INDIA'S EXTERNAL SECTOR — AGENDA FOR REFORMS

S. S. TARAPORE

1999

Published by

THE A. D. SHROFF MEMORIAL TRUST

Piramal Mansion, 2nd Floor,
235, Dr. D. N. Road, Mumbai-400 001

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OBJECTIVES

(i) Publication of one or more books in English, Hindi and regional languages annually on some of the great builders of Indian economy aimed primarily at educating the younger generation in high standards of building the national economy as practised by those great entrepreneurs and placing the example of their lives for emulation by India's youth.

(ii) Organising one or more public lectures annually on subjects, which were of interest to the late Mr. A. D. Shroff, namely, banking, insurance, and industrial finance, the subject to be chosen in rotation, and the lectures to be delivered by persons eminent in these fields.

(iii) Awarding annual scholarship or scholarships to outstanding student or students in the field of management.

(iv) Instituting a prize to be known as The A. D. Shroff Memorial Prize for the student standing first in Banking at the Sydenham College of Commerce and Economics, Mumbai.

(v) Doing all such acts, matters and things as are incidental or conducive to the attainment of the above aims or objects or any one or more of them, and

(vi) Without prejudice to the above charitable objects or any of them, the TRUSTEES shall have the power to spend, utilise and apply the net income and profits of the TRUST FUND for the TRUST FUND for the charitable object of education or such other objects of general public utility not involving the carrying on of any activity for profit as the Trustees may think proper. It being the intention of the SETTLOR that the income and/or corpus of the Trust Fund shall be utilised for all or any of the aforesaid charitable objects without any distinction as to caste, creed, or religion.

INTRODUCTION

The A.D. Shroff Memorial Trust had the privilege of having Mr. S. S. Tarapore, renowned economist, an authority on foreign exchange, and a former Deputy Governor of the Reserve Bank of India, deliver the Annual Public Lecture for 1998 on "India's External Sector — An Agenda for Reforms".

Mr. Tarapore's views on this subject deserve special attention in view of his tremendous contribution in the field of foreign exchange management in the country during his tenure with the Reserve Bank of India, and more particularly the report submitted by a R.B.I. Committee headed by him on Capital Account Convertibility.

The text of the Lecture is reproduced in this booklet for those interested in the subject, particularly, the Governmental and other authorities. For any student of economics and also for those in business, industry and government, the contents of this booklet should be invaluable in the present juncture.

We are grateful to Mr. Tarapore for delivering this learned lecture.

Mumbai,
dated : 27 April 1999

Nani A. Palkhivala
Chairman
The A. D. Shroff Memorial Trust

A. D. SHROFF
(1899-1965)

A. D. Shroff's achievements in the fields of business, industry and finance were many and varied. A large number of enterprises owe their origin and development to him. As an economist, his predictions have proved right over the years. Through the Forum of Free Enterprise, which he founded in 1956, as a non-political, educative organisation, he sought to educate the public on economic affairs. It was his firm conviction that a well-informed citizenry is the foundation of an enduring democracy.

George Woods, former President of the World Bank, paid the following tributes to A. D. Shroff :

"In every age and in every society men must express anew their faith in the infinite possibilities of the human individual when he has freedom to develop his creative talents. For this is in large part how the message of freedom is passed from generation to generation. A. D. Shroff spoke eloquently in a great tradition, and thanks to him we can be sure that other great men of India will continue to speak this message in the unknown context of our future problems."

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INDIA'S EXTERNAL SECTOR — AGENDA FOR REFORMS

by

S. S. Tarapore*

When Mr. Palkhivala invited me to deliver the *A. D. Shroff Annual Public Lecture,* I naturally agreed with great alacrity. A. D. Shroff - what a name to conjure up. The late A. D. Shroff was in many ways a unique economist. His pre-eminence spread across the academia, industry, finance and the official world. So much has been written and said about him that I would not wish to repeat what is well known - from his debate with Keynes at Bretton Woods to banking and development of industry. I hope you will bear with me while I narrate a short personal anecdote. After completing my studies I was in Bombay in 1961 looking around for a suitable opening. Hearing about my travails Mr. Shroff asked one of his friends to tell me to meet him. After looking at my CV Mr. Shroff generously offered a couple of alternative openings. When I demurred and said that I was aspiring to join the Reserve Bank of India he expressed great anxiety and said "young man you will starve, simply starve, and when you have starved enough come back to me". Alas, that was my only meeting with Mr. Shroff. I am deeply honoured at being invited by Mr. Palkhivala to deliver the Annual Lecture in the year of Mr. Shroff's birth centenary. In the Twentieth Century

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* The author is a renowned economist. He joined the Reserve Bank of India in July 1961 and retired as Deputy Governor in September 1996 and was Chairman of the R.B.I. Committee on Capital Account Convertibility (May 1997) and a Member of the Committee on Banking Sector Reforms (April 1998). The text is based on the Annual Public Lecture delivered by him under the auspices of the A.D. Shroff Memorial Trust on 7th April 1999 in Mumbai.

Mr. Shroff was clearly the eminence grise of the first half and Mr. Palkhivala of the second half.

My sense of awe and respect for the occasion is even more enhanced by the fact that Mr. A. D. Shroff had been considered for the post of the First Indian Deputy Governor of the Reserve Bank of India but was rejected because he had aroused the animosity of Sir James Grigg, the then Finance Member of the Viceroy's Executive Council, for being too close to Sir Osborne Smith who was felt to be dangerously sympathetic to Indian business.

I have chosen the subject of India's external sector reform for today's lecture, which would be appropriate given the keen interest that Mr. Shroff had in this subject. What I propose to do is to first briefly review India's external payments position, the lessons for us of the South East Asian crisis and then I would outline the thrust of future reforms.

The External Payments Position

For decades India's external payments position has been under strain, punctuated by a number of episodes of extreme crises when the country lived hand to mouth. After the broad based reforms undertaken since 1991, the external sector is, in a sense, the true success story of Indian economic reforms. From a critical juncture when the foreign currency assets (i.e. the foreign exchange reserves excluding gold) fell to less than $1 billion in July 1991, the present level is over $27 billion. What is more telling is that upto 1992-93 foreign currency assets of $ 6 billion were considered as copious. Subsequent to the crisis of 1990-91, when the current account deficit was 3.2 per cent of GDP, the deficit has averaged 1.1 per cent. Indian external debt which was 41 per cent of GDP in 1991-92 declined to 24 per cent by 1997-98. The debt service ratio (i.e. debt service payments to current receipts) declined from

35.3 per cent in 1990-91 to 19.5 per cent in 1997-98. The external indebtedness of India in relation to various parameters has come down and quite clearly India can be said to be a moderately indebted country. A characteristic about India has all along been that short-term debt has been low; in fact the proportion of short-term in total external debt has declined from over 10 per cent in 1990-91 to 3.7 per cent in September 1998. Although the outstanding short-term debt in September 1998 was only $3.5 billion it is substantially understated as letters of credit based trade credit is excluded and moreover the entire external debt data is based on a *contracted* maturity basis and not, as it appropriately should be, on a *residual* maturity basis. Given that a sizeable part of the debt service payments is due to repayments the adjusted short-term debt is significantly higher than the reported short-term debt. It must, in fairness, be recognised that the authorities are seized of this problem and it is intended that the maturity structure of the external debt will be worked out on a residual maturity basis.

The absolute amount of the external debt has risen from $83.8 billion in March 1991 to $ 95.2 billion in September 1998 but the current level is *lower* than the level of $ 99 billion in March 1995. The overall movement in the external debt in recent years is explained largely by exchange rate movements while in real effective terms the external debt has, in all probability, remained stable.

Since March 1991 there has been a structural change in the capital flows and a total amount of $ 10.4 billion under foreign direct investment and $ 15.4 billion under portfolio investment has flowed into India. While the portfolio flows are largely equity and do not form part of the external debt it is essential to view these as liabilities which can be liquidated at short notice. Again, the non-resident repatriable deposits of over $ 13 billion need to be recognised as liabilities along with the $ 4 billion of Resurgent India Bonds. Thus the total volatile proportion of India's external liabilities are around $ 39 billion as against total foreign exchange reserves, including gold, of a little over $ 31 billion. Even so the external liabilities in relation to reserves can be considered as being modest as compared with many other countries and there is no serious anxiety on this count.

The financing of the current deficit, at this stage, does not pose any problem and can be easily financed by external assistance, non-resident deposits and foreign investments. But it is important to recognise two aspects. First, we need to learn the appropriate lessons from the South East Asian experience and secondly, we need to evolve a proper sequencing of reforms in the external sector so as to ensure efficiency in the system.

Lessons of the South East Asian Experience

A large number of experts have carefully analysed and produced erudite studies on the recent South East Asian currency crisis and many of these experts have also made a number of presentations in India. But can we say that we in India have learnt the appropriate lessons? Unfortunately I am afraid that we are learning precisely the wrong lessons. We naively believe that the villain of the piece in South East Asia was capital account convertibility and all that is required is that we should continue to maintain capital controls or better still liberally add a few more controls which would then protect us from all problems. We believe that these countries allowed their banking systems to undertake speculative property loans and the corporate sector piled up imprudent short-term liabilities abroad. After all we in India have protected ourselves from capital account convertibility, our short-term external debt is very low and our banks are not deeply involved in property loans. Moreover, we can quote international experts, invariably out of context, about the dangers of capital account liberalisation and the catchy media can hardly be blamed for quoting experts to say that India should wait a hundred years before liberalising its external sector or that the root of banking crises is the prescription of prudential norms. I am aware that I am projecting a deliberately extreme perception but it is simply amazing how many people, in powerful position to determine the destiny of our country, more or less subscribe to such a viewpoint.

We in India have to be more serious and try to understand the process that led up to the South East Asian crisis. The underlying reasons for the crisis were more complex, and at the same time less exciting, but nonetheless relevant for us to understand and to draw the right lessons. While we have a proclivity to acclaim the analysis of international experts from the West, for a change I would commend to the Indian audience the percipient analysis by *Y. C. Richard Wong* of the University of Hong Kong *at the Cato Institute 16th Conference, Washington, D.C.* (October 1998). Wong argues that it is not generally appreciated that the incubation of the South East Asian crisis took place in the late 1980s and early 1990s, precisely when international experts were lauding the performance of the *Asian Tigers.* In the context of the recession in Japan in the late 1980s, following the collapse of the property boom, and the slowdown in Europe, South East Asia appeared a safe haven for high profit margins. The relatively low interest rates in the US also provided incentives for a quest for high interest rates by debt funds. With the vote of confidence signalled by international investors these countries went for broke as they tried to achieve higher and higher rates of growth and the stage was quickly set for these economies actually growing at a pace well above their potential growth. Infrastructure bottlenecks were ignored by international markets which saw little risk in providing short-term funds for projects with long gestation lags. With opaque banking and corporate practices and weak or non-existent supervision, the symptoms remained suppressed longer than they should have done if the best international practices were in vogue.

The projection of resolute policies favouring defence of nominal exchange rate pegs, which quickly translated into large real effective exchange rate appreciation, should have been an obvious signal to investors but these fundamentals were ignored because investors had faith in the authorities being able to hold up exchange rates against gravity. Currency and maturity mismatches caused no anxiety to investors and despite a slow down in the economies and widening current account deficits, capital inflows continued to accelerate. Growing current account deficits, overvalued exchange rates and unrealistic asset values should have pointed to a sinister nemesis round the corner but all this is easier said with hindsight. Any serious observer of the South East Asian scene who would have contemporaneously dared to caution investors would have been labelled as a spoil-sport. Defence of the currencies against so called speculation was applauded by the international community, but expending limited foreign exchange reserves against resolute investors who wanted out was a sure way of losing a war and as the *hemorrhage* continued central bank after central bank gave up defence of its currency.

Activating monetary policy in a last ditch do or die battle with raising interest rates to punishing levels did not discourage speculation but enriched those who had sold the currency short in forward markets. Invariably, in such a situation, it is short-term interest rates which zoom and it is precisely in these situations that borrowers use short-term funds to finance long term needs and these countries ended up punishing their own citizens for what they considered as the treachery of foreign investors.

It is now increasingly being realised that there was *no contagion effect* but merely a pattern of vulnerability of a number of economies at the same time with similar fundamental problems.

One of the fashions of the time is to argue that the IMF prescriptions were inappropriate in the South East Asian crisis. The IMF has enough pundits of their own to competently argue their case and I for one hold no brief for the IMF prescriptions but what concerns me is that the process of soul searching by IMF staff has been misconstrued as weakening of the IMF's creed and renowned experts are now using the opportunity to set out a diametrically opposite prescription. It is not merely alternative prescriptions which are of concern but the irresponsible nature of these prescriptions. One view, which has wide support, is that these countries instead of increasing interest rates should have lowered them and allowed an even larger depreciation of the exchange rate. It is little realised that the hardships caused by temporary high interest rates would be far less than a more swingeing depreciation of the currency. It is pertinent to note that the temporary period of high interest rates has enabled a number of countries to now have interest rates below pre-crisis levels. Yet another viewpoint is that if interest rates were to be raised they should be raised to such a level that the need to alter exchange rates would be obviated. Discerning observers, with hands on experience of policy, would realise the dangers in both these extreme alternatives and the eventual policy prescription of raising interest rates but also allowing depreciation was the only pragmatic and sustainable policy alternative.

What is indeed worrisone is that even some conservative economists see merit in lower interest rates and fiscal expansion as a way out of the hole. In many ways the respectability given to this alternative poses the greatest danger to India as in our context such as approach would be a sure way of ensuring a severe external payments crisis in 24-36 months.

Before we condemn the IMF prescription in South East Asia we need to note that many of these countries have already bounced back with a sharp turnaround to large current account surpluses and consequent recouping of foreign exchange reserves. While the turnaround has, admittedly, come from import compression, exports of these countries are now poised for a major breakthrough while inflation is under reasonable control. These countries are likely to bounce back to a high growth path as quickly as they got into problems.

The weaknesses of the financial structure in these economies is well documented. The lesson, with hindsight of course, is that these countries should have undertaken a reform of their financial sector to a much greater extent well before they were hit by the crisis. With a more transparent and accountable financial system the glitches would have come in the open and pressures for timely action would have built up much earlier than actually eventuated.

The clamour for capital controls has become the new creed and even renowned international experts have lent their name to give respectability to controls. It is not readily recognised that with the porosity of controls, in today's increased integration of the world economy, capital controls are effortlessly circumvented by markets shifting off-shore. The lesson drawn - and erroneous at that - is that capital account liberalisation is not worthy of pursuing as a policy and this is emphasised most in countries, like India, which have so far liberalised their systems the least. This is most unfortunate as the benefits which would flow from a significantly more efficient economy have been setback by the South East Asian episode by a decade or more and we continue to wallow in splenetic isolation afraid of joining the comity of nations. Richard Wong concludes that there is nonetheless a silver lining in that the South East Asian crisis has intellectually put to rest the idea that there are new laws of economic growth that have been uncovered by the Asian miracle. Again, an important lesson to be imbibed is that delaying reform of the financial system cannot be a panacea and that instead of arguing against liberalisation of capital controls what is needed is the stepping up of the pace of *internal* financial sector reforms to facilitate a phased liberalisation of the capital account.

Sequencing of the Financial Liberalisation Process

Financial liberalisation has witnessed an explosive increase in the literature on the subject and one can find support for any position one has a predilection for. The officials, the academics and the media are themselves all sufficiently confused and emotionally surcharged to confuse even more so the general public at large. While serious observers all do point to the need for caution in the process of liberalisation it is essential that we in India appreciate that caution on proper sequencing of reform is not an advocacy of total paralysis and a do-nothing approach. The danger in a country like India is that the path embarked on is already extremely cautious and under the weight of the advice of international experts, of impeccable standing, we could put a total cessation to the reform process.

More often than not the literature is abstruse and way beyond the comprehension of the common observer and it is in this context that I would commend the study by *John Williamson and Molly Mahar: A Survey of Financial Liberalisation (Essays in International Finance No. 211, November 1998, Princeton University).* Given Williamson's well established position on the subject the study no doubt emphasises great caution but it can in no way be concluded that there should be a paralysis of policy. Any serious approach has to concentrate on the *sequencing* of reform. The received doctrine is to tighten prudential norms, strengthen the financial sector and lastly to liberalise the capital account. Moreover, while liberalising the capital account the preference is to first liberalise on the inflows and to liberalise outflows only later in the process. Trade reforms is the most important real sector precondition for financial sector reform as a deregulated financial sector will channel funds to the most profitable industries and these will be the most desirable industries only when the price system conveys accurate information about scarcity rather than distorted incentives resulting from heavy protection. Few countries seem to have heeded the advice to precede financial liberalisation with the introduction of a system of prudential supervision staffed by skilled supervisors who have a high degree of independence. Although conventional wisdom advises that interest rates can be freed after the initial macro economic stabilisation there is an articulate viewpoint that interest rate controls should be continued till fairly late in the liberalisation process. A strong advocate is Joseph Stiglitz who has for some time been advocating this viewpoint and more recently at the NCAER Golden Jubilee lecture in March 1999 he has once again reiterated this stand. As to the question whether the central bank is in a better position than the banks to fix interest rates my own view is that the answer, in all probability, is in the negative.

The traditional sequencing in the literature is to liberalise the capital account after domestic financial liberalisation has occurred. While capital account liberalisation had earlier been considered as an all-or-nothing approach, in more recent years it has been appreciated that capital account liberalisation can be phased as between inflows and outflows and as between different types of flows. The flows can be identified as between inward and outward flows, long-term and short-term flows and bank and non-bank flows. It is often claimed that the precondition for removal of controls on capital outflows are more demanding than for capital inflows. Although it appears attractive from the host country's viewpoint to liberalise long-term flows before short-term flows and foreign direct investment before portfolio investment, the fundability of capital is such that in practice it is difficult to fine-tune the sequencing of liberalisation measures.

A number of observers have argued that capital account liberalisation, especially of short-term flows, played a prominent role in the South East Asian crisis of 1997. Williamson and Mahar make the pertinent point that while a number of countries with open capital accounts faced crises, there were also crises in countries where the capital accounts were closed and hence an open capital account is certainly not a necessary condition for a crisis. The policy challenge is to design a liberalisation programme that does not bring with it the danger of a financial crisis. There does not appear to be any ready made package other than the broad advice to ensure macro economic stability and improved supervision before embarking on capital account liberalisation.

There are advocates of a viewpoint that if there is a pressure for outward capital flow the policy response should be merely to suspend capital account convertibility - in a sense the investor is trapped and has no way to exit. While such *ad hoc* punitive measures may tackle the immediate problem they have serious adverse effects in the medium and long run and when there are episodes of slamming on of such controls investors would move out in a preemptive strike even when there is no crisis. Such *ad hoc* capital controls are just about the worst kind of system. A far more preferrable approach is to limit the inflows and properly structure maturities. The porosity of capital controls, especially in a milieu of current account convertibility, clearly points to the ineffectiveness of capital controls and as Rudiger Dornbusch puts it capital controls are an idea whose time is past (Princeton Essays No. 207, May 1998).

On the issue of sequencing of liberalisation the general consensus is that capital controls should come last after trade barriers and domestic financial regulations are liberalised. This viewpoint has been probably reinforced by the recent South East Asian currency crisis. In a recent lecture, *Jeffrey A. Frankel (Changing Views on Capital Flows, ICRIER, New Delhi, March 1999)* refers to the theory of the second best which stresses that removing one barrier while other barriers remain in place can sometimes worsen the situation. He argues that it is neither practical nor desirable to try to insulate the village from the modern world and he advocates that both domestic reform and opening up to the outside world should be undertaken in proper balance and sequence. There is a real danger that countries can use controls excessively to shield their economies from the discipline of international markets. The real danger is that capital controls get sanctified and quickly deteriorate into indiscriminate use.

Pronouncements by renowned experts like John Eatwell, Lawrence Summers, Joseph Stiglitz and Jagdish Bhagwati cautioning countries against too rapid a liberalisation of the capital account, without attaining the prerequisites, have been right to sound a word of caution but they may not fully appreciate the negative impact their statements have had in countries which were taking the first tiny steps towards a sensible and cautious integration with the world economy. What has happened in a number of countries has been a freeze on liberalisation and a seeking of excuses to roll back such measures as have already been taken. If observers see an absence of evangelical zeal in my advocacy of capital account convertibility they would be right. The reason is that with advocacy of capital controls gaining increasing respectability what is of overriding importance is that we in India recognise the total idiocy of considering intensification of capital controls as a panacea. It needs to be stressed that such controls are counter-productive and at the present time we need to fight a battle of attrition to ensure that capital controls are not intensified in India. We need to appreciate that the South East Asian episode is merely a momentary fashion of the day. As *Barry Eichengreen and Michael Mussa (Capital Account Liberalisation and the IMF, Finance and Development December 1998)* stress, capital account liberalisation is inevitable for countries which wish to take advantage of the substantial benefits from participating in today's open world economic system. There are, admittedly, risks in liberalisation but draconian financial repression can be even more damaging. The inexorable integration of the world economy and its sophistication is continuing apace and the choice before India is whether we integrate with the rest of the world in a structured and planned manner or in a chaotic manner where we clearly would not be calling the shots. It is against this background that I would now turn to a specific agenda for a reform of India's external sector.

Agenda for External Sector Reforms

With a history of extremely tight controls on both current and capital payments and the acceptance of current account convertibility in August 1994 the question is whether India should continue the first steps it has undertaken towards capital liberalisation or revert back to controls. The experience of South East Asia and India's own weakness in the fiscal and domestic financial sectors could put a virtual halt to reform in the external sector and we could misuse the advice of experts and go in for more controls; to say the least, such a reversion to controls in India would be an unmitigated disaster. India, quite appropriately, has a reputation for gradual reform. At the present time the imperative need is, as Joseph Stiglitz puts it, to ensure that under the influence of recent events India does not slide in its external sector reforms from *gradualism to zeroism.* At this stage I do not wish to talk about any grand design of external sector reforms but the kind of nitty-gritty changes we need to put through in the next 12 months.

It bears repeating that foreigners and non-resident Indians who have brought in funds into the country face a fairly liberal capital regime. The problem for these investors is largely bureaucratic hassles. Much has been already done to lighten these problems but greater attention needs to be given to ensure stability of the overall framework. We do not seem to be fully cognisant of the damage caused by major flip-flops in the overall policy framework on foreign investment. In effect what we need is a progressive removal of unnecessary redtape; while considerable efforts have been made to streamline procedures a lot still remains to be done. Let me hasten to add that as the responsibility of monitoring transactions moves from the RBI to the banks it does not mean that a liberal capital regime means a permissive regime where the bank loses the right to know what transactions are being put through. In fact, sound supervision does imply that it is legitimately a banking function to know and comprehend the financial transactions being put through the bank. Thus, banks have to become knowledgeable facilitators of transactions and not innocent bystanders in a liberalised capital regime.

Again, we need to get rid of our hang ups on our *moral* stand on what we consider good and bad capital flows. It is unrealistic to believe that we would have a large inflow of foreign direct investment if we shut our doors to portfolio flows. In fact, these are two aspects of the overall flows and it is essential that we stop having fears about foreign institutional investors.

Foreign Institutional Investors: As part of the development of the payments and settlements system in the capital market we should move rapidly with dematerialisation and despite some glitches the progress so far has been encouraging. It is essential that progress in this area should be not only in the equity segment but the debt segment. While I would later on deal with issues relating to overall exchange rate policy, suffice it to say that we need to totally give up our false fears about the forward exchange market. At the present time FIIs are allowed to cover in the forward exchange market the entire incremental equity investments from June 12, 1998 and 15 per cent of their outstanding investments as on June 11, 1998. It is sometimes argued that FIIs are not too keen on forward cover and therefore we should not provide this facility. In fact, this is the precise reason for providing an umbrella which would enable the FII to invest even if there is no rain but only an overcast sky. Thus, an *immediate* policy change should be that FIIs should be allowed unfettered access to the forward exchange market rather than restricting them to a proportion of their total investments. The right to operate in the forward exchange market does not generate capital outflows. A facility of forward cover, on the contrary, is an added incentive to FIIs to continue to invest in India even if it was felt that there are some transient uncertainties. The hesitant manner in which forward market facilities are provided points to the fact that the authorities are not totally convinced that provision of forward exchange facilities is not disruptive. In fact, the authorities should recognise that their hesitancy is based on a wrong premise and the policy needs to be modified in such a manner that all participants in the spot exchange market should have unfettered right to operate in the forward market.

Short-term Inflows: It is often argued that short-term inflows can be destabilising. This should, however, not be a real problem if a policy framework is put in place well before the gush of short-term inflows. To ensure that we get the desired maturity profile of inflows certain measures can be devised. Differential reserve requirements could be put on non-resident deposits. The reserve requirements, as have evolved so far, result in low or nil reserve requirements on non-resident deposits while higher ratios are prescribed for domestic deposits. This is clearly not desirable, other than for short periods, when for over-riding policy considerations we are willing to encourage short-term inflows. In more normal times - as at present - the reserve requirement should be uniform as between non-resident and resident deposits. When non-resident deposits are excessive the reserve requirements on such deposits could be higher than for domestic deposits; such measures are quite consistent with capital account liberalisation. Again, to discourage short-term deposits, higher reserve requirements could be imposed on the shorter maturities. In the immediate ensuing period it would be highly desirable to increase the reserve requirements on non-resident deposits atleast to the same level as applicable to domestic deposits. Another approach would be to impose a small flat tax on all inflows. In the literature, this is called a *Tobin Tax*. The way this would work is that the shorter the term of the inflow the higher the incidence of the tax. At the present juncture a Tobin Tax does not appear necessary but the detailed modalities should be kept ready for expeditious use when needed. For the immediate ensuing period it should suffice if reserve requirements are gradually raised on non-resident deposits to the level on domestic deposits. While differential reserve requirements - higher requirements on non-resident deposit - are temporarily effective, over time such measures encourage short-term inflows through instruments not subject to reserve requirements and it is in this context that the Tobin Tax is more effective.

Indian Investment Overseas: In principle, it had been decided to allow SEBI registered Indian investors (including mutual funds) to invest in overseas markets. Because of the turmoil in the exchange markets the proposal has been shelved. Here again, there is a fear that there is a loss to the country if Indian investors invest abroad. The world over investors diversify their investments to maximise their gains and to spread risks. We need to shed the erroneous notion that the country's foreign assets would come down if such investments are made. In fact, by diversifying assets the country benefits from higher investment income receipts. If all other countries find it profitable to invest abroad there also ought to be a benefit in our resources being invested abroad. As such, the earlier, in principle, approval for such investments should be operationalised immediately.

Indian Joint Ventures Abroad: Indian joint ventures abroad have been kept down to a size which does not provide for any meaningful activity. As such, the approvals are essentially for very small ventures. Joint ventures abroad upto an amount of $ 15 million can be approved by the authorised dealer and for amounts above this amount, a reference to a Special Committee is required. The argument for not raising this limit is that the total applications are far below the overall ceiling and as such there is no demand for such ventures. The real problem is the kind of restrictions placed on such joint ventures. These ventures are looked at essentially as part of export promotion. This is a totally erroneous approach. The focus should not be on export earning but on the expected investment income. In International markets there is a minimum threshold size of investments and the clearance by authorised dealers should be for investments in joint ventures upto $ 50 million. The scheme should be neutral as between cash investments and investments in kind. It is essential that India should look upon joint ventures as a vehicle for enhancing income rather than having fears that such investments result in an immiserisation of growth.

Exchange Earners Foreign Currency (EEFC) Account Scheme: Under this scheme 100 per cent Export Oriental Units are allowed to retain 70 per cent of their earning in such accounts while other exporters and exchange earners are allowed to retain 50 per cent. The ultimate objective is to allow 100 per cent retention and to the extent the use of these funds is for bonafide purposes, with *immediate* effect, the proportion should be raised to 100 per cent. The current foreign exchange regulations are biased against new entrants into the export sector. The hesitancy here appears to be attributable to fears of the authorities that there can be misuse of facilities. The approach of the authorities ought to be to provide legitimate facilities full with strong supervision and swift penalties for violations. Fear of violations by a few should not be the grounds for holding back legitimate facilities for the majority of beneficiaries.

Integration of Markets: There appears to be considerable hesitancy in allowing markets to integrate and in particular the fusion of money and forex markets. What is worrisome is that there is a growing belief in the advantages of market segmentation. Needless to say, markets have to integrate and in a sense market segmentation is sub-optimal. Banks operating in India have to learn to deal with integrating money and forex markets and they should be actively encouraged to integrate their money and forex operations. The use of controls to prevent integration is not conducive to the development of the Indian financial system and segmentation, as has been attempted, can be justified at best as an unusual and very temporary phenomenon. Allowing markets to integrate would imply that when domestic money market interest rates turn very low there would be short-term outflows and when domestic money market rates zoom to very high levels there will be short-term equilibrating capital inflows. Allowing integration of markets would then ensure that the forward premia would reflect the interest rate differentials. Thus, the integration of markets would work towards financial market stabilisation.

Need to Relax Controls on Outflows by Individuals: As I said earlier the capital regime for foreigners, non-resident Indians who have brought funds into the country and Indian corporates is quite reasonable and what the regime needs is a drastic reduction in bureaucratic redtape. But when it comes to capital controls for *resident individuals,* the Indian regime is thoroughly *barbaric.* At present, individual residents are not allowed *any* financial capital transfers and individual non-residents are not allowed such transfers out of accounts classified as non-resident ordinary (NRO) and non-resident non-repatriable rupee deposits (NRNRRD), though in the case of these non-resident accounts some remittances are allowed on "sympathetic grounds". This is a totally untenable position in today's international economy. It is pertinent to note that even in the case of Malaysia, which is lionised by those favouring draconian controls, capital transfers by individuals are permitted, albeit for small amounts. The argument against allowing capital transfers by individuals is that there would be an avalanche of outflows. Again, it is felt that a holding of a dollar asset by an individual is morally wrong. Taking the second argument first, it is interesting to observe that the holding of Rs. 42.40 is not considered to be morally repugnant, yet the holding of $1 is considered reprehensible. This schizophrenia is attributable to what can be called the *illusion of exchange* that some how we erroneously still consider $1 to be more valuable than Rs. 42.40. It is only when this illusion is corrected that the paranoia about individual capital transfers will disappear. The fear of large outward movement of funds is also unfounded. The earlier experience, at the time of introduction of current account convertibility, of non-residents being permitted to remit their investment income out of non-repatriable assets, belied all fears of large outflows. The long-desired forbidden fruit when freely available is no longer a desired object! It would, therefore, be best to allow individuals to transfer abroad, as capital assets, a modest sum, say $25,000 per year, and if the authorities are still worried about this the initial amount could be even lower.

The advantage is that this would be a strong signal of a liberal capital regime and if the figure so fixed is used as a minimum threshold for *all* capital transactions it would greatly reduce the monitoring workload on the *Exchange Control.* I am convinced that many experts, who have cautioned India against too rapid a move to capital account convertibility such as Bhagwati, Stiglitz and Williamson, would baulk at the harshness of our rigorous capital controls on individuals. I am afraid that the Indian authorities just cannot derive any support from the experts on this count.

Policy on Gold: While the liberalisation on the capital account has been undertaken with great caution the boldness of the measures in recent years relating to gold is often not realised. The liberalisation of gold imports has been a fundamental policy change after nearly sixty years of unsuccessful attempts to curb gold imports by the mere imposition of a ban. The authorities have shown great perception in recognising that gold, apart from being a commodity, is a store of value and as such it straddles both the current and capital accounts. The liberalisation of the gold import regime has resulted in a spurt in gold imports. It is often felt that under the liberalised regime there is a large drain on the reserves and that if only gold imports are once again banned the reserves would go up by $ 5 billion per annum. It hardly needs to be explained that gold imports are not gifts from the international community to India but all that the gold policy can do is to decide whether these transactions are either official or unofficial. India's total gold holdings are reportedly in the range of 12,000-13,000 tonnes while the official holdings are only 400 tonnes. The recent attempts to activate idle gold holdings are of great significance as even if a small fraction of the idle holdings is activated a very large amount of gold would enter the market and thereby dampen the insatiable appetite for gold. While devising various plans for gold deposits, gold bonds, etc. it is important that an element of liquidity is provided to these instruments. Along with the various schemes currently under consideration the idea of a *Gold Bank*, which was mooted in 1992 but later shelved, needs to be revived. The Gold Bank should have unfettered right to import gold, export gold, trade in gold, lend and borrow gold and deal in gold derivatives. It was earlier felt that the Gold Bank would not earn its keep; this fear is clearly unfounded. What the Gold Bank would do is to intermediate transactions in gold and by virtue of its size of operation be able to provide liquidity to the holders of gold. The Reserve Bank should also activate its gold holdings by treating gold as yet another reserve asset and it should undertake in and out movements in gold as it does in other reserve currencies. There would be two options. Either the Gold Bank could take on the role of handling the official gold reserves, in addition to all its other operations, or the RBI could have a very active gold management policy and the Gold Bank could, atleast initially, be given a somewhat more restricted role. The important point nonetheless is to recognise the liquidity needs of gold holders and the opportunities it provides for institutional development. A Gold Bank is an idea whose time has come and the authorities would do well to grasp this golden opportunity.

Adequacy of Reserves

There is a powerful articulation of a viewpoint that in India there has, in the recent period, been an unnecessary pile up of reserves. After all, for decades we survived on a very modest level of reserves of $ 5 billion or less and that our present level of reserves of over $ 31 billion is, in a sense, a waste of scarce resources. The adequacy of the reserves has to be viewed in the context of many factors including the overall trade and payments regime, the type of capital flows and the extent of current and capital account liberalisation. While India's reserves do appear to be high relative to its own past holdings, the reserves appear very modest when compared with those of other countries: China ($ 149 billion), Taiwan ($ 93 billion), Hong Kong ($ 90 billion), Singapore ($ 75 billion), South Korea ($ 54 billion), Brazil ($ 43 billion), Mexico ($ 32 billion), Argentina ($ 24 billion), Israel ($ 23 billion) and Egypt ($ 18 billion). It is clear that we can no longer live on our frugal reserves of $ 5-6 billion of earlier years. We need to realise that there are large debt service payments and leads and lags and there is now the existence of relatively large portfolio flows and, therefore, it is essential to hold larger reserves. While we do not have to go in for a full *Currency Board* we need to have a modicum of reserves in relation to the currency in circulation. At present the net foreign exchange reserves - currency ratio (NFA-C ratio) is a little over 73 per cent. The endeavour of policy should be to ensure that this ratio does not fall below 60 per cent. Moreover, we need to reintroduce the statutory 40 per cent minimum ratio which, in our enthusiasm for planned development, was abrogated in the

1950s. I am aware that the authorities are unmoved by incantations for the safety net of a NFA-C ratio. Let me sound a word of caution. The authorities may just not care about the NFA-C ratio but the fact is that the international community would monitor this ratio hawk-like and if the authorities dare to drop the ratio to below 40 per cent or even close to it, we should be prepared for a rapid exodus of capital of an intensity we have never known. It is the great belief that we have in discretionary policies which has been our undoing in the past and it is precisely this which prevents the authorities from seeing the advantages of a stipulated minimum NFA-C ratio. What this stipulation would ensure is that policy action would be mandatory to safeguard the reserves if the ratio falls below 40 per cent. In effect it is meant to be a *Plimsoll Line.* The authorities would be well advised to introduce a safety net committing themselves not to allow the NFA-C ratio to fall below 40 per cent. A NFA-C ratio is a fairly moderate prescription. There are some advocates of a minimum NFA-M3 ratio and in this context our NFA-M3 ratio of less than 15 per cent would be considered as being totally inadequate.

Exchange Rate Management

Exchange rate policy is perhaps the most sensitive policy area particularly in a country like India. The safe and prudent course is for the central bank to operate a satisfactory exchange rate policy but to say very little. Any attempt by a central bank to clearly articulate the exchange rate policy is black-balled for breaking the consensus on a conspiracy of silence. As such, statements by the government and the central bank are deliberately woolly. We in India appear to be afflicted by this ailment in the extreme.

The analysis and articulation of Indian exchange rate policy is, to say the least, extremely poor but let me hasten to add that the execution of the exchange rate policy is *non pareil*. It is better to have a sound policy which is poorly articulated rather than an imprudent policy which has a rigorous analytical basis with good articulation. A notable exception was the now celebrated speech by Deputy Governor Dr. Y. V. Reddy in August 1997. While this speech was subject to considerable unfair criticism I do not tire of repeating that when the definitive monetary history of the recent period is written up Dr. Reddy's speech on exchange rate policy will be recognised as a major landmark as it brought into the open issues which were earlier taboo.

Debate on the exchange rate is at two levels. At one end is the theoretical abstruse articulation which has no bearing on the actual conduct of policy and at the other end is a *punters* approach of forecasting the exchange rate at a specific point of time. Neither of these approaches is very helpful and what is required is a less inhibited articulation of the simple analytics of exchange rate policy formulation and operations.

The literature is quite clear that there are three types of exchange rate regimes viz. floating, fixed and pegged. Under a *floating* rate the authorities determine the monetary policy and there is no independent exchange rate policy. Under a *fixed* rate the exchange rate policy is set by the authorities but they have no control over monetary policy. *Pegged* exchange rates require the authorities to manage both the exchange rate and monetary policy. Strange as it seems, the Indian exchange rate policy can be classified under all three categories. Official pronouncements have taken great pains to emphasise that the exchange rate is market determined which implies a floating rate. But we need to take cognisance of the official pronouncement that given the choice between growth and external stability the authorities would vouch for external stability, which would inferentially point to a fixed rate with exchange rate policy driving monetary policy. But when we observed the operation of monetary policy and exchange rate policy and the attempt to keep both active one is led to the conclusion that we have a policy of a *de facto* peg as a desired objective with periodic retreats from the peg as the conflicts become intense.

Let me emphatically clarify that this is not an attempt to denigrate Indian exchange rate policy management. In fact Indian exchange rate management has been something that the authorities can be truly proud of. But we need to accept the fact that there is no ready made analysis and no ready made policy which can be easily adopted. Until recently, the RBI had been following a fairly simple analytical framework of the real effective exchange rates (REER). Analytical literature does admittedly point to the flaws in the REER and while complex analytical formulations are devised there is, as yet, no framework that could provide operational guidance. Having knocked down the deity of the REER the pedestal appears to be empty in the *temple of money.*

While making no pretence for setting out a better policy alternative I would set out some guidelines for the satisfactory conduct of exchange rate policy.

First, I would urge that despite the deemphasis of the REER, the Indian authorities should not totally ignore the REER. In fact the authorities should continue to closely monitor the REER and respond appropriately. Secondly, there should be certain acid tests for successful intervention. The authorities should buy spot or forward or undertake spot-forward buy-sell or sell-buy operations depending on the situation. But as a matter of policy the central bank should not have large net forward liabilities. In fact, the endeavour should be to ensure that other than for temporary periods there are no net forward liabilities on the reserves. A good test of successful intervention is that the decline in reserves is recouped within a 6-12 month period; another good test of successful intervention is that the intervention results in a balance sheet profit for the central bank. Thirdly, the rule of thumb should be that the exchange rate depreciates in line with inflation rate differentials and that the forward premium reflects the interest rate differentials. Again, all participants in the spot market should be allowed to operate in the forward market. Fourthly, the downward adjustment of the exchange rate should be undertaken in a planned manner from a position of strength. In other words, a planned gentle depreciation should be achieved while the RBI is a buyer in the market; this would be preferrable to delaying the depreciation till a situation arises when the market forces a sharp and sudden depreciation. To soften a sudden depreciation the central bank has to unnecessarily lose reserves. Against these broad criteria for exchange rate policy and operations the RBI comes out flatteringly well and it can, in all fairness, claim that its exchange rate policy stance has been effective.

Exchange Controls

International finance is more prone, than any other area, to the fashions of the time. At the present time the latest fashion is to wax eloquently about the virtues of exchange controls and to caution against capital liberalisation. This is attributable to the misdiagnosis of the problems and this results in a treatment of the symptoms rather than the disease.

As *Friedrich Von Hayek, (Road to Serfdom, 1944)* says, the introduction of exchange controls is considered to be innocuous, yet it is the complete delivery of the individual to the tyranny of the state. Exchange controls are nothing more than a ring fence within which governments can expropriate their subjects property. Contrary to popular wisdom, capital restrictions do not retard capital flight, they actively promote it. Hence use of capital controls, other than for very short periods and for specific items, are counter-productive and there is great merit in embarking on a very gradual easing of exchange controls and not waiting for all other sectors to be fully liberalised as a precondition for capital liberalisation.

It is indeed difficult to ignore what the guru on free trade Jagdish Bhagwati has to say in his article on *The Capital Myth (Foreign Affairs, 77 May-June 1998).* Bhagwati argues that many countries have grown without capital account convertibility and that it is ideological humbug to say that without free portfolio capital mobility, the world cannot function. He therefore advocates putting off capital account convertibility for quite a while. With such impeccable names arguing so strongly against capital liberalisation, it is just one easy step to fall into the morass of inscrutable controls.

We in India must recognise that our exchange controls are still draconian, miscued and counter-productive and tightening capital controls would be a dangerous act of dare-devilry and the country could well pay a very heavy price in the future. We go on debating the move from FERA to FEMA and how we should move to an ideal regime. The more practical approach is to administratively dispense with meaningless and outdated controls. It is in this context that the novel approach of the RBI needs to be commended. The RBI has recently set up a *Regulations Review Authority* which will carefully review all suggestions for doing away with redundant regulations. It is not as if there is a need to undertake a drastic change in basic policies. What needs to be altered is the nitty-gritty of regulation. It is here that the Exchange Control needs to be more user-friendly rather than take on an adversarial role *vis-a-vis* the users. This is the real challenge in external sector reform.

Concluding Observations

India has come a long way from the situation prevailing upto 1991 when the Indian economy was constrained by external sector limitations. The policy reforms undertaken since then have, in a sense, put the economy in a situation of a *Prometheus Unbound* and now the challenge is largely in sectors other than the external sector. But as the economy gathers up the momentum of change, the external sector should continue to be in the *avant-garde* of reform. It is particularly important that we do not become victims of the momentary fashion of the hour of a generous doze of capital controls.

I am conscious of the fact that the kind of measures I have talked about cannot be labelled as a major package of external sector reforms but it is a series of seemingly innocuous and routine measures which together work up to a total reform. The present time is not for rhetoric but action.