as a maiden offering under adverse circumstances. At the same time, it was necessary to ensure that amounts so obtained were restricted quantitatively to meet essential needs as a replacement for normal debt flows by keeping an option for premature closure. Furthermore, we had to ensure that the borrowing had an appropriate medium-term maturity, say five years. RIBs, which are essentially in the nature of foreign currency deposits on a par with FCNR-B, were devised in the light of these considerations. It was also necessary for the RBI to ensure that these funds did not disrupt the money, forex or government securities market.

There have been three main points of criticism regarding RIBs, i.e. cost of raising RIBs, substitution of FCNR-B deposits and exchange rate guarantee.

A total amount of $ 4.23 billion has been mobilised at a moderate cost in the face of a difficult international environment and the recent downgrading of our credit rating. Some have called it the deal of the year. To quote an international investor, "… the cost at which funds have been raised imply a perceived sovereign rating three to four notches higher than current levels. For comparison sake China's 2003 Yankee Bond Issue, rated A3 by Moody's trades at a spread of 280 basis points (on August 21) over the ten year US Treasury implying a dollar yield of 7.90 per cent and the RIB issue is not even sovereign risk."

On the second point, as most of the banks that have actively mobilised RIBs may be aware by now, there has been limited substitution from FCNR-B deposits and moreover, to the extent there has been substitution, it would result in elongation of the maturity of deposits to five years, while at the same time bringing into the country actual foreign exchange that is presently kept unswapped.

In regard to the exchange guarantee extended, it is recognised that under normal circumstances, issuance of such a guarantee is inadvisable. However, it can be legitimately held that the recent times have been far from normal. In return for a specific guarantee on RIBs, the Government can claim benefits in four ways, viz. addition to forex reserves, support to macroeconomic environment and sentiment, indirect support for its own borrowing programme and resources for infrastructure development, including for public sector entities. It can also be argued that the Government bears exchange risk in regard to bilateral and multilateral flows for its use or for onlending. Moreover, given the Indian track record on prudent macroeconomic management, the burden of the exchange guarantee could be said to be manageable.

Prospects

The trend growth rate of real GDP in India during the nineties so far has averaged 6.1 per cent per annum as against 5.4 per cent in the 1980s. Taking the entire 17-year period from 1980-81 to 1997-98, India's trend growth has averaged 5.8 per cent per annum, which is significantly higher than the trend, annual average rate of 4.7 per cent for the developing countries and 2.4 per cent for the advanced countries. The performance during 1997-98 also revealed

considerable resilience and inner strength to meet the macroeconomic challenges posed by both domestic and external developments. The performance of various sectors clearly suggests that the growth of real GDP during the current year (1998-99) would be about 6.5 per cent - an impressive figure, especially in the current international environment.

As regards prices, we have an impressive record of maintaining a modest single-digit annual inflation rate during the 1980s and most of 1990s. However, during the current year, the annual inflation rate has been a little over 8 per cent on a point-to-point basis as at September 12, 1998. The principal sources of current inflation lie in the primary articles group, within which major contributions were from fruits and vegetables, oilseeds and cereals. The price situation seems largely to reflect a shortage of supplies of certain primary articles and is perhaps attributable to seasonal factors.

There were some concerns earlier in the current year that interest rates could harden significantly due to the large borrowing programme of the Government. However, most of the market borrowing requirement of the Government for this year has already been met with only a very marginal increase in yields on government paper. Moreover, the genuine credit requirement of the productive sectors would be comfortably met by the significant accretion in bank deposits.

During the 1980s the average current account deficit was of the order of 2.0 per cent of GDP. Even when we faced the Gulf crisis we had a current account deficit of a mere 3.2 per cent. Since then, it has remained well below 2 per cent. In 1997-98, despite large uncertainties, the current account deficit remained modest at about 1.7 per cent of GDP. In 1998-99, the relatively low level of oil prices in international markets and trends in invisible receipts should help maintain the current account deficit at a sustainable level of about 2 per cent of GDP. This order of current account deficit is clearly sustainable and we expect it to be financed by capital flows. In addition, we do have the comfort of a reasonable level of foreign currency reserves, which we would not hesitate to use to curb speculative activities and ensure orderly conditions in the market.

During 1997-98, we added $ 3 billion to our foreign currency assets despite payments of over $ 2 billion effected directly from reserves under the FCNR-A deposits scheme and repayments to the IMF. During 1998-99 also, despite all the turbulence, we have increased our foreign currency assets marginally from $ 25,975 million as at end-March 1998 to $ 26,135 million as on September 18, 1998.

We fully recognise that the uncertain international financial and economic situation poses considerable policy challenges. Of late, there have been some unfavourable developments in the Russian economy and in a few Latin American countries. The developments in the industrial countries, in particular Japan, are also being closely watched as they impact not only the current account, but also capital flows. On the whole, the international scene has been unfavourable for developing countries. However, in so far as markets in India are concerned, the response has been fairly reasonable and has been less volatile than other countries in the region.

From the presentation I have made on prospects, it should be evident that India is in a position to meet the challenges of possible adverse international developments. The recent success of the Resurgent India Bonds is a clear testimony to the confidence which investors have in our country. We fully recognise that there is no room for complacency, but we do believe that the economic fundamentals, prudent management as well as the operational framework of capital flows will ensure the reasonable stability in the external sector that has been the hallmark of India’s reform process.

In conclusion, the relative tranquility of the Indian economy in the face of the Asian crisis was neither an accident nor a stroke of luck. The management of the capital account has displayed pragmatism and a contextual response to a changing environment. The prospects for 1998-99 indicate continued stability in our external sector, consistent with our record of recent performance. In fact, I expect that the second half of the current fiscal year will be better than the first half, in terms of sentiment and economic performance.