India's External Reforms
Modest Globalisation, Significant Gains

The liberalisation of India's external sector during the past decade was extremely successful in meeting the BOP crisis of 1990 and putting the BOP on a sustainable path. These reforms improved the openness of the Indian economy vis-à-vis other emerging economies. Much, however, remains to be done. India's economy is still relatively closed compared to its 'peer competitors'. Further reduction of tariff protection and liberalisation of capital flows will enhance the efficiency of the economy and along with reform of domestic policies will stimulate investment and growth.

The main lesson of the nineties is that liberalisation of the current and capital account increases the flexibility and resilience of the BOP. This applies to trade, invisibles, equity capital, MLT debt flows, and the exchange market. The author's analysis confirms that in India the exchange rate is a powerful instrument of adjustment in the current account deficit. It also confirms that equity outflows are very unlikely to be a major cause of BOP problems (unlike short-term debt). The impact of fiscal profligacy on the external account has become indirect and circuitous with the implementation of external sector reforms. It operates much more through the general expectations about economic (growth) prospects and the risk premium demanded by foreign (and domestic) investors and lenders. Thus its negative effects are likely to be focused on the domestic rather than the external account. In other words, the negative long-term effects of fiscal profligacy are more likely to be felt in future on the growth rate of the economy and the health of the domestic financial sector.

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I
Introduction

For most people the story of Indian reforms starts in the nineties, following the balance of payments (BOP) crisis of 1990-91. There was, however, a detectable increase in the rate of growth of the Indian economy in the eighties, arising from the liberalisation of the 1980s [Virmani 1989; Ahluwalia 1991]. Nevertheless, our analysis of reforms focuses on the nineties because their scope was much wider and deeper than that seen in the eighties. This was particularly so in the case of the external sector, which is the focus of the current paper.

Section II gives a summary of the broad-based and fairly comprehensive external sector reforms that followed the BOP crisis of 1990-91. It also sheds some light on the decision-making process.

Section III starts with the macroeconomic adjustment undertaken in 1991-92. The contribution of fiscal deficit reduction, exchange rate depreciation, and other factors in the dramatic reduction in the current account deficit by 2.8 per cent of gross domestic product (GDP) in 1991-92 are quantified. The section then goes on to analyse the external sector reforms in the nineties and their impact and puts them in comparative international

perspective. External reforms were among the most successful reforms undertaken in India during the nineties. These reforms have opened up the economy, strengthened the external account, and made it much less vulnerable to shocks. India's trade share rose by 0.11 per cent of world trade during the nineties raising India's world ranking by six positions. India also became more open in terms of capital flows with its rank in terms of foreign direct investment (FDI) inflows rising by nine positions. Equity inflows increased even more rapidly to raise India's rank among the emerging markets by eight positions during the nineties. In 1999 only 13 emerging markets received more FDI than India and only five received more equity inflows. Of these China, South Korea, Thailand, and Brazil had larger inflows of both FDI and foreign equity than India during this year.

Paradoxically, however, the Indian economy remains relatively closed. As shown in Section III, international trade and FDI are still small relative to the size of the economy. There is a 15-position difference between India's trade rank and its GDP rank (both in terms of US $ value). India's customs tariff rates are still among the highest in the world with only two countries known to have a higher weighted average tariffs. The contribution of FDI to gross domestic investment (GDI) is still minuscule with India ranking 126th in terms of the ratio of FDI to GDI. Further

reforms that enhance openness will therefore strengthen not only the external sector but also the competitiveness of the Indian economy.

I
Comprehensive Reform in the Nineties

One result of the BOP crisis of 1990-91 was to create the conditions under which a retired professional economist with wide experience in government and universally well-regarded for his sincerity and integrity could become the finance minister of India. The prime minister of the time deserves full credit for grabbing this opportunity, despite the heartburn that it caused among the members of his party and despite heading a minority government. The new Finance Minister, having been the government's top economic bureaucrat during the previous decade, had been instrumental in raising economic expertise within the government, by bringing a number of market-savvy economists into the government. He was, therefore, relatively well-positioned to make the move from a socialist-inspired approach to economic development to a market-oriented approach.

The new government in July 1991 initiated a new approach to economic development policy. It recognised that only correcting the underlying macroeconomic imbalance and replacing the oppressive system of controls by the discipline of market competition could overcome the BOP crisis. The new finance minister and his chosen team of advisors were aware that in many countries the textbook macro solution for a BOP crisis had led to a slowing of private investment and growth in the two years (and often for longer periods) following the macro adjustment. They were also aware of the remarkable growth rates and poverty reduction achieved by the more open economies of east and south Asia during the previous two decades. Extensive decontrol and de-licensing was recognised as necessary to release the productive potential of Indian entrepreneurs, reduce the period of private investment and growth slowdown and raise the underlying growth rate of the Indian economy. It was also clearly recognised that the best way to put the BOP on a long-term sustainable path was through comprehensive liberalisation of international trade, finance/capital inflows and the exchange regime. The phasing and timing of liberalisation were, however, determined not only by the exigencies of the economic situation, but also the problem of calming genuine fears, convincing ideological diehards, and overcoming vested interests, both within and outside the government.

The comprehensive import control (or quantitative restrictions (QRs)) regime was gradually dismantled, starting with capital and intermediate goods and moving after a period of slowdown to consumer goods. The slowdown was due to the differing nature of these two sets of goods. In the case of intermediate and capital goods, the gainers and losers are more evenly balanced, while for consumer goods the potential beneficiaries are fragmented and unorganised and no match for concentrated number of easily organised opponents. Tariff rates were brought down over a decade from a peak rate of about 300 per cent to a peak rate of 35 per cent. The problems of overdependence on debt and the high proportion of short-term debt were addressed by liberalising FDI and foreign equity (foreign institutional investment, FII) inflows while keeping a very tight lid on short-term debt obligations and maintaining the control regime for external commercial borrowing (ECB). A comprehensive reform of the exchange control regime was undertaken based on thorough intellectual and administrative preparation. The illegal foreign exchange markets and its link with smuggling and invisibles transactions were addressed by a comprehensive liberalisation of gold imports.

Macro-Adjustment

The macroeconomic response to the BOP crisis as it existed at the start of 1991-92 was the classic textbook one of expenditure compression through a sharp fiscal correction and expenditure switching through devaluation. The fiscal deficit of the centre was reduced from 7.8 per cent of the GDP in 1990-91 to 5.6 per cent of the GDP in 1991-92. The nominal effective exchange rate (NEER) was depreciated by 18 per cent in 1991 resulting in a real effective depreciation of 12.4 per cent. In terms of our estimated equation (1) below, the fiscal squeeze and the real depreciation reduced the current account deficit by 1.03 per cent of GDP and 0.97 per cent of GDP, respectively.

The total effect of these two measures was therefore to reduce the current account deficit by 2 per cent of the GDP out of the total actual decline of 2.8 per cent of the GDP. The decline of 1.6 per cent points in the private investment rate contributed about 0.5 per cent to the reduction. The remaining decline of 0.3 per cent of the GDP can perhaps be attributed to the overall increase in private confidence arising from the major economic reforms initiated in 1991-92.

The following reduced form equation is estimated to find the impact of the fiscal deficit on the current account deficit, using data from 1970-71 to 1999-2000.

$$CAD = f (FD_c, REER, Ipvt, t)$$

where, CAD is the ratio of the current account deficit to the GDP, FD_c is the fiscal deficit of the central government as a ratio to the GDP, REER is the 36-country trade weighted real effective exchange rate (1985 = 100), and Ipvt is the ratio of private investment to the GDP. The time trend 't' represents the upward trend in the private saving rate. The fiscal deficit of the central government is much more exogenous than that of the states given constitutional limitations on the latter's ability to borrow. As a longer time series is available for the REER in calendar years than for the fiscal years (April to March), the former is used. The estimation is done in first difference form with the rate of growth taken for the REER. The results are as follows.

(1) $\Delta CAD = 0.001 + 0.466 \, \Delta FD + 0.078 \, Greer + 0.301 \, \Delta Ipvt$
　　　　(0.56)　(2.80)　　　(2.94)　　　　(3.23)

$R^2 = 0.568$, R^2 (adjusted) $= 0.516$, F $= 10.95$

where, $\Delta CAD = [CAD – CAD(-1)]$, $\Delta FD = [FD_c – FD_c(-1)]$, $\Delta Ipvt = [Ipvt – Ipvt(-1)]$, Greer = rate of growth of REER, and the numbers in brackets are t-values.[1]

Thus every per cent point of GDP increase in the fiscal deficit of the central government resulted in a 0.47 per cent of GDP increase in the current account deficit.[2] It is also clear that the exchange rate has a powerful impact in countering the effect of the fiscal deficit. A 6 per cent depreciation of the real effective exchange rate is sufficient to counter and nullify the impact of a 1 per cent point increase in the fiscal deficit. The effect of private investment on the current account is also statistically very significant with a 1 per cent point increase in its ratio to GDP resulting in a 0.3 per cent point increase in the current account deficit.

Trade Reform

Export pessimism was not just a belief, but also almost an ideology among the resident economic elite of India for decades. The two prominent exceptions to this belief in academic circles, Jagdish Bhagwati and T N Srinivasan were both non-resident Indians (NRIs) [Bhagwati and Srinivasan 1975]. Among the domestic exceptions were the new finance minister himself, who as an academic had done work on exports [Singh 1964], and the economist who was to later become his finance secretary. The conventional wisdom among the domestic Indian experts as encapsulated in Nayyar (1976) and Ghosh (1990) was that Indian exports were supply-constrained and not very responsive to relative price changes. The alleged failure of the 1966 devaluation was cited as one of the proofs of this proposition. The attitude of the elites was reflected in the negative reaction that a 1989 Planning Commission research paper, which showed high relative price elasticities of demand for manufactured exports and imports, elicited in the upper reaches of the Planning Commission [Ghosh 1991].[3] The research paper of June 1989 was circulated to members of the Planning Commission and economic advisors in key economic ministries. Unlike earlier research that focused either on total exports or individual commodities this paper constructed three sub-aggregates to show that supply constraints were important only for primary exports and that both the supply and demand for manufactured exports was highly elastic [Virmani 1991a]. Imports were also shown to be very responsive to devaluation. Fuel imports and exports were not amenable to any rational analysis and could therefore have biased earlier aggregate estimates. The paper also showed that that the effect of the 1966 devaluation was spread over two years.

For non-economic participants in the decision-making process the main argument against import bans was that by providing infinite protection to manufactured goods such bans biased the economy against agriculture and labour-intensive manufactures. The QRs also favoured large, capital-intensive manufacturing and mining thus contradicting and undermining the policy of encouraging small-scale industry. The removal of QRs and the reduction of the high tariffs on manufactured goods would therefore favour agriculture and labour-intensive manufactured exports.

Import Controls: QRs

Though trade reform had begun in the 1980s, the import control regime was still incredibly complex in 1990-91. This was particularly true of the duty-free input import regime for exporters (based on the efficiency principle of either not taxing or refunding input taxes). A significant effort was made to clean up this complex regime in July-August 1991 by introducing the 'Exim Scrip' – a freely tradable import licence (30 per cent of export value as import entitlement from the Limited Permissible List) – the premium on which effectively constituted a dual exchange rate.[4] The existing Cash Compensatory System, which varied by product category and perceived domestic value-addition, was abolished. QRs were eased on 96 items by moving them from the 'restricted' to the 'limited permissible' category. The removal of QRs on 37 items by moving them from the 'limited permissible' to the 'open general licence' category was, however, overwhelmed by a reverse movement of 110 items. QRs were also lifted on six items (de-canalised) and eased on 16 others (moved from the canalised category to the 'limited permissible' category). Procedural improvements were also made in the capital goods import

regime for exporters. Export controls were also lifted on 116 items.

The trade policy of April 1, 1992 freed imports of almost all intermediate and capital goods. Only 71 items remained restricted/licensed (3 banned, 7 canalised). These consisted mainly of dual-use goods like office equipment and consumer goods. A Special Import Licence (SIL) was given to star exporters for importing restricted items. The trade policy of April 1, 1993 removed 146 items from the negative (restricted) list of exports. Kerosene, liquified petroleum gas (LPG), low sulphur heavy stock (LSHS), waxes, and fertilisers (phosphoric potash) were de-canalised. In the April 1994 policy, the scope of the SIL was expanded, and second-hand capital goods (with a residual life of five years) allowed to be imported. The import policy of April 1995 put 78 consumer goods in the freely importable category. At this point, out of a total of 5021 6-digit items on the Harmonised Tariff System's list, 3000 were freely importable while 1487 were importable using the freely tradable SIL. Further progress was made in 1996-97 by the lifting of QRs on over 100 items and the movement of about 70 items to the SIL.

After the initial major step of removing QRs on a host of intermediate and capital goods in April 1992, further liberalisation was a painful and slow process requiring infinite patience. Two main problems had to be overcome by those who believed that import liberalisation would benefit the economy and the people as a whole. The Commerce Ministry, institutionally charged with promoting exports was conditioned to thinking in terms of export incentives. Thus, they had a strong incentive to preserve the list of items importable under the SIL so that premiums would remain as high as possible in the belief that this was the best way to benefit exporters and exports. They had to be slowly and gradually convinced that exchange rate adjustments would provide the same incentives in a much more efficient manner.

The other set of objections came from producer ministries who were convinced (without being able to produce any data or hard facts), that producers of consumer goods would suffer if QRs on consumer goods imports were lifted. Unlike in the case of intermediate and capital goods where user groups or ministries could provide support, consumers were not represented in the discussions and arguments about the benefits to consumers were seldom heeded. The evidence (of no negative effect) provided by earlier removal of QRs on intermediate goods spread extremely slowly. Other arguments relating to the visible availability of certain smuggled consumer goods, which had little impact on domestic producers, were sometimes effective. The fact that tariff rates were still quite high did sometimes help to calm the fears of neutral participants. It was only the loss of the World Trade Organisation (WTO) case against India, however, that finally led to the complete elimination of QRs previously justified on BOP grounds on April 1, 2000. Otherwise the process of removal of QRs on consumer durable goods could have dragged on for another half decade or more.

Customs Tariffs

The overall objectives of customs tariff reform were clear from the beginning – to reduce overall protection by reducing the average rate of tariffs and to reduce the arbitrary distribution of protection among industries by reducing the dispersion of tariffs. An incredible array of general, specific, and end-use exemptions had also been built up over the decades in response to the demands of vested interests, backed by little or no economic analysis of the costs or benefits. Though economists working on India's customs

tariffs had some idea of its complexity in terms of multiplicity of rates and end-use exemptions, none initially had a detailed knowledge of the system and its incredible array of exemptions.

In addition to the array of industrial interests and producer ministries opposed to the lifting of QRs, customs tariff reform faced two additional difficulties. The revenue department, charged with collecting revenues understandably had an inbuilt resistance to reduction of any tariff. Secondly, the secrecy of the budget process meant that it was difficult to bring in expertise from outside the revenue department. Secrecy could also be used as a handle to keep information asymmetric and at critical points dismiss arguments as based on imperfect practical knowledge.

The Chelliah committee on tax reform, which outlined a broad structure of peak tariff rates for different categories of goods, proved important in overcoming bureaucratic inertia [Ministry of Finance 1991, 1993]. Its reports helped reformers to keep the focus on peak tariff reductions despite pressures on customs revenue. The other effort was to mount an exercise within the Finance Ministry to collect and analyse all available information on customs duties and customs revenue collection. It was only after this detailed knowledge had been acquired that economists could begin to effectively cut through the jungle of exemptions and reduce the multiplicity of rates and start removing the negative protection and other anomalies. Due to the budget secrecy issue mentioned above, the only route available was to prepare detailed tariff reform papers that applied economic principles to the detailed structure of tariffs and exemptions. This detailed knowledge could not, however, be brought to bear at the critical decision-making budget formulation stage and tariff rationalisation was often incomplete or internally inconsistent. This was also partly due to the pressures from public sector units and opposition from their ministries, which expressed themselves through their ministers at the budget formulation stage.

With the peak customs tariff rate at around 300 per cent in 1990-91 it was apparent from the start that there was a lot of 'water in the tariff'. The first step was therefore to cut the peak rate to half (150 per cent) in the 1991-92 budget and follow it up by another cut in the peak rate to 110 per cent in the 1992-93 budget. The reduction of the import duty on capital goods was accelerated by reducing the general rate to 55 per cent in 1992-93 because of the potential role of capital goods imports in investment and modernisation. Some categories of capital goods were set even lower (50 per cent for electronic industry).

The momentum of peak-rate reductions (to 85 per cent in 1993-94, 65 per cent in 1994-95, and 50 per cent in 1995-96) was maintained, often by taking recourse to the recommendations of the Chelliah committee. The fiscal problem did however constrain the pace of tariff reduction, as there was always a pressure on those recommending faster peak rate reductions to produce offsetting gains in revenue. As the peak rate recommended by this committee was 50 per cent, this recourse was no longer available once the peak rate had been reduced to 50 per cent. The next peak rate reduction (to 40 per cent in 1997-98) was based on internal recommendations and was part of a bold tax reform plan announced by the Finance Minister.[5] The peak rate was raised to 45 per cent in 1998-99 by imposing a surcharge and a special additional duty of 4 per cent was imposed as an analytical counterpart of the state sales taxes on domestically produced goods. The nominal peak rate was reduced to 40 per cent in 1999-2000, but the surcharge was increased to 10 per cent on items having a duty of less than 40 per cent. The peak rate was reduced to 35 per cent in 2000-01, reducing the effective peak protective duty to about 38 per cent. This surcharge was removed in 2001-02 bringing the effective peak rate down to 35 per cent.

Peak rate reductions, along with a gradual elimination of exemptions also helped reduce the variance of rates. Rates on capital goods (general and project-linked) were simultaneously reduced to 35 per cent in 1993-94 and 25 per cent in 1994-95, where they came to rest. The well-known (to economists) issue of negative protection for the capital goods industry, which surfaced occasionally in public debate, was addressed in the detailed customs reforms papers papered from 1992 onwards.[6] Following from these, an attempt was made to rationalise the metal-capital-good chain. A similar exercise was done for the chemicals chain. The 1993-94 budget set the rate for ferrous metals at 75 per cent to 85 per cent and non-ferrous metals at 55 per cent. The widely dispersed rates on machine tools were also reduced to three (40 per cent, 60 per cent, and 80 per cent). Chemical feed stock rates were integrated at 15 per cent and those on major intermediates at 40 per cent. Rates on personal (baggage) imports were reduced from 225 per cent to 100 per cent. The 1994-95 budget rationalised machine tool rates to 35 per cent and 45 per cent and rates on medical equipment to 0 per cent 15 per cent and 40 per cent depending on social value. It reduced rates on steel and non-ferrous metals to 50 per cent. There was also an attempt to prune end-use notifications. In the 1995-96 budget, 80 per cent of capital goods rates were unified at 25 per cent and metals at 35 per cent and 40 per cent.

As a result of these customs tariff rate reductions, the customs duty collection rate, went from 47 per cent in 1990-91 to 44 per cent in 1991-92, 37 per cent in 1992-93, 30 per cent in 1993-94, and 29 per cent in 1994-95. The movement in the collection rate since then has fluctuated with the rate rising to 31 per cent in 1996-97 before falling to 27 per cent 1997-98 and 23 per cent in 1998-99. It rose again to 24 per cent in 1999-2000. The collection rate includes not just the protective duty, but also the 'additional duty' which is the counterpart of domestic excise taxes (also referred to as countervailing duty, CVD).

Exports

The import control system for exports was primarily directed to providing duty free access to imported inputs (intermediate goods) and reduced duty access to capital goods used in export production. Profits from exports were completely exempt from income tax. 100 per cent Export-Oriented Units (EOUs) and Export Promotion Zones (EPZs) had the additional incentive of a 5 to 8 year tax holiday for profits arising from the 25 per cent Domestic Tariff Area (DTA) sales that were allowed. This incentive system was pretty much in place by the end of the eighties. Paradoxically, concern with misuse of the duty free system sometimes made the system even more cumbersome for honest exporters than the normal system for local producers. The chief objective during the reforms was to simplify the system while making it as comprehensive as possible. In the April 1993 trade policy, the EOU-EPZ system was expanded to agriculture and allied exports with 50 per cent DTA sale allowed. Under the Export Promotion Capital Goods (EPCG) scheme for exporters, the concessional duty on capital goods was reduced to 25 per cent (with an obligation to export 3 times the value of the import) and 15 per cent (with an obligation to export 4 times the value of the import). In April 1994, an Electronic Hardware Technology Park scheme was introduced on par with the EPZ. The concept of a Free Trade Zone was finally accepted in 1999-2000.

Foreign Equity Opening

The long-term considerations arguing for raising the flow of foreign equity capital relative to debt were known even before the crisis.[7] The BOP crisis reinforced these arguments for encouraging external equity vis-à-vis debt financing. The emergency loans taken from multilateral and bilateral sources to meet the BOP crisis resulted in a further rise in foreign debt. Foreign debt, which had risen to 25.1 per cent of the GDP by the end of March 1991 (from 22.9 per cent a year earlier) rose further to 33.8 per cent of the GDP by the end of March 1992 (Table 1). Part of this rise was due to the rise in the rupee value of foreign debt because of the July 1991 devaluation (or conversely the fall in the dollar value of the GDP due to the devaluation). The need to dispense with these emergency loans and repay them as soon as possible added to the urgency of opening up equity flows to India.

Foreign Direct Investment

In India's traditional policy framework, FDI was treated as just another form of foreign saving to plug the 'domestic saving gap. In the new reform approach its many other advantages, such as the bundling with knowledge (technology), trade (exports), and investment were fully recognised. Given the need for creating confidence among foreign investors, FDI policy reform formed part of the first package of industrial reforms in July 1991. The attempt at de-control of FDI took the form of an 'automatic route' through the Reserve Bank of India (RBI) (Annual Report, various issues; 'Handbook of Statistics on the Indian Economy', 2000 (CD ROM)) that basically constituted a registration procedure.

FDI with up to 51 per cent (up from 40 per cent) foreign equity was thus freed for a historically defined list of 34 'priority' (intermediate and capital good) industries and international trading companies. However, the dividend balancing condition remained.[8] The 51 per cent level was chosen as this allowed foreign companies to amalgamate profits and losses from such a company into those of the parent company for tax purposes. Technology import was also put under the automatic route subject to conditions on royalty (<5 per cent domestic and <8 per cent export) and lump-sum payment (<Rs 1 crore). Any FDI or technology import had to be approved by a newly created Foreign Investment Promotion Board (FIPB). The principal secretary to the prime minister chaired the FIPB, to ensure speedy approval of FDI proposals outside the ambit of the automatic route.

Within the next nine months, the dividend balancing condition was removed for all except consumer industries. The dividend balancing condition on consumer goods was finally removed in 2000-01. Fifty-one per cent foreign equity was also allowed for FDI in oil exploration, production, refining, and marketing and captive coal mining. NRIs and overseas corporate bodies (OCBs) were allowed 100 per cent equity in priority industries. This was made automatic in 1997-98. Dis-investment by foreign investors no longer required RBI permission. International firms were allowed to use their own trademarks and India ratified and joined the Multilateral Investment Guarantee Agency (MIGA).

In 1996-97 the automatic approval list was expanded to 48 industries, with three mining-related activities allowed 50 per cent and 9 infrastructure activities allowed 74 per cent foreign equity. The latter was raised to 100 per cent two years later. A significant step was taken in 1999-2000 with the introduction

Table 1: Balance of Payments

	1985-86	1986-87	1987-88	1988-89	1989-90	1990-91	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-2000	2000-2001
External Debt ($ million as on March 31st)																
Total Debt				64,075	75,857	83,801	85,285	90,023	92,695	99,008	93,730	93,470	93,531	97,666	98,435	100,255
(Per cent of GDP)				23.7	26.7	28.7	38.7	37.6	33.8	30.9	27.1	24.7	24.4	23.6	21.9	21.6
Concessional				31,814	35,443	38,426	38,187	40,097	41,112	44,845	41,944	39,489	36,944	37,258	38,193	36,032
(Share of total)				49.7	46.7	45.9	44.8	44.5	44.4	45.3	44.7	42.2	39.5	38.1	38.8	35.9
(Per cent of GDP)				11.8	12.4	13.1	17.5	16.7	15.0	14.0	12.2	10.4	9.6	9.0	8.5	7.8
Private share of MLT debt (per cent)													14.5	14.8	13.4	
Short term				3,889	7,501	8,544	7,070	6,340	3,627	4,269	5,034	6,726	5,046	4,274	3,933	3,462
(Share of total)				6.1	9.9	10.2	8.3	7.0	3.9	4.3	5.4	7.2	5.4	4.4	4.0	3.5
(Per cent of GDP)				1.4	2.7	2.9	3.2	2.6	1.3	1.3	1.4	1.8	1.3	1.0	0.9	0.7
(Proportion of foreign currency reserves)				0.92	2.23	3.82	1.26	0.99	0.24	0.21	0.30	0.30	0.19	0.14	0.11	0.09
MLT debt maturing within the year (per cent of MLT)													8.0	7.7	7.3	
Proportion of GDP at market prices (per cent)																
Fiscal deficit (centre)	7.8	8.4	7.6	7.3	7.3	7.8	5.6	5.4	7.0	5.7	5.1	4.9	4.8	4.5	4.1	
Fiscal deficit (centre and states)	8.5	9.8	9.1	8.5	8.7	9.3	6.9	6.8	8.1	6.9	6.6	6.3	7.2	8.3	7.5	
Current account deficit	2.1	1.9	1.8	2.7	2.3	3.1	0.3	1.7	0.4	1.0	1.7	1.2	1.4	1.0	1.0	0.5
Trade deficit	3.4	3.0	2.6	3.2	2.5	3.0	1.0	2.3	1.5	2.8	3.2	3.9	3.8	3.2	4.0	3.0
Invisibles, net	1.3	1.1	0.8	0.5	0.2	-0.1	0.7	0.6	1.1	1.8	1.6	2.7	2.4	2.2	2.9	2.6
Private transfers	1.0	0.9	1.0	0.9	0.8	0.7	1.4	1.5	1.9	2.5	2.4	3.2	2.9	2.5	2.7	2.7
Income (interest)	-0.3	-0.4	-0.5	-0.9	-1.0	-1.2	-1.4	-1.4	-1.2	-1.1	-0.9	-0.9	-0.9	-0.9	-0.8	-0.8
Capital inflows (adjusted)	1.6	2.0	1.9	2.4	2.2	1.5	1.5	1.4	2.5	2.1	2.1	3.3	2.6	2.1	2.9	2.5
External assistance	0.6	0.6	0.8	0.8	0.6	0.7	1.1	0.8	0.7	0.5	0.3	0.3	0.2	0.2	0.2	0.1
Commercial borrowing	0.4	0.8	0.4	0.6	0.6	0.7	0.6	-0.1	0.2	0.3	0.4	0.7	1.0	1.1	0.1	0.9
NRI deposits, net	0.6	0.5	0.5	0.9	0.8	0.5	0.2	0.8	0.4	0.1	0.3	0.9	0.3	0.4	0.5	0.4
Rupee debt service	0.0	0.0	0.0	0.0	0.0	-0.4	-0.4	-0.3	-0.4	-0.3	-0.3	-0.2	-0.2	-0.2	-0.2	-0.1
Reserves (increase is negative)	0.3	0.2	0.3	0.3	0.3	0.4	-1.4	-0.3	-3.2	-1.4	0.8	-1.5	-0.9	-0.9	-1.4	-1.3
Foreign investment ($ million)	0	195	434	357	410	103	133	557	4,235	4,807	4,805	6,153	5,390	2,412	5,117	2,911
Direct (FDI)						96	129	315	587	1,343	2,151	2,906	3,562	2,480	2,167	2,342
(growth rate)							34	144	86	129	60	35	23	-30	-12.6	8.1
Portfolio						5	4	242	3,649	3,579	2,747	3,418	1,828	-68	3,024	1,083
(cumulative share)						0.3	0.6	11.5	60.7	66.6	63.8	61.5	56.1	51.4	52.5	51.3
Import unit-value index of fuel	295	165	201	193	244	383	407	441	435	447	511	649	540	439		
(growth rate)	3.9	-44	22	-4.0	26	57	6.3	8.4	-1.4	2.8	14.3	27	-17	-19		
REER change: Financial Year	-2.6	-8.2	-5.4	-5.8	-2.4	-3.6	-15.1	-11.1	7.9	7.2	-3.7	0.3	5.0	-5.3	-0.2	5.0
REER change: Calendar Year	-1.9	-7.8	-7.3	-3.8	-4.6	-2.3	-12.4	-4.0	-6.6	8.7	-0.7	-3.4	6.4	-3.5	-2.3	

of a negative list approach with all other sectors open to automatic approval. The foreign equity limit in manufacturing was eliminated at this time, while some sector-specific limits such as in telecom and civil aviation remained.

A study done by a private international consultancy organisation in 1992 showed that both the FDI policy and its implementation through the RBI automatic route and the FIPB were comparable to those in south-east Asia and China. By the FDI policy is meant any element of policy that discriminates against (or provides preferential treatment to) foreign nationals and companies wanting to invest in a country relative to the country's nationals and companies. Though domestic policies and procedures that are formally neutral between foreign and domestic investors may have a differential impact on foreigners, these are conceptually distinct from FDI policy. In practice they are as, if not more, important than FDI policy per se.

The gradual liberalisation of FDI rules is an example of phasing being dictated by various pulls and pressures arising from public attitudes (the East India Company syndrome), organised pressure groups, and political resistance. Unlike trade policy where the commerce ministry is formally responsible and tariff policy for which the finance ministry is responsible, the responsibility of FDI policy for any sector or sub-sector falls within the purview of the ministry that deals with that particular sector. To the extent that the industry ministry deals with general industrial policy it is also responsible for the FDI policy for general industry. The finance ministry also comes into the picture, as it is responsible for the BOP aspects of FDI. For this reason the FDI policy for industry made much faster progress within the government and significant resistance to speedier liberalisation came only from outside the government (industry and their civic/public supporters). Because of the universal agreement on the need for FDI in infrastructure sectors, liberalisation for these sectors was also reasonably fast, though in some of these sectors the limit has got stuck below 50 per cent. The resistance to change came mainly from public monopolies or public-private bilateral monopolies that could convince the concerned ministers. Reform of domestic investment policy as well as of FDI policy in other sectors such as real estate has been relatively slow because responsibility is widely dispersed.

Portfolio Capital: FII

As shown in a recent review of financial sector issues by the World Bank (2001: Figure 4.5, p 172), among the emerging economies, India was one of the early openers of the equity market to foreign portfolio investment. According to this study only Mexico started a Country Fund for foreign equity investment about 6 years prior to India, while the South Korean fund was set up only one year before India's. In 1992-93, direct portfolio investment by foreign institutional investors in Indian equity market was allowed. At this time the degree of opening was greater than in almost all east and south-east Asian emerging economies, but perhaps less than that in the large Latin American emerging economies. In addition to the general objective of raising equity flows there were two other considerations that weighed positively in this decision. Though the domestic saving rate was relatively high the availability of risk capital in the equity market was relatively low. It was thought that the flow of foreign equity would help in developing the domestic equity market, by bringing in the world's best practices and stimulating competition. Secondly, because equity markets respond much faster than

FDI, it was hoped that the foreign equity investors would come in quickly, learn about and disseminate the opportunities available in India (i e, act as a window to the world) and, thus, help draw in more FDI. Given residual suspicions and fears, as a safety precaution all such foreign equity had to be channelled through foreign institutional investors registered with the Securities Exchange Board of India (SEBI) and the RBI (for the Foreign Exchange Regulaton Act, 1973, FERA). The FII category was however quite wide and included pension funds, mutual funds, asset management companies, investment trusts, and institutional portfolio managers. Both primary and secondary market investments up to 24 per cent of the total equity of any company were allowed. An equity-debt ratio of 70:30 was allowed for equity funds. The dividend tax was limited to 20 per cent and the long-term capital gains tax to 10 per cent. The use of Global Depository Receipts (GDRs) to raise foreign equity funds was also allowed and encouraged.

The process of reform thereafter was incremental and dependent on the exigencies of the situation including the perception of the BOP situation by the RBI and the fears of equity flow reversals in Delhi. Investment in equity of unlisted companies was allowed in 1996-97 subject to corporate governance type safeguards. 100 per cent debt funds were also allowed to invest in Gilts and listed company securities the same year, with entry into primary treasury options and access to unlisted company debt securities allowed in 1998-99. The company-specific aggregate foreign equity limits were subsequently raised to 30 per cent (1997-98), and then to 40 per cent and 49 per cent (2001-02), subject to the company boards' discretion. At present foreign nationals can directly invest in the Indian equity market through any SEBI-registered investment intermediary. A special regime for venture capital funds has also been put in place.

Indian FDI

In the attempt to raise equity inflows, the potential gains from Indian investment abroad were not overlooked. Just as in the case of inward FDI it was recognised that outward FDI also had the potential to raise the general level of technology and management available to Indian industry. The effort to compete globally could help industry upgrade domestically. The first step was taken in 1992, by putting a time limit of 30 days for approving outward FDI up to $2 million. This limit was raised progressively in subsequent years and its scope expanded.

Debt

The cautious policy towards debt flows was outlined in 1992-93. This included tight control on short-term borrowing and a cap on total ECB. At this point, ECB was to have a minimum maturity of five years, and could only be used for purchasing capital goods abroad. Priority within the cap was given to infrastructure, exports, and small and medium enterprises. This policy was gradually liberalised. The strict short-term debt policy resulted in the closing of the Foreign Currency (Banks and Others) [FC (B and O)] deposit scheme in July 1992 and the withdrawal of the Foreign Currency Non-Resident (FCNR) account scheme of less than one year in May 1993 and the FCNR account scheme of less than two years in October 1993. As a result of this policy short-term debt declined from 6.1 per cent of total external debt by the end of March 1989 to 3.5 per cent of total debt at the end of March 2001. Short-term debt was less than 9 per cent

of foreign currency reserves at the end of March 2001. Even if we include medium- and long-term debt with residual maturity of less than a year, it would be less than 30 per cent of foreign currency reserves [i e, excluding gold and Special Drawing Rights (SDRs)].

Another element of this policy was to eliminate ECB by the government, increase scrutiny of borrowing by public sector companies, and increase the share of the private sector in ECB. As a consequence, the government's share in external debt fell by about 20 per cent points between March 1989 and March 2001, while external private debt had risen to 14.8 per cent of total debt by March 1999.

New institutional structures were created to ensure that control and monitoring of ECB was economically rational and consistent with the liberalised approach. A high-level committee on debt management and a task force on external debt statistics to provide regular reports were set up. A unit was also set up for aggregate debt monitoring and management support. The first status report on external debt was produced in October 1993. This unit evolved into the External Debt Management Unit (EDMU), which helped improve debt monitoring and management.

The ECB policy was gradually liberalised, though the Asian crisis revived diffuse fears about liberalisation. It was clear to those who studied the Asian crises that the problem was one of short-term debt, which remained under strict control. In fact it was argued that the missed lesson of the Asian crisis was that medium- and long-term (MLT) debt above one year (and certainly above three years) was not a problem and could be freed completely. Greater attention would have to be paid to monitoring and modelling the residual maturity of this MLT debt.

Exchange Control

Partial Convertibility: LERMS

The exchange market reform was an example of the most surprising (to the public and outside observers) yet most thoroughly prepared and carefully executed reform. A number of development policy research papers done at the Planning Commission between 1989 and 1991 had suggested the possibility of introducing a 'dual exchange rate' system to ease the transition from a heavily controlled trade regime to a free market system encompassing both trade and payments. After the introduction of 'Exim Scrips' by the commerce ministry in August 1991, the last paper in this series spelt this out more explicitly in September 1991. This paper envisaged a complete de-licensing of intermediate and capital goods imports and inclusion of these along with, "all currently permitted service trade, technology and labour payments (including remittances)" in the "full fledged market determined dual exchange rate."[9] It was noted that the most important reason for switching over to this system was its self-equilibrating property, which would automatically ensure BOP balancing. This system was however administratively tied to what was called a foreign exchange certificate (FEC), a more comprehensive cousin of the 'Exim Scrip' applicable to services and with proportions of 85 per cent to 90 per cent (instead of 30 per cent). It was suggested that the system could be operated through FEC accounts with authorised banks.

Based on these initial thoughts a comprehensive concept paper on liberalising the foreign exchange market using a dual exchange rate was prepared in November 1991. After several rounds of comments and discussion, the final version of this internal paper (which eliminated the FEC accounts) was prepared in February 1992, which formed the economic background of the decision to move to partial convertibility.[10]

The Liberalised Exchange Rate Management System (LERMS) was announced in the Union Budget of 1992-93 and spelled out by RBI the next day. Exporters and remittances would surrender 40 per cent of exchange at the official rate (which was left unchanged at 25.89), while the rest would be converted at the free market rate. This effectively meant that export proceeds were taxed at 0.4 times the difference between the market and official exchange rate. One hundred per cent EOUs and EPZs could sell the entire amount at the market rate and were thus not taxed in this way. All capital account transactions, except those related to the International Monetary Fund (IMF), multilateral aid, and repayment of rupee debt, would also be at the market rate. Exporters could retain up to 15 per cent of earning in a foreign currency account with an authorised bank. The exchange surrendered at the official rate was to be used by the government for official transactions, thus effectively subsidising these uses by the difference between the market and official rate. Compared to a market exchange rate the system represented a cross tax subsidy scheme in which exporters subsidised certain type of government related imports. This was explicitly designed to minimise the immediate impact on the fiscal situation as well as to reduce any risk on this account at a time when a reduction of the fiscal deficit was thought to be essential for reducing the macroeconomic imbalance.

The announcement of this system in the Union Budget for 1992-93 (18 months after the crisis) took the country as well as foreign observers by surprise. The extent of excitement among common people, those who may never have the opportunity to undertake foreign exchange transactions took even those involved in its preparation by surprise. Even the common person welcomed the freedom that it implied and the confidence that it denoted on the part of the government. Many intellectuals and economists predicted that there would be huge capital outflows and the rupee would sink to Rs 40 per US $ on the market channel. Some sceptics even predicted a free fall to Rs 50 per US $. The market exchange rate opened around Rs 31.27 per US $ in March 1992 and rose to Rs 30.87 per US $ in January 1993.

Under the aegis of the Finance Ministry, the RBI, and the commerce ministry, joint committees were set up to monitor and manage the system after it was announced and to iron out any kinks that emerged. Several difficult issues such as how to deal with rupee trade arrangements and the alleged adverse effect on exporters were hammered out during the year. By the end of 1992 it was clear that the scheme was even more successful than was hoped for by its initiator, the finance ministry. It had been thought earlier that a second year of transition could perhaps be necessary, in which the surrender ratio would be reduced along with a reduction of the number of items on the official exchange channel. The performance of the exchange market, however, gave decision-makers the confidence to move directly to an integrated, market-based exchange rate system in 1993-94 by eliminating the official channel. Thus, the cross tax-subsidy (exporters to government) was in operation for only one year. On integration, the exchange rate depreciated to Rs 32.43 per US $ in February 1993, but appreciated thereafter. Till August 1995 it remained below the peak reached in February 1993. Only in September 1995 did it depreciate to Rs 33.58 per US $.

As the RBI retains the right to intervene (and does intervene) to even out excessive volatility in the exchange rate, in inter-

national terminology this system is classified as a 'managed float.'

Gold Imports

In October 1991, the Remittance in Foreign Exchange Immunity Scheme was introduced for repatriation of funds. This was followed by longer term structural attempts to decriminalise transaction that are considered legitimate in a free and open society and to move them from the 'hawala' (unofficial/underground) market to the open market

Reform of the ban on gold imports also received attention in the run up to the 1992-93 budget. Though there were no official statistics, knowledgeable people agreed that most gold smuggling was financed by labour and other remittances through the 'hawala' market. The 'hawala' operators had a network of agents in the west Asia and other countries, who bought the remittance earnings of Indian migrants and sold it to the smugglers. The rupee leg of the transaction was completed in India by collecting the payments from the smugglers' agents in India and paying the beneficiaries of the worker remittances. Thus, it was essential to liberalise gold imports to eliminate smuggling and ensure that labour remittances to India were sent through official rather than 'hawala' markets. This would reduce the size of the 'hawala' market and strengthen the newly liberalised market exchange rate channel.

The only contentious issue among the experts was on what duty rate to set. One side argued for a very low duty rate, close to zero, with the hope that this could eliminate gold smuggling in one fell sweep. The other side argued that the duty rate should be set competitively to the smuggling margin. Based on available information about normal smuggling costs and risks through the sea route, a duty rate of about 15 per cent was judged to be optimal for maximising revenues.[11] As there is little domestic production of gold the customs duty can be viewed as the notional counterpart (CVD) of a domestic indirect tax on gold.[12] It was further argued that this could be lowered subsequently if smuggling remained high. The former argument however prevailed.

As silver or gold is one of the first quasi-financial assets to be acquired by all households including the poor, gold import liberalisation was expected to benefit the common man by making it cheaper and easier to buy gold.[13] There was some fear that the government would be accused of wasting scarce foreign exchange on inessential consumption. All the experts on the subject were however convinced that opening of gold imports would merely shift the whole market above the line with no adverse effect on the BOP. There would also be a benefit in terms of additional customs revenue. The compromise solution was to allow gold imports only by returning Indians.[14] They were allowed to import gold up to 5 kg at a duty of Rs 220 per 10 grams (3 per cent). Subsequently silver import was also freed at a duty of Rs 500 per kg.[15] These duty rates were made applicable in 1994-95 to gold and silver imported as personal baggage.

Further liberalisation of gold imports took place through a transfer of gold to list of commodities importable under the SIL. The SIL was an entitlement given to exporters to import specified items such as gold whose import was otherwise on the restricted or banned list. Subsequently, selected banks were allowed to import and sell gold freely in the domestic market. The case for complete freedom for gold imports rested on the argument that this would allow specialist gold import and sale companies to come in and thus reduce margins through competition. This would also allow customs tariffs on gold to be closer to those on other

commodities. The counter argument, that import of gold has monetary implications and thus must be handled differently from other commodities has, however, prevailed so far. Prima facie, with all vestiges of the gold standard removed, this argument is not very convincing.

By comparing the estimates of the World Gold Council, on import of gold into India, with the official Indian data on imports one can get an idea of the trends in smuggling of gold into India. If it is assumed that the difference represents the amount of gold that is smuggled into India, then the supply of gold through the smuggling declined from virtually almost 100 per cent before liberalisation to 48 per cent by 1995-96 and 39 per cent by 1996-97. Up to 1996-97 most (87 per cent) of imports were through the NRI baggage route, which had been opened up in 1992. Thirteen per cent were through the special import license given to exporters, a route that was opened subsequently. After the opening of the normal (OGL) route to selected importers the proportion of imports through the normal route increased rapidly to reach 42 per cent in 1997-98, 93 per cent the next year, and 99 per cent in 1999-2000. However, even in this year about 36 per cent of gold imports were through the smuggling route. A rise in import duties during 1998-99 (to Rs. 400 per 10 grams in January 1999) increased the incentive for smuggling, which increased rapidly to 54 per cent of total import the next year (59 per cent in 2000-01). To eliminate smuggling, gold import needs to be treated like any other import, so that anyone can import it (i e, unrestricted OGL). The duty rate can be set (keeping in mind that gold is a relatively easily smuggled high-value good) to maximise customs revenue collection.

Current Account Convertibility

Restrictions relating to the non-trade elements of the current account were also addressed subsequently. The foreign exchange rules for business travels were the first to be eased. In 1994, several measures for liberalisation of current account transactions were announced. These included indicative limits for travel, etc, on the basis of which foreign exchange could be bought by citizens directly from authorised foreign exchange dealers. In August 1994, India accepted the IMF's article VIII and thus the rupee officially became convertible on the current account. Further liberalisation of exchange purchase rules for current account transactions took place in 1995-96 with authorised dealers allowed to sanction funds above indicative limits themselves and in 1997-98 with higher indicative ceilings for travel, studies medical and other service purchases from abroad. A new foreign exchange Act was introduced in 1999-2000, based on a conceptual approach that current account convertibility must be codified in the new law and capital controls minimised and based on a regulatory rather than control approach.[16]

I
Impact of Nineties' Reform

External sector reforms have been the most successful of all the reforms that were undertaken in the nineties. They have confounded all the fears of Indian critics and the sceptics that imports would go through the roof and current account deficits would balloon. They confirmed the faith of the reformers that a well-regulated market-based foreign trade and payments system would be more efficient and equally stable. Both the trade and invisibles account are now much more resilient than they were

in the eighties. Capital inflows are now much more diversified and therefore much less risky for the country. Both FDI and portfolio flows increased rapidly through the mid-nineties. The strength of the external account rests substantially on the flexibility of the 'managed float', in response to changes in demand-supply conditions in the exchange market. Difficulties and temporary weaknesses have emerged and will arise in the future if and only if considerations other than market supply-demand determine the management of the floating exchange rate.

One result of the success of the capital flow liberalisation was the unprecedented surge in equity capital inflows between October 1993 and November 1994. Based on analysis by the Economic Division and internal discussions, the Department of Economic Affairs developed a macro-management strategy for this 'Dutch Disease' problem that was quite different from the standard one proposed by the IMF.[17] Though other countries in other time periods have undoubtedly used variants of the same policy, our experience in this regard may also have useful lessons for others.

Even in the case of the successful trade and capital account liberalisation the country has not in my view moved as far or as fast as it could have without taking undue risk. The Asian crisis and the economic sanctions share some of the blame as they the revived the primal fears of the sceptics, which were gradually being laid to rest. Too often, however, this has spectre been used to avoid or slow down external sector reform. The

nineties experience shows that external liberalisation will pay further dividends probably in the form of higher growth.

Contrary to the perception of many outside observers the Indian economy has become more open relative to other emerging economies. India's ranking with respect to trade, FDI, and portfolio flows has improved noticeably over the eighties (Table 4). Only in the case of tariffs is there is no relative improvement, probably because India was a complete outlier. There is however still a very long way to go to attain a ranking in trade and FDI that is commensurate with the size of the economy. Trade as well as FDI remain pathetically low when measured as ratio to GDP and ranked accordingly. China's success in trade and FDI is not only a challenge but also a message of hope that India too can make a quantum jump by greater opening of the economy and by ensuring that domestic economic policies are conducive to the exploitation of the growth potential of trade and FDI.

Trade

The opening of the economy to international trade has successfully raised the share of trade in the GDP. Goods and services trade has increased from an average of 15.1 per cent of the GDP during the eighties to an average of 24.8 per cent of the GDP in the nine years (1992-93 to 2000-01) after the crisis. Similarly merchandise trade, which had averaged 12.6 per cent of the GDP

Table 2: Balance of Payments (US $ Million) Growth Rates (Per Cent)

	Financial Year Averages							
	1970-79	1980-89	1992-00	1990-99	1980-84	1985-89	1990-94	1995-99
	Seventies	Pre-crisis	Post-crisis	Nineties	1st half	2nd half	1st half	2nd half
Exchange Rate (ER): 36-Country-Trade weighted								
Real effective (REER)	-2.1	-2.0	0.0	-1.9	0.8	-4.9	-2.9	-0.8
Standard deviation	5.8	4.6	6.4	7.4	4.6	2.4	10.4	4.0
Nominal effective	0.4	-3.0	-4.6	-6.5	0.4	-6.5	-9.2	-3.8
Standard deviation	2.2	4.8	6.5	7.9	2.7	3.8	10.2	4.9
REER: Calendar year	-3.9	-1.7	-0.7	-2.0	1.6	-5.1	-3.3	-0.7
Inflation (WPI)	8.5	7.2	6.7	7.9	6.5	7.8	10.5	4.6
Standard deviation	9.4	3.9	3.2	3.6	5.3	1.5	2.1	1.8
Money supply	17.5	17.2	17.4	17.3	16.8	17.5	17.5	17.1
Bank Credit, net	17.2	18.5	14.0	14.4	19.7	17.3	13.8	15.0
Commercial	18.9	17.2	14.6	14.3	18.3	16.1	13.3	15.4
Government	15.0	20.4	13.4	14.5	21.9	18.9	14.5	14.6
RBI credit to government	14.5	20.0	5.6	7.1	22.2	17.8	6.8	7.5
Payment (BOP)								
Exports, fob	17.3	8.3	10.8	8.6	5.2	11.4	9.9	7.2
Imports, cif	20.6	7.8	12.7	9.7	6.3	9.4	9.9	9.5
Foreign investment			114	102			189	14.5
FDI			49	52			98	15.0
Customs Export								
Total ($)	16.6	8.1	10.9	8.6	4.5	11.6	10.0	7.3
Quantum Index	6.9	5.4	10.2	10.0	2.7	8.0	10.9	8.9
Unit-Value Index	10.2	10.3	7.7	9.5	10.1	10.5	12.6	5.7
Manufacture ($)	18.4	10.4	10.9	9.7	2.2	18.6	11.5	7.8
Primary	14.9	2.4	8.9	6.2	-0.1	4.9	6.7	5.6
Oil	20.3	109.6	-11.9	-14.5	231.1	-11.9	1.5	-30.6
Customs Import								
Total ($)	21.9	7.2	11.4	9.6	6.3	8.2	7.3	12.0
Quantum Index	7.1	7.5	16.3	12.7	6.9	8.2	12.9	12.5
Unit Value Index	16.3	8.0	4.2	6.9	8.0	8.0	7.6	6.0
Manufacture ($)	18.7	11.1	14.5	8.5	6.4	15.8	5.9	11.1
Machinery and equipment	14.2	13.4	9.4	1.7	9.9	16.8	5.3	-2.0
Primary	15.8	4.6	19.5	12.5	10.4	-1.3	17.1	7.9
Oil	54.1	3.3	5.5	15.8	-0.8	7.5	13.2	18.3
Net Exports (US$ million)								
Non-oil	493	-2,136	1,894	1,809	-1,413	-2,858	2,539	1,079
Manufacture	-207	-2,686	-1,220	-1,131	-2,258	-3,880	212	-2,473
Primary	684	1,026	2,594	2,477	814	845	2,091	2,864
Oil	-1,487	-3,944	-7,211	-6,810	-4,572	-2,811	-5,381	-8,240
World Merchandise Export Growth (per cent)								
Value ($)	20.2	6.6	6.1		3.6	9.6	6.7	5.9
Volume	6.0	3.7	6.7		2.1	5.4	5.5	7.0
Unit Value	13.4	2.7	-0.7		1.4	3.9	1.1	-1.0

Sources: Handbook of Statistics on the Indian Economy, RBI; WTO, World Merchandise Trade Data.

in the decade of the eighties, has increased significantly to an average of 20.1 per cent of the GDP in the post-crisis period (Table 3). Contrary to the expectations of reform critics, the change on the import side has been less than on the export side. Exports (imports) increased from 4.7 per cent (7.9 per cent) of the GDP in the decade before the crisis to 8.5 per cent (11.6 per cent) in the nine years succeeding it (i e, post crisis period). As a consequence, the proportion of imports financed by exports has increased from 0.59 in the pre-crisis period to 0.74 in the post-crisis period (Table 3).

For a disaggregated view one has to go from the payments data to the customs data. The growth of customs exports in US $ value accelerated from an average of 8.1 per cent during the pre-crisis years to an average of 10.9 per cent during the post-crisis years (Table 2). This increase in growth was solely due to the acceleration in the quantum of exports, whose growth rate almost doubled from 5.4 per cent per annum in the first period to 10.2 per cent per annum in the second period. This compensated for a deceleration in the growth of unit values from 10.3 per cent per annum in the pre-crisis period to 7.7 per cent per annum in the post-crisis period. The net terms of trade have actually improved in the post-crisis period. Despite the slowing down of unit value growth rates they remain high by world standards. World merchandise (manufacture) export unit values increased

by 2.7 per cent (2.9 per cent) per annum during the eighties and 0 per cent (0.5 per cent) per annum in the nineties.

Manufactured exports responded well to the trade reform and increased from an average of 60.7 per cent of total exports in the eighties to an average of 76.1 per cent of total exports after the crisis (Table 3). As a result, the ratio of manufactured exports to the GDP more than doubled from a pre-crisis average of 2.8 per cent to a post-crisis average of 6.3 per cent. Its share of total exports also increased from 60.7 per cent to 76.1 per cent between the two periods.[18] The importance of manufactured exports to domestic manufacturers has correspondingly increased. This is best captured by the ratio of manufactured exports to the GDP from registered manufacturing, which has also more than doubled from a pre-crisis average of 6.4 per cent to a post-crisis one of 13.2 per cent. Thus, even with the many domestic controls and policy distortions still hampering manufacturing in India this sector has demonstrated its comparative advantage vis-à-vis other trade sectors.

On the import side, oil and non-oil imports have followed a significantly different path. Oil imports have increased marginally by 0.2 per cent of the GDP after the crisis (Table 3). Non-oil imports have in contrast jumped from a pre-crisis average of 5.2 per cent of the GDP to a post-crisis average of 7.6 per cent of the GDP. Given the relatively low price elasticity of

Table 3: Balance Of Payments Ratios
(Per Cent of GDP at Current Market Prices)

	1970-79 Seventies	1980-89 Pre-crisis	1992-2000 Post-crisis	1990-99 Nineties	1980-84 1st half	1985-89 2nd half	1990-94 1st half	1995-99 2nd half	Max	Min
				Financial Year Averages						
Fiscal deficit (centre)	3.6	6.6	5.2	5.5	5.6	7.7	6.3	4.7	8.4	0.2
Fiscal deficit (centre and states)	8.1	7.2	7.4	7.3	8.9	7.6	7.2	9.8	6.3	
Current Account Deficit	0.1	1.8	1.1	1.3	1.5	2.2	1.3	1.2	3.1	-1.7
Goods and services deficit	1.5	3.7	3.1	3.0	4.1	3.2	2.2	3.7	5.2	0.4
Trade deficit	1.2	3.2	3.1	2.9	3.5	3.0	2.1	3.6	4.3	0.3
Exports, fob	4.4	4.7	8.5	8.0	4.7	4.7	7.3	8.7	9.5	3.1
Imports, cif	5.6	7.9	11.6	10.9	8.2	7.7	9.4	12.3	12.8	4.0
Export-import ratio	0.80	0.59	0.74	0.74	0.57	0.61	77.8	70.7	0.94	0.52
Non-customs import	0.3	0.7	1.8	1.6	0.5	1.0	1.3	1.9	2.6	-0.1
Invisibles, net	1.1	1.4	2.0	1.6	2.0	0.8	0.8	2.4	2.9	-0.3
Non-factor services	0.3	0.4	0.4	0.3	0.6	0.3	0.3	0.4	0.9	-0.1
Private transfers	0.6	1.1	2.5	2.2	1.3	0.9	1.6	2.7	3.2	0.2
Official transfers	0.6	0.2	0.1	0.1	0.3	0.2	0.1	0.1	2.7	0.0
Income (including Interest)	-0.3	-0.4	-1.0	-1.1	-0.1	-0.6	-1.3	-0.9	0.2	-1.4
Capital Inflow (adjusted)	0.9	1.6	2.4	2.2	1.1	2.0	1.8	2.6	3.3	-1.7
Foreign investment	0.0	0.0	1.1	0.9	0.0	0.1	0.7	1.2	1.6	0.0
FDI (from quarterly)			0.5	0.4			0.2	0.7	0.9	0.0
Portfolio (from quarterly)			0.6	0.5			0.5	0.6	1.3	0.0
External assistance	0.7	0.6	0.4	0.5	0.6	0.7	0.8	0.2	1.5	-1.9
Private/market (ECB+NRI)	0.2	0.9	0.9	0.9	0.5	1.2	0.7	1.1	1.6	0.0
Commercial borrowing	0.1	0.4	0.5	0.5	0.3	0.6	0.3	0.6	1.1	-0.1
NRI deposits, net	0.1	0.4	0.4	0.4	0.2	0.7	0.4	0.5	0.9	0.0
Rupee debt service	0.0	0.0	-0.2	-0.3	0.0	0.0	-0.4	-0.2	0.0	-0.4
Reserves (increase is negative and decrease is positive)	-0.5	0.2	-1.1	-1.0	0.1	0.3	-1.2	-0.8	1.0	-3.2
Customs Data (DGCI and S)										
Total imports	5.3	7.2	9.8	9.3	7.7	6.7	8.2	10.4	11.0	3.4
Oil imports	1.2	2.0	2.2	2.1	2.8	1.2	2.0	2.1	3.6	0.3
Non-oil imports	4.0	5.2	7.6	7.2	4.9	5.5	6.1	8.3	8.9	3.1
Manufactures imports	2.7	4.1	6.6	6.3	3.7	4.5	5.4	7.2	7.5	2.2
Total export	4.5	4.6	8.4	7.8	4.6	4.5	7.2	8.5	9.3	3.3
Manufactures exports	2.5	2.8	6.3	5.9	2.5	3.1	5.4	6.5	6.7	1.8
Other Ratios										
Export/Import ratio	0.87	0.64	0.86	0.85	0.61	0.68	0.88	0.82	1.06	0.53
Manufactured exports ratio										
to total	55.7	60.7	76.1	75.4	54.7	66.7	74.7	76.2	80.0	50.9
to registered manufacturing	7.2	6.4	13.2	12.4	5.9	6.8	11.3	13.7	14.1	5.1
Net imports of manufactured goods ratio to manufacturing GDP	1.8	8.9	2.5	2.3	7.7	10.1	-0.2	4.8	13.7	-6.2
Machinery and equipment import share in manufacture imports	26.0	29.0	29.6	29.7	26.6	31.4	31.1	28.4	36.3	19.1

Sources: RBI, *Handbook of Statistics on the Indian Economy*; Directorate General of Commercial Intelligence and Statistics (DGCI and S).
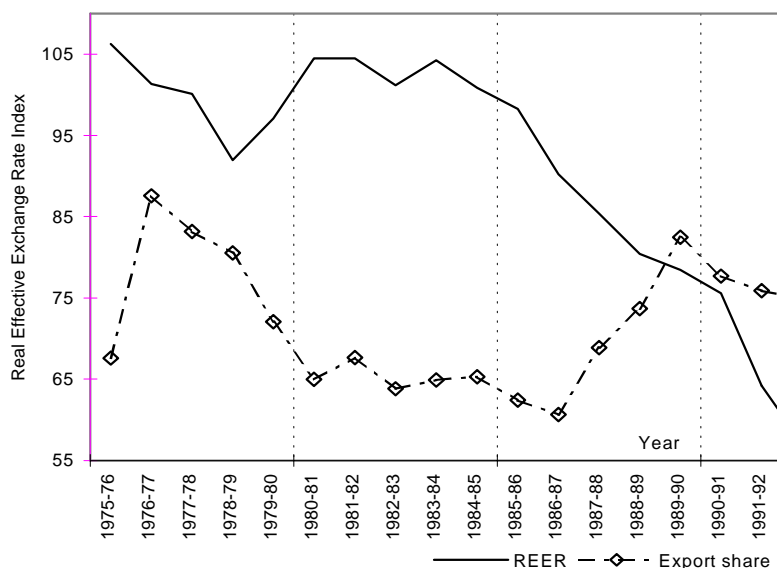
demand for oil, prices determined by the Organisation of Petroleum Exporting Countries (OPEC) have largely driven the changes in value (US$) of oil imports, with domestic disruptions in supply[19] playing a small role.

Elasticity pessimists in India have generally been very concerned about the effects of opening the economy on the manufacturing sector ('de-industrialisation'). That these fears have proved unjustified can be seen from the value of net imports of manufactured products (calculated as the value of imports less the value of exports). This has fallen dramatically from a pre-crisis average of 8.9 per cent of the GDP to a post-crisis average of 2.5 per cent of the GDP (Table 3). In fact, exports of manufactures exceeded imports of manufactures (i e, a net surplus) during each of the four years from 1991-92 to 1994-95. This shows that manufacturing trade was highly responsive to the exchange rate devaluation of July 1991, as predicted in Virmani (1991b).

Despite all these changes in the trade account, the trade deficit has not changed significantly in the post-crisis period. It averaged 3.1 per cent of the GDP in the post-crisis period, compared to 3.2 per cent in the eighties and 3.0 per cent in the second half of the eighties. The trade balance was in fact stronger than is apparent from the bare numbers, as the post-crisis imports include a substantial proportion of gold imports that earlier were not captured in the import numbers (due to smuggling). The break-up of the USSR also disrupted established trade patterns and new markets had to be found to replace those lost in the USSR and East Europe. Further, despite the Asian crisis in late 1997-98, the trade balance improved in 1998-99.

Paradoxically, these changes in exports and imports have occurred despite the fact that the real effective exchange rate averaged the same in the post-crisis period as in the pre-crisis decade. This is however quite misleading as the real effective exchange rate depreciated by an average of 1.9 per cent per annum in the nineties, because of a depreciation of 15.1 per cent in 1991-92 and 11.1 per cent in 1992-93 (Tables 1 and 2). The real depreciation rate was therefore only 0.1 per cent per annum slower than in the eighties and 0.2 per cent per annum slower than in the seventies. As a result India's share in world exports continued to increase from 0.52 per cent in 1990 to 0.67 per cent in 2000 (Table 4). This increase was higher than in the previous

decade because of the gradual lifting of the QRs and reduction in customs tariffs.

Several commentators have, however, raised the issue of a slowing and perhaps even some reversal of reforms (tariffs and exchange rate management) during the second half of the nineties and its affect on exports and balance of trade. A comparison of the performance in the second half of the nineties relative to that in the first half can shed some light on this issue. The ratio of exports to the GDP, which was identical during the two halves of the eighties (4.7 per cent) jumped to 7.3 per cent in the first half of the nineties and thence to 8.3 per cent in the second half of the nineties. It was 9.5 per cent of the GDP in 2000-01 (Table 1).

The trajectory of India's share in world merchandise exports shows a similar trend. India's share of world trade increased by 0.08 per cent points between 1990 and 1995 and by 0.07 per cent points between 1995 and 2000 (Table 4).

The share of manufactured exports in India's total exports also increased during the nineties. It went from an average of 74.7 per cent during the first half of the nineties to an average of 76.2 per cent in the second half of the nineties (Table 3). This increase was however significantly less than the 8 per cent-point increase in the share of manufactured exports between the second half of the eighties and the first half of the nineties. The deceleration in the manufactured-export growth rate over the nineties may be partly due to the slowing of real effective depreciation to 2.9 per cent per annum during the first half and to 0.8 per cent per annum during the second half of the nineties (Table 2 and Figure 1).

The trade deficit after falling sharply during 1990-94 (2.1 per cent of the GDP) has increased even more sharply during 1995-99 to an average 3.6 per cent of the GDP (Table 3). This is higher than in 1980-84 (3.5 per cent). It touched 4 per cent of the GDP in 1999-2000 but fell back to 3 per cent in 2000-01. The increase in the import-GDP ratio over the nineties is driven by the increase in manufactured imports (Tables 2 and 3). The net imports of manufactured goods, which become negative (i e, net exports), have risen in the second half of the nineties. They still remain well below that in the first half of the eighties. There are a number of reasons for these developments. The euphoria that preceded the Asian crisis created large capacities in many (un-differentiated) products in Asia that has put downward pressure

Figure 2: Balance of Payments

Legend: —— Capital inflow: adj ——△—— C A D ——◇— — NRI deposits
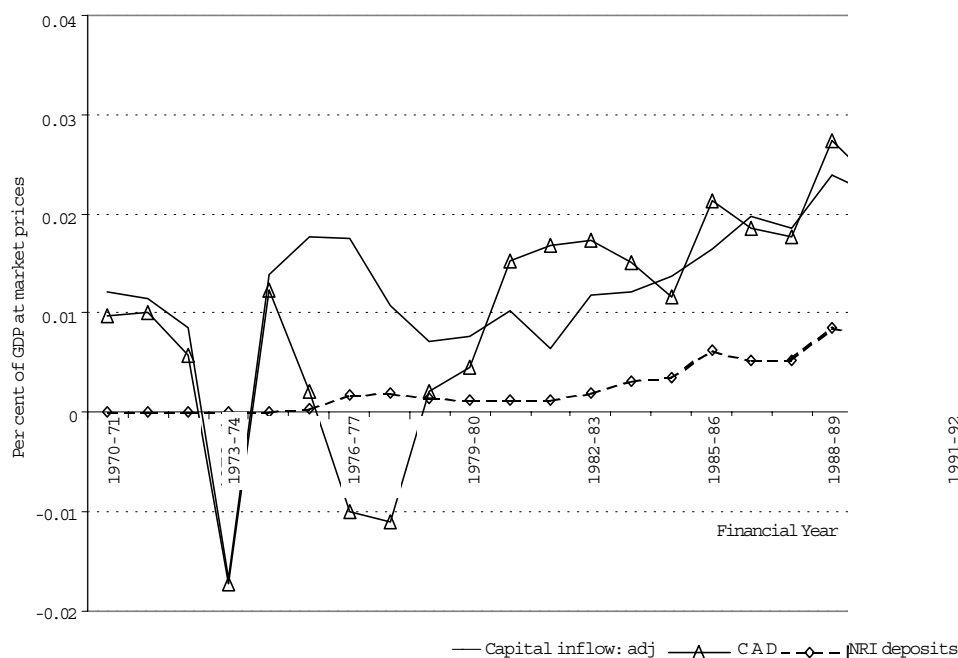
on the global prices of manufactured goods. This combined with the slower pace of real depreciation (0.8 per cent per annum) during the second half of the nineties compared to the first half (2.9 per cent per annum) to eliminate any remaining 'water under the tariff.' Indian manufacturing is therefore subject to competitive pressure for the first time. The solution is to increase competitive efficiency further through faster tariff reductions combined with greater freedom to exchange markets to depreciate.

Another factor is the slow speed of fundamental reform in the power and railway sectors that has raised the effective cost (direct cost, rationing, and quality) of these two vital non-tradable goods. This means that the real exchange rate as measured by the ratio of the virtual cost of non-tradable goods to prices of tradable goods has probably risen faster than the tariff-adjusted real exchange rate. When the real cost of other domestic distortions such as labour inflexibility is added, this denotes a loss in the competitiveness of Indian producers of import substitutes that has not been fully compensated by firm-specific productivity improvements. As long as the overall BOP is in equilibrium the solution lies in domestic reform rather than in faster exchange rate depreciation. This recommendation does not however apply when the economy is subjected to external shocks such as the Asian crisis or the lagged effect of external economic sanctions. In this situation the exchange rate must be allowed to adjust in preference to seeking special financing through government-owned financial institutions.

Imports of capital goods as a per cent of manufactured imports have also fallen, after rising to a peak of 33 per cent in the period from 1993-94 to 1996-97, though they were still in the second half of the nineties a higher proportion of manufactured imports than in the first half of the eighties. This rise is partly due to the decline in FDI from 1997-98 onwards and partly due to the decline in domestic investment (GDI) over the same period. The ratio of capital goods imports (US$) to domestic production of capital goods [measured by the index of industrial production (IIP)], which rose during the FDI and GDI boom of 1993-94

to 1996-97, has since fallen. This is a precursor of lower productivity growth in future. Elimination of the remaining controls on domestic investment and production [small-scale industry reservation, outsourcing (under the Contract Labour Act), drugs, sugar, petroleum, fertiliser, coal, rail transport], regulatory and other reforms in infrastructure, and elimination of remaining restrictions on FDI (see sub-section on capital flows) can help revive both GDI and FDI.

Current Account

The invisibles account improved significantly in the post-crisis period with inflows rising from the average of 1.4 per cent of the GDP in the eighties to 2.0 per cent of the GDP in the pre-crisis period (Table 3). Thus, these invisible flows are back to the high levels seen in the first half of the eighties. That some of this improvement is due to the reform of gold policy can be seen from the big jump in remittances through official channels. Private transfers, which averaged 1.1 per cent of the GDP in the pre-crisis period, have more than doubled to 2.5 per cent of the GDP in the post-crisis period (Table 3). The investment and other income outflows after rising to a peak of 1.4 per cent of the GDP in 1991-92 and 1992-93 declined progressively to 0.8 per cent of the GDP by 2000-10 (Table 1). In the earlier years external debt was the driving factor, while in the latter years FDI and portfolio flows have also started playing a role.

Contrary to popular perception non-factor services, which include software exports, have not played a role in this improvement. This is primarily because software exports have offset declines in other non-factor services. The sharp increase in software exports is reflected in the increased miscellaneous receipts (not net) from 0.6 per cent of the GDP in the eighties and the first half of the nineties to 1.3 per cent of the GDP in the second half of the nineties. The improvement on this account has, however, been offset by deterioration in the net travel receipts. This points to the need for addressing the basic problems

that bedevil foreign tourists coming to India, like lack of health and hygiene (at tourist sites and in hotels), information (about tourist sites, places, and cities), common courtesy (from immigration counters to local transport to tourist sites) and entertainment at tourist destinations.[20]

The most critical area of infrastructure reform from the tourism perspective is transport. The quality and efficiency of airports and domestic airlines can be improved through increased competition. Domestic airlines must be allowed to enter into joint ventures with foreign airlines and the foreign equity proportion raised at least to the level in the telecom sector. Airport services can be unbundled so that the government can focus on improvement in air traffic control and landing equipment and in security and safety procedures. The rest can then be left to the private sector. Railway transport can also play a part in tourism earnings if the metropolitan railway stations are privatised and turned into clean commercial hubs and the supply of passenger rail services opened up to private entry and competition (with no price control).

There was also a minimal effect of the Asian crisis on invisibles with a decline of 0.2 per cent of the GDP in the invisible surplus in 1998-99 and a strong bounce up the next year (Table 1). The improvement in invisibles earning has ensured that there was little criticism of the current account liberalisation.

As a result of the strengthening of the invisibles account, the current account deficit averaged 1.1 per cent of the GDP in the post-crisis period (Table 3). There is no evidence of deterioration in the current account over the decade, with the current account deficit being marginally lower in the second half (1.2 per cent) of the nineties compared to the second half (1.3 per cent). The current account deficit is lower than the pre-crisis average of 1.8 per cent of the GDP and the 1.5 per cent average of the first half of the eighties. The position was even better (0.5 per cent) in 2000-01. The external reforms have therefore been successful in putting the current account balance on a sustainable path.

Fiscal Deficit

The total fiscal deficit during the last five years is comparable to the fiscal deficit in the first half of the eighties. This has not prevented the current account deficit from declining dramatically. The difference in impact is due to the external sector and other reforms that have improved the flexibility of the economy. The fiscal adjustment that has taken place during the nineties may however be underestimated because quasi-fiscal elements such as exchange guarantees have also been absorbed. The high fiscal deficit may in future act as a drag on economic growth even if its impact on the external deficit is lower.

The central government fiscal deficit declined from an average 6.6 per cent of the GDP, during the pre-crisis decade of the eighties, to an average of 5.2 per cent of the GDP in the post-crisis period (1992-93 to 2000-01). This decline of 1.4 per cent of the GDP was double the 0.7 per cent of the GDP decline in the current account deficit between the two periods (Table 3). Using the coefficient of our estimated equation (1), the decline in the fiscal deficit explains about 0.65 per cent of the improvement in the current account deficit, while the rest is explained by the average real effective depreciation of 0.7 per cent per annum in the post-crisis period.

Underlying this unchanged quantitative picture are a number of changes that may have affected the links between the fiscal deficit and the external account and other variables. Firstly, exchange guarantees on NRI deposits had to be paid by the

government after the 1991 devaluation. There has also been a conscious effort to reduce exchange and interest guarantees on debts incurred by public financial institutions and public sector units. The reduction of the statutory liquidity ratio (SLR) requirements on banks to hold government securities coupled with payment of market interest on these liabilities has eliminated the implicit tax on banks while raising government interest payments. Customs duty reforms have similarly raised the efficiency of the tax system, while reducing revenue collections. Capital expenditures have been cut much more sharply than salaries and wages, thus decreasing the share of tradable goods in the government expenditure basket. The overall result is that the primary deficit has fallen much faster than the fiscal deficit (by 2.5 per cent points of the GDP), the efficiency of the tax system has increased, while the quality of expenditure has declined.

Prima facie the fiscal picture appears bleaker if one looks at the total deficit of the centre and the states (C and S). The total fiscal deficit (C and S) has declined by only 0.9 per cent of the GDP, from an average of 8.1 per cent of the GDP in the pre-crisis decade to an average of 7.2 per cent in the post-crisis period (1992-93 to 1999-2000). The total fiscal deficit (C and S) increased by 1.6 per cent of the GDP between the first and second half of the eighties. It then declined by 1.7 per cent of the GDP in the post-crisis period. Though the average fiscal deficit in the second half of the nineties (7.2 per cent of the GDP) was marginally lower than in the first half of the eighties (7.3 per cent of the GDP), in 1999-2000 it was again up to 7.9 per cent of the GDP (Table 1). Such a high fiscal deficit also makes it difficult to respond to cyclical fluctuations with an active fiscal policy. Further the underlying problem of efficiency and productivity of government expenditures remains to be addressed. Thus, the fiscal problem remains a potential threat to the economic health of the country.

Regressions using a slope dummy for the post-crisis period, suggest that the impact of the central fiscal deficit on the current account is a fraction of what it was till 1991-92.[21]

Similar results are obtained if the central government's primary deficit is used in the equations instead of its fiscal deficit. This is not surprising given the fundamental changes in the external sector. One of these has been to reduce the share of the government in total external debt thus reducing the direct link between the fiscal deficit and external borrowing. More generally, the reduction in controls and restrictions has changed the nature of the link between government behaviour and private actions. Thus, the combination of fiscal and external sector reform has moderated the fiscal influence on the current account and inflation. The movement to a managed floating exchange rate has reduced the external spillover effect of the fiscal deficit on the current account deficit, while the elimination of import barriers has mitigated the effect of the impact of the fiscal deficit on inflation.

Capital Flows

The capital account of the BOP has also shown corresponding improvement. Capital inflows (adjusted or excluding 'other capital') increased from an average of 1.6 per cent of the GDP in the pre-crisis decade to an average of 2.2 per cent of the GDP in the post-crisis period (Table 3). Even more significant than the overall increase was the increase in the foreign investment inflows from negligible levels in the eighties to an average of 1.1 per cent of the GDP in the post-crisis period. The contributions of external assistance and rupee debt declined by 0.2 per cent of the GDP, each. The contribution of ECB increased by 0.1 per

cent of the GDP while that of NRI deposits remained unchanged. Thus, the objective of raising the equity-debt ratio of external liabilities has been achieved (Figure 2).

FDI responded extremely quickly to the new policy announcement in July 1991, recovering to $129 million in 1991-92 itself and then more than doubling to $ 315 million the next year (Table 1). It continued to grow fairly rapidly to reach $ 3.56 billion by 1997-98. Between 1990-91 and 1997-98, FDI grew at a compound annual rate of 67 per cent (with a simple average of 73 per cent for the 1991-92 to 1997-98 period). This rapid growth was followed by the Asian crisis and economic sanctions, resulting in a decline of about 30 per cent in 1998-99 and 13 per cent in 1999-2000. Though much of the decline in 1998-99 was part of the overall decline in FDI flows to emerging markets because of changed risk perceptions, India did not share in the recovery of flows in 1999-2000. Despite positive growth in 2000-01 India's share in FDI to emerging markets remains below the peak reached in 1997-98.

During 1990-91 to 2000-01 about half of the foreign investment inflow was FDI and the other half portfolio (FII and GDR). This suggests that the opening of the equity market has been relatively more successful than the opening of FDI. This is not due to FDI policy alone. In the manufacturing sector where 100 per cent automatic FDI is allowed in all areas open to large domestic industry, there is only one specific restriction that applies to FDI but not domestic investment. This is the requirement that an existing foreign direct investor must obtain a no objection from the Indian joint-venture partner before starting a new independent unit. This restriction has no relevance to green-field investors and those without a domestic joint-venture partner, but may have slowed the growth of the existing FDI. The more important problems in the case of FDI in the manufacturing sector are domestic policy constraints such as small-scale industry reservation and labour policy and rules and procedures that make China a more attractive destination than India. This discourages both foreign and Indian companies from investing in a slew of labour-intensive exportable sectors.

In the case of infrastructure, foreign equity limits exist in two major sectors, aviation and telecom. The 49 per cent limit in telecom has clearly had a negative affect on FDI inflows into this sector and should be removed. The ban on foreign airlines in domestic aviation has been a more important factor in aviation and needs to be removed forthwith. A generic problem affecting many infrastructure sectors has been one of regulatory capture (and potential capture-creating regulatory risk) by public sector monopolies abetted by their supervisory ministries. This problem has taken an excruciatingly long time to sort out thus slowing investment in infrastructure. A modern independent regulatory system in all infrastructure sectors would help to accelerate both foreign (FDI) and domestic investment.

In the case of the power sector the most fundamental problem is the 'T and D (transmission and distribution) Mafia,' that has a vested interest in maximising power theft by consumers. This problem has to be addressed through a special police task force that arrests the corrupt employees and sequesters their ill-gotten gains. Some amendments may also be required in the Prevention of Corruption Act to make it possible to freeze the financial returns from investment of stolen power by employees. A break up of the 'T and D Mafia' will also make it easier to solve the secondary problem of raising user costs to economic levels. It will also make it possible to attract private entry into the power sector within a competitive generation industry and well- regu-

lated distribution and transmission sub-sectors. In the meanwhile, greater transparency in the implicit tax-subsidy arrangements and their replacement by an explicit tax-subsidy regime will make it possible for private generators to operate outside the stranglehold of the state electricity boards (SEBs).

In non-infrastructure services, particularly in some service sectors that have attracted large investments in other countries, domestic reforms as well as liberalisation of FDI has been painfully slow. The entire policy framework for private entry into provision of urban infrastructure, real estate, housing, and retail trade (particularly grocery super markets) needs to be reformed to attract both domestic and foreign investment.[22]

Equity flows also responded quickly to the policy change, rising from almost nil in 1991-92 to $ 244 million in 1992-93 and then to an incredible $ 3.57 billion in 1993-94 followed by another $ 3.8 billion in 1994-95 (Table 1). The quarterly build-up of equity flows was even starker and created issues for monetary and exchange range management. Equity flows increased from $ 307 million in July-September 1993 to $ 935 million in October-December 1993 and to $ 2,283 millon in January-March 1994, before stabilising at a lower rate of about $1 billion a quarter in the next three quarters. Thus, the four quarters of (calendar year) 1994 saw a portfolio inflow of $ 5.5 billion with an unprecedented $ 6 billion flowing in over a 12-month period starting in mid-October 1993.

In analysing the reasons, it was found that this was partly due to the push provided by the reduction of US interest rates, but mainly due to the opening of the equity market and the favourable environment created by the broad based economic reforms.[23] Given the accelerated build-up, part of this incredible flow was therefore viewed as a portfolio stock adjustment. In the absence of any historical data it was, however, difficult to determine how much of the increased flow was temporary and how much permanent. In dealing with the monetary and exchange rate implications of the flow the following three-fold strategy was suggested.

(a) To absorb the temporary part of the upsurge in reserves and to partially sterilise the reserves build up. The inflation rate would be carefully watched so that the sterilised proportion could be stepped up if pressure is built up on the inflation front.

(b) To not sterilise the permanent increase in the inflow so that it could increase the capital available in the economy, reduce real interest rates and stimulate investment.

(c) To accelerate the opening of the current and capital accounts, to improve the efficiency of the economy, so that these permanent inflows would be productively utilised.

The build-up of reserves meant that the nominal exchange rate would not appreciate. It was the Economic Division's argument that partial (incomplete) sterilisation was essential to allow this newly available source of saving to be translated into lower interest rates that would stimulate investment. In the implicit model it was understood that there would be some pressure on prices, but it was believed that the real appreciation would be lower through this channel than if the capital flow was translated instantaneously into a nominal appreciation (i e, no purchases by the RBI to build reserves).[24] Given the thinness of the foreign exchange market, nominal appreciation to equilibrate an inflow of $6 billion over 12 months would have been in double digits. Inflation as measured by the wholesale price index in fact increased by about 4.3 per cent in 1994-95 (relative to the average inflation in 1993-94 and 1995-96).

There was an alternative monetarist view that this equity flow

was due to the high Indian interest rates produced by the higher fiscal deficit in 1993-94. Responding to the fears of the monetarists, part of the inflow could be sterilised. Our preferred alternative to the monetarist approach was, however, to accelerate the pace of external liberalisation, including on capital account, and thus absorb the permanent component of the inflow to increase efficiency of resource use and stimulate investment and growth.

India's debt statistics reflect the reduction in the dependence on debt. The ratio of total external debt to the GDP has declined from a peak of 33.8 per cent at the of end March 1992 to 19.8 per cent of the GDP at the end of March 2000 (Table 1). The share of short-term debt in total debt has been reduced from a peak of 10.2 per cent on March 31, 1991 to 4.1 per cent on March 31, 2000. The ratio of short-term debt was only one-tenth of foreign currency reserves (excluding SDRs and gold) at the latter date. At the end of March 1999, the MLT debt of residual maturity less that one year was less than 1.5 times the short-term debt, which was about 4.5 per cent of total debt and one-tenth of reserves. Thus, even if the residual short-term debt element of the MLT repayments coming due within the year 1999-2000 is added to the short-term debt, this constituted only a quarter of foreign exchange reserves at the beginning of the year.

The effectiveness of the external sector reforms was demonstrated by the ease with which the BOP weathered the double whammy of the Asian crisis in late 1997-98 and the nuclear-related economic sanctions imposed in early 1998-99. The current account deficit declined as a per cent of the GDP in the subsequent years. As anticipated, the most clear and significant effect of this shock was on equity inflows, which declined from 1.3 per cent of the GDP in 1997-98 to 0.6 per cent of the GDP in 1998-99 (Table 3). It had been anticipated that FDI may slow down temporarily and equity inflows may stop for a while.[25] FDI flows did in fact decline by 31 per cent in 1998-99 and by 12.6 per cent in 1999-2000 before recovering the next year (Table 1). Our forecast of portfolio flows turned out to be marginally over-optimistic. There was an outflow in each of the first three quarters of 1998-99, of $ 423 million, $ 117 million, and $ 149 million, respectively (Table 2A).[26] Almost the entire outflow was, however made up in the last quarter of 1998-99 with an inflow of $621 million, leaving a net outflow of $ 68 million for the year as a whole. As a result, total foreign investment declined from 1.3 per cent of the GDP in 1997-98 to 0.6 per cent of the GDP in 1998-99. They recovered quickly to 1.1 per cent of the GDP the next year (Table 1).[27]

BOP and REER

The strengthening of the BOP as a result of the external sector reforms was (also) reflected in the overall balance and the real exchange rate. There was an annual average reserve accumulation of 1.1 per cent of the GDP in the post-crisis period compared to the annual draw down of 0.2 per cent of the GDP during the pre-crisis decade. The real effective exchange rate showed no depreciation on average during the post-crisis period after depreciating by an average of 2 per cent per annum during the eighties.

The issue of temporary fluctuations and anticipated temporary shocks and how to deal with them has arisen in the context of the borrowing through the India Millennium Deposits in 2000-01. Consumption-smoothing arguments suggest that short-term borrowing or a temporary draw-down of reserves would be justified if an adverse shock to imports, exports, or an item of the capital account were temporary. The alternative is to let the exchange rate depreciate when the adverse shock hits and then appreciate after the shock has reversed itself. Medium-term borrowing is, however, inappropriate to meet a short-term shock. If the external fluctuation is of uncertain duration, the policy choice between external borrowing and allowing the currency to depreciate is much starker. In the case of a shock that could last more than a year, the exchange rate should be allowed to depreciate sufficiently to improve the trade balance and make the financing unnecessary. The lesson of the 1990-91 BOP crisis is that external borrowing through government-owned financial institutions is a palliative, which ultimately weakens (rather than strengthening) the external balance.

Comparative Perspective

The comment has often been made that though India may have stepped up the pace of reforms during the nineties, it has not improved its position vis-à-vis other countries as they have all been reforming at the same or faster pace. This paper addresses this issue for the external sector using a number of parameters for which international comparative data is available.

India's merchandise export growth increased from 7.7 per cent per annum during the 1980s to 8.7 per cent per annum during the 1990s (Table 4). This was faster than the rate of growth of world exports at 5.4 per cent and 6.3 per cent for the two periods respectively. As a result the share of India in world exports improved from 0.42 per cent in 1980 to 0.52 per cent in 1990 and further to 0.67 per cent in 2000. India's growth was however slower than the average for Asia during the eighties, but rose above it in the nineties. India's growth ranking consequently improved from 52 during the eighties to 46 during the nineties. Most of the economies whose GDP growth was faster than India's during these decades, like China, Korea, Singapore, Thailand, Malaysia, Ireland, and Vietnam, also had a faster growth of exports. Other countries like Hong Kong, Bangladesh, Sri Lanka, and Mexico had a faster growth of exports than India, but their per capita GDP growth was slower than India's.

The improvement in the trade share was from 0.57 per cent in 1980 to 0.60 per cent in 1990 and further to 0.71 per cent in 2000 (Table 4). This improvement was reflected in the country ranking (total trade in US $ or share of trade). This ranking improved from 43 to 33 to 27 (Table 4). Thus, the improvement in rank was less than commensurate with the improvement in share, suggesting that a number of competitor countries improved even more. The import rank was slightly better and the export rank slightly lower than the trade rank.

Given that India's GDP in US $ was the 12th highest in the world, India's trade rank (in terms of US $ value of trade) of 27 clearly shows that India is still a very closed economy. Economies that are smaller than India's in US $ GDP, but are relatively large like Korea, Australia, Russia, Netherlands, Switzerland, Belgium, and Sweden have a higher value of trade than India. The reasons are not far to seek. At the end of the decade India still had the highest tariffs in the world with only a few exceptions. Of the 70 countries for which (weighted) average tariff rates are available in the World Development Indicators (WDI) database, India had the third highest rates (Table 4).[28] Only Pakistan and Cameroon had higher rates. Despite the fact that the India had reduced its tariff rates by 40 per cent over a five-year period (the 22nd highest reduction), its overall rank improved by only one position. In fact, this happened only because Cameroon raised its tariff rates sharply.

Among the countries having a lower weighted-average tariff than India (29.5 per cent) are its neighbours, Sri Lanka (22.5 per cent), Bangladesh (22 per cent), Nepal (18 per cent), and China (15.7 per cent). This creates additional problems of import diversion and smuggling. The fact that India has some form of free-trade arrangement with several of its neighbours means that it becomes profitable to import many items into these countries and then export them to India. Any objective assessment would suggest that Indian industry can surely compete with industry in these countries and there can be no rationale for an average rate higher than that of Nepal. Thus, the commitment made in the Union Budget of 2001-02, to reduce peak rates to 20 per cent must be implemented as soon as possible. In fact, it should be our endeavour to bring the weighted average rate subsequently down to that of Thailand (15 per cent) and then to that of Chile (9.9 per cent).

Customs duty collection rates are available for a larger set of countries (about 114 in 1999). According to these India ranked 103rd in 1999 (Table 4).[29] Only 11 out of the 114 countries had a higher customs duty collection rate than India. Among the 11 countries are Malawi, Myanmar, and Syria. Even though the collection rates for India (and possibly other countries) include the counterpart of domestic taxes, this is offset by exemptions such as for inputs and capital goods used by exporters.

The comparative picture with respect to FDI contrasts somewhat with that for trade. India's position at 39th with respect FDI inflows (US $ value) was better than its trade rank in 1980

(Table 4). India's overall rank however worsened during the eighties to reach 42nd in 1990. Since then it has improved significantly to 33rd in 1999, but is now worse than its trade rank. If the rich countries are excluded, as is often done, and we consider only the emerging markets and developing countries, then India was ranked 14th in 1999 up from 22nd in both 1980 and 1990. Even Russia and Angola, however, had more FDI inflow than India in 1999.

Domestic resistance to further opening of FDI has focused on the fear of foreigners taking over Indian industry/economy. A good way to quantify this fear in a comparative perspective is to look at the share of FDI in GDI. In 1999 the ratio was only 2.1 per cent for India compared to 5.3 per cent for Russia, 8.5 per cent for S Korea, 10.5 per cent for China and Mexico, 21.3 per cent for Brazil 23.8 per cent for Thailand, and 25.1 per cent for Singapore (Table 8A). What is most telling is that both China and Singapore have among the highest domestic saving rates in the world. They recognise that the knowledge, initiative, and international marketing links that comes with FDI is much more important than the fact that it also constitutes use of foreign saving in the domestic economy. In terms of the comparative rank this puts India at 126 out of 201 countries, with only about 25 countries having a lower role for FDI in the domestic economy. Thus fears about the role of foreign investment in the Indian economy are quite unjustified given the very low proportion of FDI in Indian GDI.

Table 4: Global Share, Comparative Rates, and Rank of India

Item/Country	Share/Ratio/Growth					International Rank					Set/
	1980	1985	1990	1995	1999	1980	1985	1990	1995	1999	Numbers
Share of India in World (per cent)											
Exports	0.42	0.47	0.52	0.60	0.67	45	45	33	31	32	All
Imports	0.72	0.79	0.67	0.67	0.75	33	24	29	28	26	All
Trade	0.57	0.63	0.60	0.63	0.71	43	33	33	31	27	All
Export Growth (decadal average)											
		1980s		1990s			1980s		1990s		
India		7.7		8.9			52		46		
Asia		9.4		8.7							
World		5.4		6.3							
Customs Tariff Rate (weighted average)											
India			32.2		29.5			69		68	70
(Change)					-41					22	
Sri Lanka			20.1		22.5					66	
Bangladesh			22.0		22.0					65	
Nepal			17.7		18.0					60	
China			16.8		15.7					51	
Thailand			21.0	15.0						49	
Chile			10.0		9.9					34	
Import Duty Collection/Import											
India	26.4	44.1	42.2	24.8	21.1	97	115	107	104	103	
(Total number)						100	115	108	111	114	
FDI Inflow, net ($)											
India						40	39	43	28	33	All
Share in Low-Middle Income Countries Total (Emerging Markets) (per cent)					1.2	22		22		14	Emerging Markets
Ratio to GDI											
India	0.2	0.2	0.2	2.3	2.1	78	89	99	108	126	All
South Korea	0.0	0.8	0.8	1.0	8.5	83	81	92	124	85	All
China	0.0	1.4	2.8	12.5	10.5		68	71	44	75	All
Portfolio Investment, Equity (US$ million)											
South Korea		94	518	3559	12426		1	8	4	1	52
South Africa				4571	3855			1	2	2	52
China		0	0	2807	3732			17	5	3	52
Thailand		44	449	2154	2527		2	9	7	4	52
Brazil		0	0	4411	1961			17	3	5	52
India		0	105	1517	1302			14	10	6	52
Interest Rate Spread (lending rate is the London Inter-Bank Offer Rate)											
	1980-84	1985-89	1990-94	1995-99			1985-89	1990-94	1995-99		
India	3.5	8.6	11.6	8.6			55	45	37		97
Thailand	3.5	4.9	7.6	7.1			30	28	33		97
Korea, S	0.4	2.3	4.2	5.2			18	11	26		97
Malaysia	-3.5	1.0	3.0	3.1			13	8	19		97
China	-6.7	0.9	4.5	2.9			10	15	17		97

Sources: WTO, Merchandise Trade Data Set; World Bank, *World Development Indicators 2001.*

The position with respect to portfolio flow is better than for FDI. In the WDI database, only emerging market data is available. According to this India's rank has improved from 14th in 1990 to 6th in 1999 (Table 4). Only South Korea, South Africa, China, Thailand, and Brazil received more portfolio flows in 1999. Except for South Africa the other four countries also received more FDI than India in 1999. Because of foreign equity holding limits, the weight of Indian equity in emerging market equity indices has been reduced in 2000-01.

The improved access to external capital markets during the nineties has reduced the relative interest cost to the Indian economy. The lending rate spread over the London Inter-Bank Offer Rate (LIBOR) gives some indication of this convergence. Because of fluctuations we use five-year averages over the last 15 years. India was ranked 55th over 1985-89, 45th over 1990-94, and 37th over 1995-99 (Table 4). Thus, the opening of the capital account has also helped lower the relative cost of capital, but India still has a long way to go.[30]

The comparative picture presented above confirms, for those who still need such confirmation, that foreign direct investors are not knocking at our gates to enter the Indian markets. The least we can do is to remove unnecessary barriers created by FDI policy. One of these is to put all FDI into India on the 100 per cent automatic route (as manufacturing and much of infrastructure already are). A fair and transparent safeguard would be to apply this unlimited automatic route only on a reciprocal basis. Thus a foreigner from a country that does not allow Indians to own TV stations would have to go through the FIPB route for investment in Indian TV stations. In a few sectors in which national security conditions may be relevant, a security clearance can be prescribed for foreign nationals and companies from sensitive countries (for instance those harbouring terrorists). All laws that apply to Indians would assuredly continue to apply to foreigners (for instance, land ceiling laws in agriculture). Rules and regulations applicable to professional practice by foreigners would have to be made more explicit (a reciprocity rule would also be applicable here).

To retain and strengthen our equity ranking, foreign equity inflows should be freed from the remaining controls. Further liberalisation of equity inflows has to go hand in with domestic liberalisation of financial markets and strengthening of the regulatory system for these markets. Restrictions on foreign equity investment in the Indian capital market can be removed immediately by allowing 100 per cent foreign equity in all listed companies.

IV
Conclusion

The liberalisation of India's external sector during the past decade was extremely successful in meeting the BOP crisis of 1990 and putting the BOP on a sustainable path. These reforms improved the openness of the Indian economy vis-à-vis other emerging economies. Much, however, remains to be done. India's economy is still relatively closed compared to its 'peer competitors.' Further reduction of tariff protection and liberalisation of capital flows will enhance the efficiency of the Indian economy and along with reform of domestic policies will stimulate investment and growth.

The main lesson of the nineties is that liberalisation of the current and capital account increases the flexibility and resilience of the BOP. This applies to trade, invisibles, equity capital, MLT debt flows, and the exchange market. Our analysis confirmed

that in India the exchange rate is a powerful instrument of adjustment in the current account deficit. It also confirms that equity outflows are very unlikely to be a major cause of BOP problems (unlike short-term debt). The impact of fiscal profligacy on the external account has become indirect and circuitous with implementation of external sector reforms. It operates much more through the general expectations about economic (growth) prospects and the risk premium demanded by foreign (and domestic) investors and lenders. Thus its negative effects are likely to be focussed on the domestic rather than the external account. In other words, the negative long-term effects of fiscal profligacy are more likely to be felt in future on the growth rate of the economy and the (health of the) domestic financial sector. EPW

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Notes

1 Monetary and credit variables are found to be statistically insignificant when included in equation (1). The estimates are virtually unchanged if the primary deficit is substituted for the fiscal deficit in (1).

2 If private investment is crowded out (reduced) by government borrowing to finance the fiscal deficit the total (direct plus indirect) impact of the fiscal deficit is less than indicated by this coefficient.

3 It did, however, help subsequently in persuading some sceptics and dispelling some fears.

4 The commerce secretary responsible for introducing 'Exim Scrips' moved to the Finance Ministry soon afterwards as the Secretary, Department of Economic Affairs (DEA).

5 Internal research papers of the Economic Division, DEA, Ministry of Finance, see the references in Virmani (2000).

6 Internal research paper of the Economic Division, DEA, Ministry of Finance, see the references in Virmani (2000)

7 As analysed in the report of the Working Group on BOP for the Eighth Five-Year Plan, 1989. A change in the government, however, meant that the Working Group was reconstituted and this report was not published.

8 Cumulative dividends remitted out of the country could not exceed the total FDI in that company.

9 See Virmani (September 1991b)

10 The understanding and belief of the Secretary, DEA and the Minister of Finance, as well as the political judgment and authority of the latter were critical to the actual decision. Without these, the paper titled 'Toward Rupee Convertibility: A Free Market Exchange Rate Channel', would undoubtedly have met the same fate as so many other papers and suggestions did before June 1991.

11 Internal research paper of the Economic Division, DEA, Ministry of Finance, see the references in Virmani (2000).

12 Formally a sales tax of 15 per cent would have to be imposed on gold produced in India.

13 India was well recognised in the nineteenth century as a sink for world precious metal production and remained so to some extent till independence. Though the spread of modern banking has increased the ratio of financial instruments in India's stock of saving, virtually every household in India, even the poorest, own some gold or silver jewellery. These are often purchased for weddings.

14 This restriction on free import ensured that smuggling would not be eliminated.

15 In contrast to gold India was a net exporter of silver till recent times and was in near balance at the beginning of the nineties.

16 Internal paper of the Economic Division, DEA, Ministry of Finance, see the references in Virmani (2000).

17 See for instance Virmani (1998). I should add that the IMF's India division/Asia department staff endorsed the strategy after it was implemented. They also helped us collect the literature on the capital inflow experience of other countries that we needed urgently.

18 This is also consistent with the elasticity measured in Virmani (1991a). The paper will be updated using data from the nineties to see the quantitative significance.

19 Virmani (1991a) showed that neither oil export nor oil import functions could be estimated because these were not market-determined in the period of estimation.

20 The average duration of stay at Agra is less than one day because there is no tourist-oriented entertainment in Agra.

21 The estimated equation (2) is
CAD = 0.001 + 0.685 FDc – 0.766 FDc(92+) + 0.072 Greer + 0.247 DIpvt, where FDc(92+) is the dummy variable. All slope coefficients remain highly significant while adjusted R^2 increases to 0.58.

22 See, for instance, Virmani (1999).

23 Internal research paper of the Economic Division, DEA, Ministry of Finance, see the references in Virmani (2000)

24 This paper was later presented at a seminar organised by the Asian Development Bank (ADB) and the World Bank in March 1998 (Virmani 1998).

25 Internal research paper of the Economic Division, DEA, Ministry of Finance, see the references in Virmani (2000)

26 Appendix tables, suffixed by A or B, are not included here but are available with the author.

27 ECB has, however, declined because of demand factors. Total private demand for credit has fallen because of weak industrial demand, while demand for external credit has fallen even more because of the rise in world interest rates relative to domestic rates.

28 Appendix table 7A.

29 Appendix table 7A.

30 China, South Korea, and Thailand, which have both higher FDI and equity flows than India, had lower spreads than India during the nineties.

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