REPORT OF HIGH LEVEL COMMITTEE ON BALANCE OF PAYMENTS

EXECUTIVE SUMMARY

1. INTRODUCTION

A High Level Committee on Balance of Payments was constituted by the Government under the Chairmanship of Dr. C. Rangarajan, with Secretary, Department of Economic Affairs (DEA), Secretary, Department of Industrial Development, Secretary, Ministry of Commerce, Secretary and Chief Consultant, DEA, and a nominee of Governor, RBI, as Members and Joint Secretary (Exernal Commercial Borrowing), DEA, as Member Secretary, (vide G. O. No. 1 (24)/91-BP dated November 19, 1991).

2. LESSONS OF RECENT EXPERIENCE

The Committee reviewed the developments in the external sector during the Seventh Plan. The highlights of these developments were:

(i) There was a rise in the debt service ratio from 13.6 per cent to 21.0 per cent;

(ii) Use of reserves was minimised mainly on account of capital flows and also as a result of recourse to short-term debt to finance imports of canalised commodities;

(iii) Exports achieved a very high growth rate except in the first year of the Plan. The share of manufactured exports increased but import-intensity also rose sharply. The growth rate in imports was broadly in line with the GDP growth;

(iv) Although non-oil imports (in U.S Dollars) rose on an average annual rate of over 12 per cent the total import bill did not rise because of relatively lower oil prices despite the volume of import of POL increasing significantly; and

(v) Invisible account, which had given considerable support to balance of payments in the past, showed a sharp deterioration.

The Committee identified the following as the most important lessons learnt from the management of balance of payments in the Seventh Plan.

(i) No country can live beyond its means for long without running into difficulties. Budgetary deficit, revenue deficit and fiscal deficit all have implications for the drafting of resources from the household and other sectors. Combined with inadequate returns on investments made out of borrowings, they contribute to a situation wherein the environment was not conducive to a healthy balance of payments situation.

(ii) The current account deficit must be limited to a level that can be sustained by normal capital flows. The overhang of continuous current account deficit can be corrected only in the medium-term.

(iii) Export possibilities of India have been grossly under-estimated and the import-intensity of a strategy of import substitution not understood adequately.

(iv) There was an under-estimation of the impact of unrealistic exchange rate on the diversion of foreign exchange inflows from official to private channels.

(v) The composition of capital flows is even more important than their size in as much as they affect the future liabilities on both capital and current account.

(vi) While the opportunities available through foreign investments were not exploited there was reliance on high-cost NRI deposits and external commercial borowings which, though relatively inexpensive at that time, tended to result in bunched repayments.

(vii) An appropriate real effective exchange rate would constitute a necessary though not sufficient condition for export growth.

(viii) The level of foreign currency reserves and their management should be such as to provide assurance to international financial and trading community about the country's ability to service its obligations.

3. REVIEW OF RECENT DEVELOPMENTS

The Committee submitted an Interim Report which outlined the Liberalised Exchange Rate Management System (LERMS) in February 1992. The LERMS was introduced with effect from March 1, 1992 as a first step towards the full convertibility of the rupee on current account. The new system attempted to combine the advantages of a relatively stable managed float and the balancing properties of freely floating rate of exchange by creating two exchange rate channels.

With the downward adjustment of the external value of the rupee in 1991 and the introduction of LERMS in March 1992, the rupee cost of the imports have gone up considerably and consequently the basis on which custom duty has been levied had grown larger. Accordingly the tariff levels can be reduced without adversely affecting the quantum of revenue accruing to the exchequer from this source. If this is not done, high tariff rates combined with higher import values would push up the cost of imports to a considerable extent. The Committee was of the view that from the point of view of improving export competitiveness it is necessary to ensure that custom tariff levels are comparable to those prevailing in competitor countries, many of which have reduced their rates substantially. The process of such a reform should, however, be structured and well thought out giving adequate notice to the domestic industry both in order to cushion the impact on revenues and to ensure that there is a reasonable opportunity to Indian industry to become internationally competitive.

The Committee noted with satisfaction that the changes in the area of Foreign Exchange Budget provided the necessary pre-conditions for a gradual movement towards fuller convertibility of the rupee on current account. It, therefore, recommended that the mechanism of allocation of foreign exchange should be dispensed with from 1993-94. The Committee expected the financial advisers in the Ministries to exercise appropriate control over foreign exchange expenditure just as they were expected to exercise control over rupee expenditure.

The Committee noted that the freedom granted to users in sourcing foreign exchange for their requirements had resulted in not only ease of operations but also relatively lower cost at which external commercial debt had been made available to Indian entities. It was found that the drawal of foreign currency loans had been less than in the previous years, but the overall availability of foreign exchange for import of capital goods had matched the demand.

4. BROAD POLICY CONSIDERATIONS

The Committee noted the need for redefining self-reliance in the light of the following statement of the Finance Minister: "Our vision of a self-reliant economy should be of an economy which can meet all its import requirements through exports, without undue dependence on artificial external props such as foreign aid." Over the medium-term, therefore, the Committee considers that an atmosphere of liberal trade regime with a self-correcting exchange rate and a gradual movement towards international competitiveness would have to be the basic objectives.

The Committee felt that there should be a distinct shift in the policy framework in favour of equity as against debt in the matter of capital receipts from abroad. It recognised that direct foreign investment would contain both equity and debt, and the system of approvals would be applicable to all external debt. Hence, as an operational guideline, the Committee recommended that the approval of debt (excluding aid from bilateral and multilateral sources) linked to equity be limited to a ratio of 2:1.

The Committee felt that considerations of prudent debt management would imply restricting growth in the stock of NRI deposits, containing net addition to other external commercial borrowings outstanding and a cautious recourse to instruments such as India Development Bonds. Recourse to external debt for balance of payments support would have to be discouraged unless it is on concessional terms or with a very long maturity. Recourse to exceptional financing, including IMF credit would be inevitable, but the objective would be to phase out such needs by the terminal year of the Eighth Plan.

5. EXCHANGE RATE POLICY

The Committee recommended that consideration be given to (i) a realistic exchange rate, (ii) avoiding use of exchange mechanisms for subsidisation, (iii) maintaining adequate level of reserves to take care of short-term fluctuations, (iv) continuing the process of liberalisation on current account, and (v) reinforcing effective control over capital transactions. The key to the maintenance of a realistic and a stable exchange rate is containing inflation through macro-economic policies and ensuring net capital receipts of the scale assumed in BOP projections.

The Committee made the following observations on the working of LERMS:

(i) After the introduction of LERMS the rupee exchange rate was quite stable and there were very few volatile fluctuations in the market.

(ii) One major expectation from LERMS was that the gap between the hawala rate and the market rate would be brought down and hawala transactions would be eliminated. Though the hawala market still exists, the gap between the hawala rate and the market rate appears to have narrowed down considerably and the turnover in hawala transactions was also reported to have come down substantially.

(iii) Exim Scrips were not applicable to beneficiaries of inward remittances under the earlier regime but under LERMS 60 per cent of inward remittances were also converted at market rate. This was expected to improve remittances through official channel. However, the procedural delays for remittances through the banking system and the incomplete reforms under FERA appeared to have constrained the realisation of full benefits of LERMS.

(iv) Exporters justifiably felt that since 40 per cent of their export proceeds were being converted at the official rate of exchange, LERMS actually carried a tax on exports.

(v) The general belief that LERMS was only an interim measure and that full convertibility of the rupee on current account might be introduced at any time in the near future appeared to have resulted in a postponement of foreign investment decisions.

(vi) In terms of magnitudes of flows, the expectation that 40 per cent of current account receipts would finance special imports appeared to have been fully realised.

The Committee, in the light of experience gained under LERMS, considered two options in moving towards convertibility on current account; change the proportions to reduce transactions at official rate as an intermediate step or to bring about a unified market without any intermediate step.

The Committee noted that while the intermediate step would have the advantage of moderation in inflationary pressures and fiscal deficits, the earlier disadvantages such as the implicit tax, albeit to a lesser extent, on exports and inward remittances, etc. would continue to exist.

The unified rate system, under which the exchange rate for all foreign exchange transactions would be determined by the market forces, would have the advantages of the elimination of the tax on exports and inward remittances, removal of the contradictions in respect of ACU transactions, transactions with the erstwhile USSR and the remittances and payments through NRE accounts and an end to uncertainties and the related anticipatory actions. As against this, some risks and disadvantages such as inflation on account of higher prices for essential commodities, strains on containing the fiscal deficit because of the higher budgetary provision needed for the debt servicing and the import needs of defence, higher cost of importing fertilizers affecting both prices for farmers and the amount of subsidy needed, etc., were noted.

In weighing the advantages and the disadvntages, the Committee took into account, factors such as the relative stability of the market rate of exchange of the rupee leading to the expectation that the unified rate will be in alignment with the market rate established in the past few months, the measures taken to transmit changes in exchange rate to the domestic prices of POL and the favorable macroeconomic indicators such as the lower rate of inflation, the anticipated growth rate and the sustainable fiscal deficits inspiring confidence to effect changes.

The Committee, after weighing the advantages and the disadvantages of the two options, recommended that a decision be taken to unify the exchange rate, as an important step towards full convertibility.

6. FOREIGN CURRENCY RESERVES

The Committee made a general recommendation that a reserve target range should be fixed from time to time and the foreign currency reserves should always be within the range and not allowed to fall below the floor. It has traditionally been the practice to view the level of desirable reserves as to percentage of the annual imports, e.g. reserves enough to meet three months' imports or four months' imports. However, this approach would be inadequae when a large number of transactions and payment liabilities other than those relating to import of commodities arise. Thus, liabilities may arise either for discharging short-term debt obligations or servicing of medium-term debt, both interest and principal. Hence, the Committee recommended that while determining the target level of reserves due attention should be paid to the payment obligations in addition to the level of imports.

The Committee recommended that the option of RBI converting gold into foreign currency reserves should be constantly reviewed though an immediate case for exercising such an option is not established. Additionally, the Committee recommended that a part of gold reserves, say 30 per cent, should be available for conversion at short notice into currency resources to meet contingencies.

7. EXTERNAL ASSISTANCE

Considering the vital role that can be played by timely utilisation of external assistance in placing the country's balance of payments position on a sound footing, the Committee recommended that immediate action be considered in the following areas:

(i) A review of the existing projects with a view to identifying those where the progress is slow, those that need redefining of project scope or coverage and where cancellation would be better than continuing to pay commitment fees and keeping them in our books.

(ii) As recommended by the National Development Council, 100 per cent of external assistance may be passed on to the States for all sectors.

(iii) Additional Central assistance may be released to the States on a monthly basis. The advances at any point of time may be limited to around 8 per cent of the accepted reimbursement during the year.

(iv) Since availability of rupee resources is one of the major constraints, priority may be accorded to externally-aided projects in making plan allocations and corresponding budget provisions. However, overall resource availability has to be increased to ensure adequate and timely absorption of external aid without sacrificing the larger segment of projects other than those externally aided.

(v) The contracting procedures will have to be streamlined and decentralised so that reference to Government would become unnecessary. General guidelines on evaluation procedures should suffice.

With a view to eliminating certain ambiguities in the administration of external assistance, the Committee recommended that the Department of Economic Affairs may continue to play the role of a nodal agency in terms of developing pipeline (to specifically address the issue of resource availability, commitment of user-unit and issues of direct lending/on-lending/additionality), negotiating external assistance and monitoring implementation. However, the issue of direct lending vs on-lending should recognise the need for disintermediation by Government. Consequently a framework is recommended indicating the different uses, users and methods to be adopted for different categories of external assistance.

The rupee debt of the country is of three categories, viz., NRI deposits denominated in rupees but repayable in foreign currency, NRI deposits denominated and repayable in rupees, and bilateral arrangements, especially with the former Soviet Union, where the debt is expected to be discharged by exporting goods and services to non-residents but liabilities are expressed in rupee terms as per agreed rates. The committee noted that India and Russia have reached a new agreement on the mechanism for determining the rupee value of the Rouble denominated debt.

8. COMMERCIAL BORROWINGS

The Committee noted that, on the whole, in terms of cost, maturity, currency composition, markets, liability management and exercise of control over individual transactions the performance in regard to external commercial borrowings was satisfactory. However, the events following the Gulf crisis led to a drastic change in India's commercial borrowing prospects and policies. The flow of funds virtually stopped when the Credit Rating Agencies announced a downgrading of the rating for India and Indian entities in 1990.

With this background the Committee identified the major issues that have to be addressed in the context of external commercial borrowings. The Committee recommended the following approach.

(i) Considering the maturity profiles and the fact that a large part of external commercial debt is through institutional sources, the amounts that can be subjected to refinance would be just abut US $ 500 million per year for the next two years. As long as there is a possibility of raising commercial borrowings with longer maturity to sustain the overall balance there is no advantage in giving signals of distortion for such small amounts by taking recourse to debt refinance mechanism.

(ii) There is a danger that recourse to debt-equity swaps would reinforce sentiments that would equate India with some of the countries that have defaulted in honouring their debt obligations. The Committee, therefore, concluded that debt-equity conversion was not a desirable option for debt management in India.

(iii) There is a need to keep the option of sovereign borrowing in external commercial markets open, but it should be exercised when the need and cost-advantage are established.

(iv) The Committee felt that (a) caution should be exercised in creating permanent institutions or corporate bodies for mobilising gold; (b) gold bonds may be launched immediately as an experiment; and (c) a review be made of the economics of such a scheme in 1993-94.

(v) The practices of liability management should be encouraged.

(vi) On an average the disbursements of external commercial borrowings should not exceed US $ 2.5 billion per year during the Eighth Five Year Plan.

(vii) No approval should be accorded for any commercial borrowing with a maturity of less than five years.

(viii) The Committee recommended a cautious approach to guarantee for external borrowings.

9. NRI DEPOSITS

The Committee, recommended that there was a need for a deliberate policy shift with regard to FCNR deposits with a view to reducing volatility and the cost and to make it attract the genuine savings of NRIs. To this end, the Committee suggested that the NRI deposit scheme be modified on the following terms :

(a) FCNR deposits should have a minimum maturity of one year; and

(b) The differential between international interest rates and FCNR rates should be progressively reduced to ensure that the scheme benefits only the genuine savers.

The Committee was also of the opinion that a market for NRI Bonds should be developed to satisfy the investor appetite among NRIs for some form of medium-term investments in India with facility for secondary trading.

10. SHORT-TERM DEBT

The Committee noted that serious concerns had been expressed about the level of short-term debt and its contribution to the crisis situation in the recent past.

In the light of past experience, the Committee recommended that the policy of the Government and the RBI in regard to the mangement of short-term debt should be on the following lines:

(i) Short-term debt should be permitted only for trade-related purposes and under normal terms; (ii) Recourse to short-term debt should not be taken as an instrument for protecting the reserves; (iii) No roll-over beyond six months should be resorted to in regard to any short-term facilities without careful consideration of the implications; (iv) Any short-term debt not governed by the above considerations should be specifically approved by RBI after satisfying itself that recourse to such debt was trade-related or on genuine cost considerations; and (v) RBI should set up a monitoring system for short-term debt so that it is possible to ascertain with a reasonable amount of accuracy the extent of such debt that may be outstanding at any point of time.

11. STRUCTURE OF EXTERNAL DEBT

The Committee noted with satisfaction the Reports of the Policy Group and Task Force on External Debt Statistics of India and its adoption by the Govrnment and the Reserve Bank of India. The Committee also noted that a Standing High Level Committee on Debt Management had been constituted by the Government. They would facilitate improvements in the structure and mangement of external debt.

In regard to the future directions in the structure of debt, the Committee recommended necessary policy and procedural changes to bring about the following: quick disbursement of concessional and semi-concessional flows; disintermediation of Government to the maximum extent in aid and flows; absorption of aid only when it is consistent with the requirements of the enterprise concerned or department/State concerned; and continuation of NRI deposits at a level that would ensure no net outflow but with longer maturities profile; insistence on a minimum maturity of five years for commercial borrowings except for purposes of consolidation of short-term debt; recourse to commercial sources of financing essentially to meet foreign currency expenditures, particularly for non-tradeable goods, priority sectors like oil and fertilizer, export oriented units, etc., or borrowings linked with inflow of equity; and a prudent policy of extending guarantees by sovereign or public sector financial and banking institutions.

12. FOREIGN INVESTMENT

The Committee felt that the steps already taken would go a long way in promoting the confidence of foreign investors for investing in India. The Committee noted the important parameters of a global nature that would determine the scope and limits for foreign investments in the immediate future and examined the concerns of foreign investors.

Having recognised the concerns of the foreign investors, the Committee, recommended that a National Investment Law be seriously considered codifying the existing policy and practices relating to dividend repatriation, disinvestment, non-discrimination subject to conditions that may be specified, employment of foreign nationals, non-expropriation, and sanction and servicing of external commercial borrowings. Such a law could also provide for policy procedures and institutional framework for approval of investments under the non-automatic route, according pioneer status or domestic-investor status, new instruments of private commercial flows and applicability of local or international laws. Such an Investment Law need not in any way exclude consideration of bilateral investment treaties.

The Committee noted with satisfaction the most recent liberalisation measures in FERA and recommended that an appropriate framework be evolved to promote Indian investment abroad in desired directions, countries and sectors in addition to liberalising procedures.

13. EXPORTS

To achieve the targets set forth in the Eighth Plan and reflected in the balance of payments projections in this Report, the Committee recommended measures for export promotion including

(i) Movement towards fuller convertibility of the rupee since partial convertibility imposes a tax on exports;

(ii) Reforms in interest rates on export credit to ensure reasonable costs to exporter;

(iii) Stability of existing export incentives, i. e., an assurance that the incentives would continue;

(iv) Encouraging deemed exports by measures such as freedom for Indian bidders to bid in foreign currency when they bid under ICB procedures (since implemented);

(v) Simplification of Export-Import Policy especially replacing quantitative curbs on exports with duties.

14. BOP PROJECTIONS FOR MEDIUM-TERM

In making the balance of payments projections the Committee kept in view (a) the macro-economic parameters as envisaged in the Eighth Plan, (b) likely impact of the policy changes, (c) outlook and prospects of international trade, and (d) updated estimates for 1991-92 and the latest available estimates for 1992-93.

An average annual growth in exports of at least 15 per cent in dollar terms over the medium-term is considered necessary as well as feasible. The Committee strongly recommended that trade policy and exchange rate regime be managed not only in a stable manner but also oriented towards export promotion.

The Committee believed that the import growth rate might be marginally higher than what had been estimated on the basis of import elasticity to GDP at 1.5.

Net inflows in the 'Invisibles' component of the current account are estimated to contribute almost a negligible share even though there would be a turn around from a net outflow within a year or two.

The Committee felt that the order of current account deficit envisaged, viz. 1.6 per cent of GDP, can be met through a sustainable level of net capital receipts.

Exceptional financing arrangements of the order of $ 3 billion per year on a gross basis would be necessary during the medium-term. However, these could be reduced somewhat through better export performance, better 'Invisibles' receipts and higher investment inflows all of which is not impossible.

15. BALANCE OF PAYMENTS — STATISTICAL ISSUES

The Committee recommended certain changes in the compilation and presentation of balance of payments statistics. Having identified the major factors contributing towards a difference between DGCI&S data and BOP data in respect of imports, the Committee recommended that

(i) All Defence debt may be formally registered as commercial debt as per the normal practice;

(ii) Debt in respect of rupee payment area (RPA) may be reflected separately in the capital account consistent with recently concluded Rupee-Rouble Agreement;

(iii) In respect of Defence debt to general currency area (GCA) principal repayment is to be reflected in the capital account and interest payment under 'Invisibles';

(iv) Where imports do not pass through customs declaration, concerned agencies may be requested to report in a consolidated form the value of imports on a routine basis for purposes of incorporation into the customs data; and

(v) Information system may be established through Ministry of Shipping and Ministry of Petroleum to obtain information on payments made but not reflected in customs data.

The Committee recommended that a Technical Group be appointed by RBI with representatives from the Ministry of Finance and the Ministry of Commerce similar to the Policy Group on External Debt Statistics, to review in detail, timeliness compilation methods and suitability of reporting systems for purposes of management of balance of payments.

THE MAIN REPORT*

1. INTRODUCTION

1.1 A High Level Committee on Balance of Payments was constituted by the Government under the Chairmanship of Dr. C. Rangarajan, with Secretary, Department of Economic Affairs (DEA), Secretary, Department of Industrial Development, Secretary, Ministry of Commerce, Secretary and Chief Consultant, DEA, a nominee of Governor RBI, as Member and Joint Secretary (External Commercial Borrowing), DEA, as member-Secretary (Vide G. O. No. 1 (24)/91-BP dated 19-11-1991). The following are the terms of reference :-

(a) To make projections of the various elements in Balance of Payments over the next five years and estimate the financing gap taking into account the repayment obligations;

(b) To study the appropriate mix of capital flows and to suggest measures to bring about the desired changes;

(c) To examine and suggest ways of changing the existing structure of debt;

(d) To examine the possibility of converting certain types of existing debt into equity, to suggest ways to enhance the flows of invisible earnings, including private remittances through the banking system; and

(e) To examine the functioning of the existing exchange rate regime in the context of the move to Exim-Scrip and to consider the implications of a shift to convertibility on current transactions in the near future.

1.2 In order to tackle the severe BOP crisis faced by the country during 1990-91 and 1991-92 the Government took several emergency measures such as the raising of foreign currency resources using gold, the downward adjustment of the external value of the Rupee, drastic curtailment of imports, etc., to pull the economy back from the brink of default in debt service. Simultaneously, with a view to finding a long-term

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solution to the problem, the Government undertook policy initiatives such as a macro-economic stabilisation programme through a planned reduction in fiscal deficit and, a trade policy reform to create an environment which would give an impetus to increase India's share in world trade, in general, and growth in the country's exports, in particular. The package included Industrial Policy Reforms to promote a more efficient and competitive industrial economy and reforms to improve and streamline the working of the public enterprises. It was in this context that the need for making medium-term projections of the country's BOP scenario and for evolving appropriate measures to bring down the current account deficits to sustainable levels was felt. The formulation of the Eighth Five Year Plan warranted that these policy initiatives be integrated with a medium-term strategy for the management of the external sector.

1.3 The Committee was required to give its report by March 1, 1992. However, it submitted an interim report and sought extension of time which was granted by the Government. In the context of the all-encompassing and complex nature of the tasks entrusted to the Committee, the members have been holding continuous and extensive discussions among themselves and with the other officials. Various background papers prepared in RBI, GOI and the Planning Commission on several aspects of BOP management and policy were made use of by the Committee in its work.

2. LESSONS OF RECENT EXPERIENCE

2.1 **The Committee noted the following developments during the Seventh Plan.**

(a) There was a widening of current account deficit, the ratio of such deficit to GDP averaging 2.4 percent as against the projection of 1.6 per cent;

(b) Current account deficit was financed by external assistance, commercial borrowings and deposits by non-resident Indians increasing the debt-service ratio from 13.6 percent to 21 percent by the end of the Plan;

(c) Use of reserves was minimised mainly on account of capital flows and partly due to recourse to short-term debt to finance imports of canalised commodities;

(d) Exports achieved a very high growth rate except in the first year of the Plan;

(e) The share of manufactured exports increased but their import-intensity also rose sharply;

(f) The growth rate in imports was broadly in line with GDP growth;

(g) The non-DGCIS imports, mostly accounted for by defence, increased substantially (the other factors being procedural variations in exchange rate adopted and difference in timing of payments vis-a-vis commodity movement);

(h) Non-oil imports (in US dollars) rose at an average annual rate of over 12 percent but total import bill did not rise because of the fortuitous circumstances of relatively lower oil prices, though volume of import of POL increased significantly; and

(i) The invisible account which had given considerable support to the balance of payments in the past showed a sharp deterioration with stagnant earnings from tourism, a modest increase in private transfers and mounting interest burden.

2.2 Thus, the positive developments on the export front were overshadowed by the structural problems in external sector. With the onset of the Gulf crisis and political uncertainties such a fragile situation resulted in a crisis situation of such magnitude that economic policy making had to be almost totally devoted to the management of balance of payments during 1991-92. The Gulf crisis had an immediate effect on India's oil import bill. It could however, have been managed with appropriate restraints on imports but for the liquidity crisis caused by the rapid withdrawal of NRI deposits and denial of normal access to external commercial borrowings as a result of the downgrading of India's credit rating. The liquidity crisis expressed itself in terms of a total denial of short-term facilities and difficulties in honouring letters of credit. Such a situation required harsh measures of import restriction, access to exceptional financing through IMF, World Bank, ADB and bilateral channels and temporary utilisation of gold available with Government and RBI for raising foreign currency resourcers to meet contractual commitments.

2.3 The Committee noted that, with the onset of relative political stability and initiation of a package of economic reforms, there had been some restoration of international confidence. Even so, the sustainability of balance of payments required not only substantial support from multilateral and bilateral agencies but also recourse to two somewhat extraordinary measures, namely, an Amnesty Scheme by which private remittances were encouraged and the India Development Bonds at a relatively high cost.

2.4 **The Committee, after a careful review of experience, identified the following as the most important lessons of experience in the management of balance payments.**

(a) No country can live beyond its means for long without creating adverse consequences. Thus, budgetary deficit, which has implications for money supply, revenue deficit, which has implications for the resources available out of current revenues for developmental expenditures, and fiscal deficit, which has implications for the amount of resources drafted from the household and other sectors combined with inadequate returns on investments made out of borrowings, all contributed to a situation where the macro-economic environment was not exactly conducive to a stable balance of payments situation.

(b) Current account deficit must be limited to a level that can be sustained by normal capital flows. What is normal cannot be defined but it could be reasonably assessed. While current account deficit in any particular year for reasons such as drought or volatility in POL prices may be inevitable, persistent deficits financed by relatively expensive capital flows are bound to adversely affect the sustainability of balance of payments.

(c) Overhang of persistent current account deficits can be corrected only in the medium-term. In other words, while a sustainable balance of payments position may be defined as a level of current account deficit that can be met by normal capital flows, to achieve such a goal of sustainability, there would be need for exceptional financing during the transition to a stable situation.

(d) In respect of exports, it is clear that the export possibilities of India have been grossly underestimated and the import intensity of a strategy of import substitution not understood adequately. Export acceleration on a sustained basis would require across-the-board improvements in infrastructure, labour productivity efficiency of industry and in the macro-economic environment.

(e) Management of imports requires a focused attention on a few commodities or users of importance rather than an attempt to control a large number of small and individual transactions. Thus the three important areas which would ensure substantial import substitution are POL products, fertilizers and imports on account of defence. As a medium-term strategy, there is need to concentrate on reducing the dependence on imports in respect of these products.

(f) In regard to the invisible account, the impact of an unrealistic exchange rate on the diversion of foreign exchange inflows from official to private channels was under-estimated. The impact of interest burden on invisibles was not fully recognized. The potential of tourism in providing balance of payments support is yet to be fully exploited.

(g) While current account transactions can be subjected to short-term restrictions, the liabilities created out of debt will have to be discharged and hence a medium-term framework requires considerations of debt liabilities that have already been incurred as also the sustainable level and composition of external debt that can be incurred afresh.

(h) The normal capital flows have a quantitative relation to the financing of current account deficit in a particular year, but the composition of such capital flows is more important in as much as it affects the future liabilities on both capital and current accounts. Further, the use to which the capital flows are directly applied will determine the capability to service liabilities.

(i) At a time when the aid flows were getting constrained and their concessionality flows gradually eroded, reliance was placed on high-cost NRI deposits which proved to be volatile. External commercial borrowings, which were relatively inexpensive have, however, tended to result in bunched repayments. The window of opportunities available through encouraging foreign investments has not been exploited though other countries have accessed this source on a large scale. The volatility of flows in capital account and the link of such flows with BOP performance require greater attention in future.

(j) While a number of factors such as world demand, quality of products, marketing skills and supply availabilities have a bearing on export growth in the medium-term, an appropriate real effective exchange rate would constitute a necessary though not sufficient condition for export growth.

(k) The level of foreign currency reserves and the management of such reserves should be such as to provide the much needed assurance to the international financial and trading community about the country's ability to service its obligations. Hence a targeted level of reserves as a proportion of imports would be required to convince the international community about the determination to mange the external sector on a sustainable basis.

3. REVIEW OF RECENT DEVELOPMENTS

3.1 **The Committee submitted an interim report on the partial convertibility of Rupee (PCR) in February, 1992. (The Report may be seen at appendix). The Liberalized Exchange Rate Management System (LERMS) was introduced with effect from March 1, 1992 as a first step towards full convertibility of the Rupee on current account.** The main objectives behind the introduction of LERMS were the fulfillment of the need for a market-oriented and flexible exchange rate mechanism as a means to achieve self-reliance through improved export performance and a reduction in the scope for illegal transactions in foreign exchange so that the flow of inward remittances into the country can be increased substantially. With the introduction of PCR, except for a few essential commodities, the task of allocating scarce foreign currency resources to various uses has been shifted from GOI/RBI to the market and price acts as the vehicle for such allocation. The PCR system attempts to combine the advantages of a relatively stable managed float and the BOP balancing properties of freely floating rate of exchange, by creating two exchange rate channels. In the market channel the exchange rate is determined by the demand for and supply of foreign exchange, where access is free for all foreign exchange transactions (wih a few exceptions). In the official channel the exchange rate continues to be determined by the RBI but access is restricted.

3.2 Since under the new trade policy, all goods may be freely imported except those included in a short Negative List, Government has indeed ceased to control the quantum of imports into the country and through that the demand for foreign exchange. This function, as mentioned earlier, is now being determined by the price ruling in the market. Thus, under the new strategy for managing BOP, the market, through its pricing mechanism, would regulate to a large extent the quantum of permissible (trade account), authorised (invisible account) and approved (capital account) transactions that would be put through by the public. If the relaxation of import trade controls were to result in an increasing demand for foreign exchange, the consequent rise in its price would provide an incentive for export growth.

3.3 Having assigned a crucial role for the market forces of demand and supply in the determination of the external value of the Rupee, it has become imperative to have an efficient institutional arrangement in place that would monitor the functioning of the system closely, reduce acute imbalances between demand and supply and the consequent volatility in exchange rates and review the official exchange rate with reference to the market rate on a regular basis. The Committee **noted that such systems have been put in place in the form of a Standing Group on the forecasting of Foreign Exchange Reserves (RBI), the Balance of Payments Monitoring Group (Ministry of Finance) and the Committee on Transitional Arrangements (RBI/MOF/MOC).**

3.4 With the liberalisation measures being introduced to revitalise the economy and the goal of self-reliance having been redefined in a more positive sense, the role of customs duty in the country's fiscal structure has had to be re-oriented. It has been recognized that a growing economy needs to import a larger volume of fuel and other important industrial inputs and also capital goods signifying technological upgradation and that such imports should be financed by its own exports and not through external support like foreign aid. Further, it has been noted that for boosting exports to the required extent, the prime requisite would be to make Indian industry internationally competitive. With the downward adjustment of the external value of the Rupee in 1991 and the introduction of LERMS in March, 1992, the rupee cost of imports has gone up considerably and, consequently, the base on which customs duty is levied has grown larger. Accordingly, the tariff levels can be reduced without adversely affecting the quantum of revenue accruing to the exchequer from this source. If this is not done, high tariff rates combined with higher import values would push up the cost of imports to a considerable extent, thereby affecting the competitiveness of Indian Industry and possibly causing cost-push inflation. Therefore, **the Committee is of the view that from the point of view of improving export competitiveness it is necessary to ensure that customs tariff levels are comparable to those prevailing in our competitor countries, many of whom have reduced their customs duty rates substantially. The process of such a reform should, however, be structured, and well thought out giving adequate notice to the domestic industry both in order to cushion the impact on revenue and to ensure that there is a reasonable opportunity for Indian industry to become internationally competitive.**

3.5 The highlights of the new Exim-Policy are: i) External trade is free subject only to a negative list of imports and a negative list of exports; ii) Negative list of imports is the smallest ever; iii) Negative list of exports has been pruned; iv) Negative lists would be administered, as far as possible, by general schemes. Case-by-case licensing would be minimised. Actual user conditions have been eliminated except in a few special cases; v) Import of capital goods has been liberalised. They are no longer in the negative list of imports. Imports of second-hand capital goods have been allowed, in some sectors without licence and in others under licence; vi) Raw material imports have been liberalised. Barring a few items, they are no longer in the negative list of imports; vii) Value-based Advance Licences have been introduced with self-certification, they being made available for Export Houses, Trading Houses and Star Trading Houses; viii) The EOU and the EPZ schemes have been liberalised. These schemes have been extended also to agriculture, horticulture, acquaculture, poultry and animal husbandry. EOU/EPZ units may now export through Export Houses, Trading Houses and Star Trading Houses; ix) The definition of Deemed Exports has been streamlined; x) The crucial roles of EPZs, Export Houses, Trading Houses and Star Trading Houses have been recognised; and xi) A national campaign for quality awareness is proposed to be launched. **The Committee noted that there had been an orderly transition from import compression to import of required commodities and that imports had proved to be price elastic.** There appears to be a distinct reduction in inventory levels because of the assured supply of imported commodities and the high cost of holding inventory. There is also judgemental evidence to show that some amount of import substitution is taking place in the economy.

3.6 Exports, however, have not picked up rapidly largely because of the climate of recession prevailing in the industrialised countries, the disruption in rupee trade with the former USSR and also the time-lag between reforms and results. There is, however, clear evidence of acceleration in the rate of growth of exports to general currency areas, especially in the very recent past. **The Committee concluded that it would, therefore, be premature now to evaluate fully the export performance of the industry on the basis of the reforms introduced, though the trends are distinctly encouraging.**

3.7 The foreign exchange budget of Government of India traditionally covered almost the entire requirements of foreign exchange of the public sector. However, the coverage has been drastically reviewed for 1992-93. Firstly, canalisation is itself restricted to a few commodities as part of the EXIM policy. Even here, the foreign exchange budget is restricted to foreign exchange made available at official rate and therefore to select POL products and fertilizers. Allocations, however, are made for import of foodgrains from the foreign exchange budget. In regard to some other essential commodities which are canalised, such as edible oils, access to market rate is permitted and hence they do not form part of the foreign exchange budget. This approach helps in passing on international prices to the domestic market moderated by appropriate fiscal policies. Thus immunising the management of external sector from domestic policies in respect of prices of individual commodities has added some stability to the management of the external sector. Secondly, even with regard to the Departments, during 1992-93 a number of pulic sector undertakings which were originally part of the foreign exchange budget were removed therefrom. This gave them greater autonomy. Even public sector undertakings of Defence have been removed from the foreign exchange budget. Thirdly, even in regard to foreign exchange requirements for the Departments, the foreign exchange budget was made applicable only for acquisition of goods for which foreign exchange was made available at official rates. Fourthly, the Departments as well as the canalising agencies are permitted to access foreign exchange at the market rate if their requirements exceed what has been provided for in the foreign exchange budget. This gave freedom and manoeuverability to the various agencies to promptly meet the domestic demands without being constrained by foreign exchange budget allocations. Fifthly, in order to ensure proper management of foreign exchange reserves, the outflow of foreign exchange at the official rate through the foreign exchange budget is subjected to management in cash terms by imposing monthly ceilings on drawal of such foreign exchange. Finally, the practice of utilising the canalising agencies as instruments of protecting the foreign exchange reserves by encouraging them to import commodities under short-term credit arrangements has been discouraged with a view to eliminating such a procedure altogether as soon as possible. The Committee noted that all these measures tended to impart the necessary freedom to the various agencies within the public sector in managing their foreign exchange needs and give incentives for saving on foreign exchange. Inventory management has also been made easier. The incentive to export and earn foreign exchange has been provided for the public sector undertakings. **The Committee noted with satisfaction that these measures in the area of Foreign Exchange Budget impart necessary**

pre-conditions for a gradual movement towards fuller convertibility of the rupee on current account. It, therefore, recommends that with the objective of moving towards full convertibility, the mechanism of allocating foreign exchange should be dispensed with from 1993-94. The Committee expects the financial advisers in the ministries to exercise appropriate control over foreign exchange expenditure just as they are expected to exercise control over rupee expenditure.

3.8 The import of raw material components was till recently facilitated by the availability of foreign exchange partly through normal channels and for some time being linked with Exim Scrips. Such a differentiated and administered approach has been replaced by the general arrangement of access through market rate and for select commodities access through foreign exchange at the official rate. Further, the insistence on utilising short-term credits to protect reserves was dispensed with once the crisis situation was overcome. On the whole, therefore, the import of raw materials and components is now governed by a free access to foreign exchange without the constraints of specific user-wise allocative mechanisms. In regard to capital goods the traditional approach has been to indicate the sources of foreign exchange including, in particular, linkage with foreign currency loans either through the Development financial Institutions or by insistence on direct external commercial borrowings. In some cases there was a linkage with utilisation of bilateral credits. This system which required a number of clearances within the Government and by various financial agencies-domestic as well as international-has now been replaced by freedom to the individual entrepreneurs to decide on the source of funding for import of capital goods. The users are now at liberty to choose the means of financing depending on their own requirements and market conditions. The mix would be debt, equity or foreign exchange from the market. Thus, both the providers of foreign capital and the users of foreign capital in India are at liberty to negotiate and utilise the sources depending on their requirements. This procedure has imparted greater freedom and competitiveness in transactions relating to external borrowings. **The Committee noted that the freedom granted to users in sourcing foreign exchange for their requirements has resulted in not only ease of operations but also relatively lower cost at which exernal commercial debt was made available to Indian entities. It was noted that the drawal of foreign currency loans had been less than in previous years, but the overall availability of foreign exchange for import of capital goods had matched the demand.**

3.9 **The Committee noted the following parameters of the new Industrial Policy and steps taken by the Government to attract foreign investment:**

(a) Majority foreign ownership, even up to 100% in certain sectors, is allowed.

(b) Foreign equity proposals need not necessarily be accompanied by foreign technology agreement.

(c) Automatic approval is given by the Reserve Bank of India for direct foreign investment up to 51% foreign equity in 34 high priority industries if foreign equity covers the capital requirements of imported capital goods which must comprise plant and machinery which are new and not second-hand.

(d) Automatic approval by the Reserve Bank of India for majority foreign equity holding up to 51% in trading companies primarily engaged in export activities subject to the condition of dividend balancing for a period of 7 years.

(e) Proposals outside the criteria in (c) & (d) are to be considered by the Secretariat of Industrial Approvals/Foreign Investment Promotion Board/Project Approval Board.

(f) Automatic approval for raising foreign equity up to 51% in the existing companies also allowed by the RBI provided the proposed activities are in the high priority area.

(g) For foreign technology agreements in high priority industries, automatic approval allowed subject to the condition that the lump sum payment does not exceed Rs. 1 crore and royalty does not exceed 5% on domestic sales and 8% on exports.

(h) Payment of dividends only in the case of consumer goods industries would be monitored by the RBI to ensure that outflows on account of dividend payments are balanced by export earnings. The general condition of dividend balancing has been withdrawn for items other than consumer goods.

(i) All payments flowing from the approval of foreign technology agreements are to be met through foreign exchange purchased at the market rate.

(j) Phased manufacturing programme is no longer applicable.

(k) Disinvestment of equity by foreign investors can take place at the market rates on the stock exchanges.

(l) India signed the Multilateral Investment Guarantee Agency Protocol on 13-4-1992.

(m) General permission is now granted to companies with more than 40% non-resident interests to accept appointment as an agent or technical or management adviser of any company in India in any activity of a trading/commercial or industrial nature.

(n) Companies with more than 40% foreign interest may now borrow money and accept deposits in India for which the Reserve Bank of India will accord general permission.

(o) Companies with more than 40% foreign equity are granted general permission to deal in immovable property in India.

(p) Foreign companies have also been permitted by RBI to open liaison offices and branches in India on receipt of applications from them.

(q) Foreign companies are now free to use their trade marks for domestic sales.

4. BROAD POLICY CONSIDERATIONS

4.1 The committe deliberated on major policy considerations relevant to management of balance of payments viz. redefinition of self-reliance in trade policy, convertibility of the rupee, the approaches to medium-term development, emphasis on foreign equity flows, optimum utilisation of debt, role of tariffs, management of external sector and need for transparency.

Redefinition of self-reliance and trade policy

4.2 The first step, in our long term strategy to tackle the country's BOP problems, it was felt, would be to reexamine our earlier understanding of one of the key objectives we had set for ourselves, namely, self-reliance. In this respect, it would be apt to quote from the speech made by the Honourable Finance Minister, while presenting the Budget for 1992-93.

"Self-reliance in today's world of integrated global markets cannot be achieved merely by reducing import dependence and insulating the economy from the world. Following that path will only lead to more import controls and promote inefficiency and corruption. It will perpetuate an environment in which Indian entrepreneurs will not have the flexibility they need to compete with other developing countries in world markets. The resulting inability to export will actually make us more rather than less dependent on the outside world. Our vision of a self-reliant economy should be of an economy which can meet all its import requirements through exports, without undue dependence on artificial external props such as foreign aid."

4.3 **In this background, the approach to self reliance has been set by the Committee in the following terms.**

(a) Improve export earnings and receipts on invisible account, especially on account of tourism and remittances;

(b) Ensure that essential imports take place and generally imports are restricted to the available receipts on current account supplemented by a sustainable level of net capital receipts;

(c) Aim at a sustainable level of net capital receipts by gradual reduction in exceptional financing (such as IMF facilities and fast disbursing flows from multilateral/bilateral agencies) and debt servicing burden;

(d) Add to the foreign exchange reserves to avoid a contingency of "liquidity crisis"; and

(e) Eliminate dependence on short-term debt for BOP support by restricting the use of short-term facilities up to a six-month period for trade-related purposes, under normal terms, on a voluntary basis by importing agencies concerned.

Convertibility and trade policy changes

4.4 While announcing the new trade policy last year, the Government mentioned its intentions to move towards full convertibility of the rupee on the trade account. The PCR has been introduced to provide a boost to exports as well as to efficient import substitution, to reduce the scope for bureaucratic controls and to reduce the incentives for illegal transactions in foreign exchange.

4.5 The strategy of managing trade followed till recently was to partly subsidise exporters to make up for negative protection implicit in the domestic policy and contain imports through canalisation, physical controls and restricted regime of imports in general. Such an administered system led to current account deficits well beyond what was sustainable, resulting in increased recourse to commercial borrowings and volatile NRI deposits; short-term debt of less than one year was rolled over and reserves were drawn down. The trade policy changes are now redirected to ensure that exporters have non-discriminatory and inbuilt attractiveness through exchange rate and other fiscal and monetary measures rather than being eligible for case-by-case disbursements of compensatory payments. The importers would also have a generalised access to imports moderated by tariffs to protect indigenous industry, ban on imports of consumer goods, and a very small list of items subject to quantitative restrictions as an interim measure.

4.6 **Over the medium-term, therefore, the Committee considers that an atmosphere of liberal trade regime with self-correcting mechanism of exchange rate and a gradual movement towards international competitiveness would have to be the basic objectives.**

The Planning Commission's Approach

4.7 The Eighth Five Year Plan estimates the sustainable level of current account deficit for the next five years at 1.6% of the GDP. This has to be treated as a ceiling rather than as a target. Secondly, exports are expected by the commission to grow at a rate of 13.6% in volume terms. However, the initial conditions of world recession, uncertainties in trade in rupee payment areas and the extent of impact of reform measures will have to be reckoned with. Thirdly, the import elasticity of GDP growth has been estimated by the Planning Commission at 1.5. However, given the low level of imports at the beginning of the Five Year Plan, due to the import compression measures warranted by the limited access to capital receipts, the average growth rate in imports may be higher than what is indicated by import elasticity. Finally, consistent with the Planning Commission's approach both in terms of access and sustainability, debt should be restricted, the composition of the capital account should show a distinct bias in favour of equity, and there should be continued reliance on external assistance and a decline in the recourse to commercial sources and NRI deposits.

4.8 **The Committee thus adopted the basic parameters of the Eighth Five Year Plan, which are in a sense normative, and took note of subsequent domestic and international developments to make recommendations with immediate operational significance.**

Composition of capital receipts

4.9 Financing of current account deficits, even at the levels projected by the Planning

Commission, is likely to present difficulties, unless the perception of India as a country risk changes favourably in the international credit markets. It would, therefore, be appropriate to encourage equity investments with a view to increasing forex inflows into the country as well as to promote industrial growth consistent with the Plan targets. Foreign Direct Investment is also expected to increase competition in the Indian industry and improve manufacturing efficiency leading to higher exports. As has been mentioned, growth in exports to the projected levels is a pre-requisite for achieving the key objectives of self-reliance and restriction of current account deficit to 1.6% of GDP. In emphasizing equity flows, qualitative aspects in terms of the priority sectors (such as power and telecommunications), technology imports (in sunrise industries like electronics, computer software and biotechnology), and the size of industry (such as the medium-sized, preferably in collaboration with existing medium-sized Indian industry) have to be kept in view.

4.10 Considering all this and also the fact that the servicing of debt has an immediate adverse implication for forex outlfows from the country unlike in the case of servicing equity, the **Committee felt that there has to be a distinct shift in the policy framework in favour of equity from debt in the matter of capital receipts from abroad. Further, the Committee feel that it is not only the quantum of equity but also the areas of application of foreign direct investment that is important.** Moreover, **the Committee cautions against extending concessions or facilities to foreign investors which are more favourable than what are offered to domestic investors and also against enhancing external debt to supplement equity. In fact, efforts should be made to replace debt flows with equity flows. However, the Committee recongises that direct foreign investment will contain both equity and debt, and the system of approvals is applicable to all external debt. Hence, as an operational guideline, the Committee recommends that the approval of debt (excluding aid from bilateral and multilateral sources) linked to equity, be limited to a ratio of 1:2.**

4.11 With the limited availability of external debt, it becomes imperative that it is put to optimum use. The primary concern should be to ensure that priority sectors such as the nontradeables, mainly power sectors and telecommunications, oil industry, fertilizers, the export sector, etc., are not starved of the much needed foreign currency resources. Care also should be taken to see that external debt is not contracted for meeting requirements of rupee resources. With a view to lessening volatility, efforts should also be made to bring about an appropriate maturity pattern of the country's external debt. Since short-term debt is considerably more volatile, the endeavour should be to tilt the maturity profile of external borrowings in favour of the long-term. Such longer maturities are helpful in reducing immediate pressures on BOP in the form of debt service obligations, providing the much needed breathing space to stimulate exports from the country.

4.12 **In operational terms, the Committee felt that considerations of prudent debt management would imply restricting growth in the stock of NRI Deposits, containing net addition to other external commercial borrowings outstanding and cautious recourse to instruments such as India Development Bonds as part of commercial sources. Recourse to external debt for balance of payments support would have to be discouraged unless it is on concessional terms or with very long maturity. In terms of magnitudes also, the Committee felt that recourse to external debt should be continuoulsy monitored over the Eighth Plan Period to ensure sustainability, cost-effectiveness and use-efficiency. However, recourse to exceptional financing, incuding IMF credit would be inevitable, but the objective would be to phase out the exceptional financing needs by the terminal year of the Eighth Plan.**

Transparency

4.13 A healthy public debate on the BOP position of the country, the targets for sustainable levels of current account deficit and external debt and the strategies proposed to be adopted to achieve the planned objectives would result in building up a viable concensus in favour of the proposed plan of action. This would go a long way in the timely achievement of the objectives. It is, therefore, worth pursuing increased transparency as a goal in itself both at the stage of formulating the long-term policy framework for BoP management as well as at the stage of operationalising the policy framework. Transparency is important to enable economic agents to take well informed decisions.

4.14 **The Committee, therefore, concluded that greater transparency in operational terms would involve the following:**

(i) Making public update statistics on balance of payments, as in the case of trade statistics by DGCIS;

(ii) The guidelines on external commercial borrowings including prioritisation are made available to the public as general guidelines;

(iii) The conditions under which foreign exchange financing for imports is permissible are not only non-discriminatory but also made known to public as general guidelines;

(iv) The regulations governing commercial flows, especially, foreign investment, should be positive and explicit in terms of automaticity rather than as an exception to general rule of restriction; and

(v) The control mechanism in regard to capital transactions should be well laid down, systematic and subject to monitoring and reviewed from time to time.

5. EXCHANGE RATE POLICY

5.1 **The Exchange Rate Policy during the Eighth Five Year Plan and beyond will have to clearly reflect technological developments, the world of integrated global markets and the consequent redefinition of self-reliance. Firstly, it is necessary to recognise that an appropriate exchange rate policy is a prerequisite though not a sufficient condition for a sustainable balance of payments position. Secondly, there is a need for a constant review of the differentials in price levels between India and other countries and the extent of movement of values of currencies of the countries competing with India with a view to making** necessary corrections required in the exchange rate. Thirdly, a transparent and stable policy towards exchange rate minimizes distortions through market expectations. Fourthly, the exchange rate should, as far as possible, not be an instrument of cross subsidisation as between commodities either for import or export. The appropriate instrument will have to be fiscal or even monetary but not the exchange rate. In any case, the whole package should be transparent and non-discriminatory. Fifthly, while efforts should be made at all times to maintain an appropriate real effective exchange rate there are bound to be both transitional problems and strains on the system due to seasonal factors, protectionist tendencies in the world, etc. They will still have to be tackled more by a combination of fiscal and sector-specific methods rather than through multiple exchange rates or cross-subsidisation in terms of differential prices of foreign currency.Sixthly, recent experience in regard to introduction of partial convertibility and exchange rate adjustment shows that it is possible to have a stable exchange rate through emphasis on a realistic exchange rate and a dominant role for the market. However, it should be recognised that **stable exchange rate was possible only because of some amount of restriction on trade and invisibles apart from very close control over capital transactions that create future liabilities. Hence it is necessary to ensure that both a realistic exchange rate and a gradual relaxation of** restrictions on current account transactions have to go hand in hand. In the medium-term, care has to be taken to ensure that there is no capital flight through liberalised windows of transactions under invisibles. Finally, also in the medium-term, there is no escape from a very close control over all capital transactions so that future liabilities are kept under control.

5.2 **The Committee, therefore, recommends that consideration be given to a realistic exchange rate, avoiding use of exchange mechanisms for subsidisation, maintaining adequate level of reserves to take care of short-tern fluctuations, continuing the process of liberalisation on current account and reinforcing effective control over capital transactions. Further, the key to the maintenance of a realistic and a stable exchange rate would, in the view of the Committee, be possible by containing inflation through macro-economic policies and ensuring net capital receipts of the scale assumed in BOP projections.**

In its interim report (copy enclosed as Appendix) the Committee recommended the adoption of partial convertibility on Current Account. It noted with satisfaction that the PCR system implemented so far conformed to the dual system (the ratio of 60:40 in the allocation of foreign exchange receipts between the free market and official channels) and supplementary policy changes in trade and tariff regimes were adopted. Minor variations were warranted in respect of the treatment of grants, aid-receipts, import of drugs etc.

Transitional problems

5.3 While recommending the adoption of partial convertibility on Current Account, the Committee had envisaged certain transitional problems particularly the overhang of Exim Scrips, non-applicability of LERMS for Asian Clearing Union arrangement and likely disadvantages to capital intensive service industries such as international shipping and airlines which are akin to 100 percent EOUs in several respects. The Committee has noted with a great satisfaction that most of those transitional problems envisaged in its interim report were solved smoothly through a "Transitional Arrangements Committee on LERMS," Also contrary to fears expressed in some quarters that the rupee may undergo a steep depreciation there has been remarkable stability in the official exchange rate as well as in the spread between the official and market rate of exchange. Rarely did the spread exceed 20 percent and mostly it remained around 17 percent.

Review of performance

5..4 **The Committee noted the following important features of performance of Partial Convertibility:**

(a) One of the fundamental fears expressed at the time of introduction of LERMS was that there would be a steep fall in the external value of the rupee. Consequently, inflationary pressures on the economy were expected. Actual experience, however, was more in conformity with official expectations. While the official (middle) rate continued to be Rs. 25.89 per dollar till December 3, 1992 the market rate ranged between Rs. 30 to Rs. 31.50 per dollar. The rupee exchange rate has been quite stable and there have been very few volatile fluctuations in the market.

(b) One major expectation from LERMS was that the gap between the **hawala** rate and the market rate would be brought down and **hawala** transactions would be eliminated. Though **hawala** market still persists, the gap between the hawala rate and the market rate appears to have narrowed down considerably and the turnover in **hawala** transactions is reported to have come down substantially.

(c) LERMS has provided an additional incentive to a large body of exporters who were entitled to receive Exim Scrips to the extent of 30% of their exports. (Exporters who were entitled to receive Exim Scrips to the extent of 40% of their exports may have, however, suffered marginal losses with the introduction of LERMS.) The major advantage of LERMS over Exim Scrips, namely that it is simpler, straightforward and promotes general efficiency has been appreciated by various industrial and exporters' associations.

(d) Exim Scrips were not applicable to beneficiaries of inward remittances under the earlier regime but under LERMS 60% of inward remittances are also converted at the market rate of exchange. This was expected to improve remittances especially through official channel. However, the procedural delays for remittances through banking system and incomplete reforms under FERA appear to have constrained realisation of full benefits of LERMS.

(e) Exporters justifiably feel that since 40% of their export proceeds are being converted at the official rate of exchange, PCR actually carries a tax on exports.

(f) The general belief is that PCR is only an interim measure and that full convertibility of the rupee on current account may be introduced at any time in the near future. There is definitely an element of uncertainty in this regard and expectations that full convertibility will be introduced shortly appear to be resulting in a postponement of foreign investment decisions.

(g) In terms of magnitudes of flows, the expectation that 40% of current account receipts would finance special imports appears to have been fully realised. The system, in brief is poised for further progress.

Future Actions

5.5 The Interim Report of the Committee clearly listed the steps beyond partial convertibility.. Broadly speaking, the steps contemplated were:-

(a) Minor adjustments in the system in the first few months by keeping a close watch.

(b) Measures to transmit exchange rate to domestic prices in regard to special etc.

(c) Impose a proportion between access to foreign exchange at official rate and at market rate even in respect of special category transactions so that, over a period, the portion at market rate is increased.

(d) Bring in a unified market as the difference between official rate and market rate narrows.

(e) Step-by-step movement towards full convertibility on current account.

The Committee, in the light of experience gained under LERMS, considered two options in moving towards convertibility on current account, change the proportions to reduce transactions at official rate as an intermediate step or to bring about unified market without any intermediate step.

I. ***Intermediate Step:***

5.6 The intermediate step consists of changing the proportions to reduce official transactions whereby the number of items and amounts available for official rate transactions would be reduced and percentage of surrenders of foreign exchange receipts at official rate gets correspondingly reduced to say 15 to 20 from 40. The advantages of the intermediate step are:

(a) Allocations at official rate to POL would continue to be made, though at a far lower level;

(b) Some fertilizers can continue to be imported at official rate, thereby making available fertilizers at reduced prices and moderating impact on fertilizer subsidies;

(c) Budgetary allocations for import as well as debt servicing of Defence Department would continue to be computed at official exchange rate;

(d) Life saving drugs would continue to be available at the official exchange rate; and

(e) Risks of inflationary effect of POL prices, fertilizer prices, and fiscal deficits continue to be moderated.

As against these advantages, the disadvantages are as follows:

(i) Implicit tax on export earnings though on a reduced scale, compared to the present system, would continue to operate, thus undermining the policy of export-thrust;

(ii) Similary, NRI remittances would pay an implicit tax to subsidise imports of POL, fertilizers, departmental payments for imports etc.;

(iii) The contradictions inherent in the dual exchange system in so far as they relate to ACU transactions and trade with erstwhile USSR will continue;

(iv) As long as a dual exchange rate system operates, there would be pressure to expand access to foreign exchange at official rate; and

(v) In view of the uncertainties, and expectations anticipatory actions such as withholding of foreign investment decisions or even remittance of export-earnings may continue.

II. Unified Rate:

5.7 The option of unified rate implies that exporters and other earners of foreign exchange will convert all their earnings at market rate and all imports will correspondingly take place at one market rate. The exchange rate for all transactions would thus be determined by market forces. Foreign exchange would, however, continue to be available only for purposes approved or authorised by the Reserve Bank of India. The RBI would continue to have the option at its discretion of buying or selling foreign currency from the authorised dealers (who will continue to be subjected to FERA discipline). The advantages of such a system are:

(a) The justifiable demand of exporters that they should have the benefit of market rate (and not subject to a tax) can be met;

(b) The cumbersome procedures of claiming a part of import needs at official rate through Advance Licence mechanism can be eliminated to help exporters;

(c) The large number of workers who make remittances to India would have the full benefit of market rate;

(d) The existing contradictions in rates applicable to remittances and payments through NREA account would be removed;

(e) Similarly, contradictions between dual exchange rate system and transactions in respect of ACU and erstwhile USSR will also be removed;

(f) There will be an end to uncertainties and anticipatory actions on this account;

(g) A clear signal would be emitted to inspire the confidence of the international community; and

(h) There could be a distinct psychological impact on our people which should help reverse capital flight and further reduce hawala transactions.

As against these advantages, there are some risks and disadvantages that should be assessed. These are:

(i) If the international prices of POL harden during the course of the year, some of the anticipated surplus on "OCC account" may not come about, if all and not a part of imports are paid for at unified rate. Thus, there is need to monitor the developments and consider review of POL prices during later part of the year.

(ii) There would be additional cost of importing fertilizers affecting both prices for farmers and amount of subsidy needed.

(iii) Additional budgetary provisions would be needed, depending on where unified exchange rate settles, for debt servicing and import needs of defence.

(iv) Import of life saving drugs would be more expensive than at official rate.

(v) There are possible risks of inflation on account of prices of esssential commodities and, strains on containing fiscal deficit. But these would be off set by possible liberalised imports that would be afforded.

Assessment:

5.8 In weighing the advantages and disadvantages, the Committee took into account the following factors:

(a) Under LERMS, market rate has proved to be reasonably stable and within the range of anticipated levels. Hence the unified rate, in the normal course, should be in alignment with the market rate established in the past few months. Technically, unified rate should settle between the ruling official and market rates.

(b) Measures have already been taken to transmit changes in the exchange rate to domestic prices in respect of POL.

(c) The macro-economic environment in terms of rate of inflation, anticipated growth rate and sustainable fiscal deficit inspires confidence to effect changes.

5.9 **The Committee, after weighing advantages and disadvantages of the options, as described above, recommends that a decision be taken to unify the exchange rate, as an important step towards full convertibility.**

6. FOREIGN CURRENCY RESERVES

6.1 The Committee is of the view that the crisis in balance of payments in the recent past was essentially a crisis of confidence and a liquidity crisis. Such a liquidity crisis could have been managed without resorting to fire-fighting operations if adequate levels of foreign currency reserves were at all times maintained. No doubt there is a trade-off between accumulating the reserves and permitting imports to take place. However, allowing the reserve drawdown for what could have otherwise been regular and recurring imports (without replenishments of such reserves on an assured basis in a foreseeable future) implies serious erosion of the manoeuverability in the management of balance of payments.

6.2 **The Committee, therefore, makes a general recommendation that a reserve target range should be fixed from time to time and the foreign currency reserves should always be permitted to operate within the range and in any case under no circusmtances below the floor.**

6.3 It has traditionally been the practice to view the level of desirable reserves as a percentage of the annual imports-say reserves to meet three months imports or four months imports. However, this approach would be inadequate when a large number of transactions and payment liabilities arise in areas other than import of commodities.Thus, liabilities may arise either for discharging short-term debt obligations or servicing of medium-term debt, both interest and principal. Hence, the **Committee recpmmends that while determining the target level of reserves due attention should be paid to the payment obligations in addition to the level of imports. The Committee, recommends that the foreign exchange reserves targets be fixed in such a way that they are generally in a position to accommodate imports of three months.**

6.4 **In the view of the Committee, the factors that are to be taken into consideration in determining the desirable level of reserves are:** the need to ensure a reasonable level of confidence in the international financial and trading communities about the capacity of the country to honour its obligations and maintain trade and financial flows; the need to take care of the seasonal factors in any balance of payments transaction with reference to the possible uncertainties in the monsoon conditions of India; the amount of foreign currency reserves required to counter speculative tendencies or anticipatory actions amongst players in the foreign exchange market; and the capacity to maintain the reserves so that the cost of carrying liquidity is minimal.

6.5 The Committee also noted that the Reserve Bank of India maintains a stock of gold of about 351 tonnes in addition to the foreign currency reserves. While the currency reserves provide the necessary liquidity, the gold reserves are expected to provide comfort. Often, it is argued that financial circles are aware of the comfort of gold and hence conversion into currency is merely a change in the form of asset. However, there is reason to believe that this approach resulted in some adverse consequences. Firstly, the price of gold which was ruling at $460 per oz. on an average in 1981, has come down to a level of a little over $380 in 1989-90 and dropped to $360 in 1991. In other words, if the gold had been converted into foreign currency, this loss could have been avoided. Secondly, if the gold had been leased, a return of 0.25% to 1% would have been obtained and the value of gold per oz., today after crediting the lease value would be a little over $400 per oz. Thirdly, if gold had been converted into foreign currency and invested, the foreign currency resources would have been enhanced even furher. Fourthly, at a time when the reserves were falling, in view of the fact that the RBI Act does not effectively permit utilisation of gold beyond 15% of its holdings in the Issue Department, the international community started withdrawing support to India and even insisting that the Letters of Credit established by Indian banks should be reconfirmed by a foreign bank. Fifthly, when the problem did arise, it became inevitable for the country to sell a part of its gold. **The Committee recommends that the option of RBI converting gold into foreign currency resources should be constantly reviewed though immediate case for exercising such an option is not established. Additionally, the Committee recommends that a part of gold reserves, say 30%, should be available for conversion at short notice, into currency resources to meet contingencies.**

7. EXTERNAL ASSISTANCE

7.1 External debt has been an important source of financing the current account deficit. India's external debt may be classified for purposes of convenience into (a) multilateral (b) bilateral (c) commercial (d) non-resident Indian deposits (e) short-term loans and (f) Rupee-debt. Each one of these forms of debt has its own characteristics and they will have to be considered before taking a total view of debt management and outlook for external debt in the medium-term. Multilateral and bilateral sources are generally treated as "external assistance."

7.2 Multilateral assistance, particularly from the World Bank group, has been the single most important source of support to India's balance of payments. There has, however, been a gradual reduction in net transfers on account of multilateral assistance for a number of reasons such as reduction in the overall aid flows in the world, entry of larger claimants (especially China) and the repayment obligations that have come about over a period. The Committee considers that the amount of resources available on concessional terms has been somewhat static even in nominal terms in the recent past.

7.3 The Committee noted that the most serious problem in regard to multilateral flows is the large amount of committed but undisbursed aid. Such amounts have been rising progressively in the last decades. Thus any significant improvement in the power sector would substantially improve the overall utilisation of external assistance. The following are some of the major reasons or constraints in aid utilisation:-

(a) The nature of the projects themselves are such that they take on an average about 5 years to be implemented.

(b) Delays involved in project approvals and tender finalisation.

(c) Paucity of rupee resources (both in the case of Central Ministries and State Governments) reflecting inadequate preparedness, budgetary constraints and non-convergence of the project-interests and Plan priorities.

(d) Non-adherence to financial and other covenants agreed to at the time of negotiation. Property Tax Reforms, Water

Tax Revision, Electricity Tariff Revision, etc., are some of the examples.

(e) Absence of cost-related tariff structure in the power sector adversely affects the finances of the State Electricity Boards (SEBs). SEBs are thus unable to provide adequate funds for the power projects resulting in the delayed utilisation of external assistance.

(f) Problems caused by delays in land acquisition and rehabilitation and resettlement of displaced persons.

(g) Some times major changes are sought to be made even after the finalisation of the projects, resulting in delayed utilisation of external assistance.

7.4 In respect of bilateral assistance also there has been a problem of utilisation. Experience gained in this regard shows that some of the projects are taken up merely because foreign exchnge is available only through bilateral credit. Secondly, bilateral approach where credit is often made available on a tied basis has resulted in high-cost imports. Often the concessionalities are absorbed by the Government and the project authorities are compelled to procure equipment at higher than market price simply because bilateral aid is available. In such a situation, to the extent concessionalities are absorbed by the Government, the project authorities have little incentive to ensure quick absorption of bilateral aid.

7.5 The Committee noted the major suggestions made by 9th Finance Commission in its Report for 1990-'95 regarding the utilisation of external assistance. These were: (a) The entire aid should be passed on to the States for externally-assisted projects; (b) For projects under IBRD, Government of India should recover loans from State Governments over the same period as provided by IBRD; and (c) For the projects under IDA, the maturity period for the loans to the states should be increased to 30 years and the loans should carry an interest rate of 6%.

7.6 The Committee also noted that the National Development Council (NDC) made the following suggestions in this regard at its 42nd Meeting on October 11, 1990. (a) The entire aid meant for the externally-assisted projects should be passed on to the States; (b) Advances may be given by the Government of India against the likely additionality; (c) Weaker States may be assisted to formulate projects which would be entitled for external aid; and (d) Any formal and informal ban on such projects in Special Category States should be removed.

7.7 The undesirable consequences of large unutilised aid are well recognised. Firstly, it reflects adversely on the absorptive capacity of the economy and the management of projects and may reduce the possible continued support from the multilateral agencies. Secondly, delayed implementation of the projects involves locking up of resources without productive results. Thirdly, there are instances where committed amounts of aid had to be cancelled as a result of such delays. Fourthly, over a longer period, there are distortions in implementation both on account of cost escalations and the changes in the rupee value-the latter adversely affecting the amount of foreign currency resources that should be available against rupee expenditure. Fifthly, commitment charges are paid on unutilised aid.

7.8 Considering the vital role that can be played by timely utilisation of external assistance in placing the country's balance of payments position on a sound footing, the Committee recommends that immediate action be considered in the following areas:-

(a) A review of the existing projects with a view to identifying those where the progress is slow, those that need redefining of project scope or coverage and where cancellation would be better than continuing to pay commitment fees and keeping them in our books.

(b) As recommended by the NDC, 100% external assistance may be passed on to the States for all sectors.

(c) Additional Central assistance may be released to the States on a monthly basis. The advances at any point of time may be limited to around 8% of the accepted reimbursement during the year.

(d) Since availability of rupee resources is one of the major constraints, priority may be accorded to externally-aided projects in making Plan allocations for both Five Year and Annual Plans and corresponding budget provisions. However, overall resource-availability has to be increased to ensure adequte, and timely absorption of external aid without sacrificing the larger segment of non-externally aided projects.

(e) The contracting procedures will have to be streamlined and decentralised so that reference to Government would become unnecessary. General guidelines on evaluation procedures should suffice since, with the introduction of LERMS, foreign exchange allocation by sources and uses is more or less dispensed with. In order to ensure that the domestic industry is encouraged to bid, the bidding procedures should be such as to give adequte opportunity to the domestic industry for competing for such contracts. (The Committee noted with satisfaction that the Government has already taken measures to allow Indian bidders to bid in foreign currency in respect of multilateral and bilaterally-assisted projects.)

(f) The approval procedures and monitoring mechanisms will have to be reviewed to ensure adequte preparedness and timely actions.

7.9 In a review of the existing practices with regard to administering the external assistance, the Committee found certain ambiguities more particularly in the backdrop of the recent reform measures in the external sector of the Economy. These related to the lack of plan provisions for externally aided projects executed by the Government departments, terms and conditions of the assistance passed on to PSUs and States, absorption of concessionality in assistance by the Government and use of concessional flows for commercial purposes. **The Committee, therefore recommends the following broad approach to reorient the administering of external assistance:**

(a) Department of Economic Affairs may have to continue to play the role of a nodal agency, in terms of developing pipeline, negotiating external assistance and monitoring implementation. With relief in work on individual cases after LERMS, there is scope to focus on adequate planning for externally aided projects. In particular, there is need for a medium term framework of project pipeline which will specifically address issue of resource availability, commitment of user-unit and issues of direct lending/on-lending/ additionality.

(b) The issue of direct lending vs on-lending should recognise the need for disintermediation by government. The suggested framework needs to be worked out on the following lines:

Terms	Use	User	Method
1. Bilateral & Multilateral (Other than soft loans)	Commercial activities	PSUs (Centre and States)	Direct (not through Central or State budgets)
2. Soft loans (esp. IDA)	Social sectors	Departments in Centre or State or autonomous agencies specially set up	Through budget
3. Grants	Social sectors	NGOs or government	Umberalla agreements for NGOs and budget for government as grants to State Govt. also.

Rupee Debt

7.10 External debt denominated in rupees has different dimensions. First, there are NRI deposits which are denominated in rupees but require to be discharged in foreign currency at the option of the depositor. Clearly this is not a rupee debt even though it is rupee denominated. Second, there are NRI deposits which are non-repatriable which implies that the debt has to be discharged in rupees and as per present arrangements there need be no outflow of goods and services to non-residents. Third, there are bilateral arrangements, especially with the former Soviet Union, where debt is expected to be discharged by exporting goods and services to non-residents but liabilities are expressed in rupee terms as per agreed rates.

7.11 The former USSR extended to the Government of India a number of State credits for both defence and a civilian sector projects in India. The credits were denominated in Roubles but repayments by India were to be made in Rupees by means of export of Indian goods. The rate of exchange between the Rupee and Rouble for determining the repayment schedule was established by the Protocol of November 1978 between the two countries. The formula provided for changes in the value of Rupee in relation to a 16-currency basket (the old SDR basket) but assumed that the value of Rouble to be invariant. As per this formula, the Rouble appreciated from Rouble 1 = Rs. 10 to Rouble 1.00 = Rs. 31.7874 when the exchange rate was last notified on 17-11-1991. The principal debt outstanding as on 31-3-1992 was Rouble 9871 million which at the last announced protocol exchange rate amounted to Rs. 31,377 crore.

7.12 The **Committee noted with satisfaction that India and Russia have reached a new agreement on the mechanism for determining the Rupee value of the Rouble denominated debt.** The agreement provides for the principal amount of the debt as on 1-4-1992 being converted from Roubles to Rupees using the exchange rate on 1-1-1990 as determined by the Protocol. The amount of the principal debt as on 1-4-1992 would also be converted from Roubles to Rupees using the exchange rate on 1-4-1992 as determined by the 1978 Protocol. The difference in the two amounts as calculated above, would be fixed in Rupees and would be rescheduled and repaid in annual instalments over a period of 45 years. This rescheduled portion would carry no interest. It will also have no protection against any fluctuation in the value of the Rupee for a period of 5 years. Thereafter, it will be indexed to the SDR if the average annual depreciation of the Rupee exceeds 3% over this 5 years period. Similar reviews will be conducted at the end of every 5 year period. This means that this portion of the debt will not be indexed if the Rupee depreciation is 3% or less per year on the average.

7.13 As per the agreement with Russia, Rs. 19,660 crore will be repaid with interest over the next 10-12 years in accordance with the schedule laid down in the credit agreements. The balance amount of Rs. 11,682 crore will be paid without interest over the next 45 years.

7.14 In accordance with the above agreement, the likely debt service payments to the former USSR over the next 5 years would be on average about Rs. 2,400 crores per annum. These amounts will be paid in Rupees against which Russia will buy Indian goods and services for export to Russia.

7.15 Simultaneously, the new trading arrangements with Russia provide for trade in freely convertible currencies. Such trade could also provide for dollar denominated counter trade deals through ESCROW accounts opened in India. However, such counter trade deals would have to be negotiated on a case-by-case basis and no definite guidelines have been laid down. It is expected that a portion of defence imports would be done on the basis of counter trade deals.

8. COMMERCIAL BORROWINGS

8.1 External commercial borrowings are defined to include debt owed to international banks, borrowings in bond markets, suppliers' credits, export credits supported by official export credit agencies and loans provided on commercial terms by specialised multilateral or bilateral institutions like IFC (W), Commonwealth Development Corporation, DEG of Germany etc. (Definition has since been changed).

8.2 Recourse to external commercial borrowings (defined as those with a maturity of more than one year) was essentially a phenomenon of eighties. The instruments of the supplier/buyer credits and the syndicated bank loan market were mainly used. An entry was also made in the securitized instrument market and the public bond market in Japan emerged as an important source since 1989. Recourse was also taken to offshore leasing as a cost effective arrangement and a diversified source of funds. In terms of maturities, it was possible to obtain commercial credits on an average maturity of seven years. The cost of funds was extremely favourable to India. While Japan emerged as an important source, the markets by and large continued to be diversified. Over 80% of such commercial borrowings were by public sector-both financial and non financial ones. During late 80s, a large inflow was on account of the development financial institutions which were encouraged to borrow well in advance of their requirements of disbursements under foreign currency loans. There were also instances when ECB was approved to finance imports of raw materials and components by Public Sector Undertakings. Thus, recourse was taken to external borrowings virtually for balance of payments support in the recent past. **The Committee noted that on the whole, in terms of cost, maturity, currency composition, markets, liability management and exercise of control over individual transactions, the performance in regard to obtaining external commercial borrowings was satisfactory.**

8.3 However, the events following the Gulf war led to a sea change in India's commercial borrowing prospects and policies. The flow of funds from international commercial banks and bond markets virtually stopped when the Credit Rating Agencies announced a downgrading of the rating for India and Indian entities in 1990, taking into account both the BoP situation and the political uncertainties. There was no scope to access the bond market with such a rating. Under the circumstances, as part of crisis management, importers were required to resort to external borrowings for a minimum period of one year for raw materials and components' and for at least two years for capital goods imports. There was also a freeze on the foreign currency resources parked by the development financial institutions with the RBI. Export credits supported by official export credit agencies emerged as the single important source of external funds. Soon, even the export credits were reaching the exposure limits and the premia for individual borrowers increased. The problem turned out to be essentially one of access rather than cost. The picture, however, changed slightly for the better after the initiation of the reform package in 1991. There was an improvement in the exposure limits by the institutional sources and premium has been gradually reduced. Till now, the availability of untied funds in the form of bank loans and bond market issues continues to be uncertain.

8.4 In this background the **Committee identified the major issues that have to be addressed *in the context of* external commercial borrowings.** These are :- (a) The desirability and the scope for debt refinancing. (b) The scope and limits for debt equity swaps. (c) The desirability of incurring sovereign debt. (d) Use of gold bonds for raising debt. (e) Further scope for liability management. (f) Appropriate timing and magnitudes for re-entry into commercial borrowings through bond market. (g) Determining the levels of sustainable commercial debt. (h) Prioritising the utilisation of commercial debt. (i) A view on the maturities and instruments and (j) A view on extending sovereign guarantees.

8.5 On consideration of the experience gained so far, the practices and procedures of international financial markets and the policy parameters for managing balance of payments in general and external debt in particular, the **Committee recommends the following approach in regard to each one of the issues mentioned above:**

(a) India has demonstrated its determination to honour all contractual obligations. At no point of time the option of debt rescheduling was considered. There is no need, therefore, to pursue this option. However, proposals have been received from some of the international bankers suggesting debt refinance i. e. borrowing to specifically repay loans due. Considering the maturity profiles and the fact that a large part of external commercial debt is through institutional sources, the amounts that can be subjected to refinance would be about 500 million dollars per year for the next two years. As long as there is a possibility of raising commercial borrowings with longer maturity to sustain the overall balance, there is no advantage in giving signals of distress for such small amounts by taking recourse to debt refinance mechanism. **The Committee considers that it would not be advisable to consider the option of debt refinance.**

(b) Debt-equity conversions refer to an arrangement whereby an external lender converts the foreign currency loan to a borrower into an equity stake in the same country on mutually negotiated terms. The converted equity could be acquired by the original lender or sold by him to investors. In theory, debt conversions have certain immediate advantages for all participants. The process helps the lender to realign his exposure portfolio according to his risk preference and business objectives. From the borrower's point of view, the debt burden is removed and from the country's point of view the servicing of debt is replaced by payment of dividends linked to performance. No doubt, debt equity conversions have been important options of debt reduction for several highly indebted countries. However, the position of India is different from any of these countries. First, debt-equity swaps have taken place in many countries as part of rescheduling programmes. Second, debt equity conversion has taken place at a time when the country is in default and its external debt is quoted at a substantial discount in secondary market trading abroad. In the case of India none of these circumstances exist. The concept, therefore, does not essentially apply to India which has a flawless debt service payment record. In the circumstances, there is a danger that recourse to debt equity swaps would reinforce sentiments that equate India with some of the countries that have defaulted in honouring their debt obligations. **The Committee, therefore, concludes that debt equity conversion is not a desirable option for debt management in India.**

(c) Suggestions have been received that India should borrow in the international financial markets as a sovereign in addition to the present practice of accessing external commercial borrowings essentially through public sector enterprises and to some extent through private enterprises. Such a sovereign borrowing could be accessed by the Government itself or by creating a separate designated entity. The main arguments in favour of sovereign borrowing seem to be that a centralised approach may provide access in terms of larger quantities; that there could be better execution; that economies of scale can be captured and that it will clearly give signals of government being in direct command over commercial borrowings. In the recent past, given the credit rating of India, many lenders are advocating sovereign borrowing as a desirable option and indicated that to the extent sovereign guarantee is being insisted upon for many enterprises, there is no great advantage in accessing commercial markets though entities rather than by the Government directly. The Committee examined this issue in the light of the following considerations, namely, (i) consistency with structural reforms; (ii) quantum of commercial borrowings; (iii) cost of commercial borrowings; (iv) control and management; and (v) signals to the international financial community. Firstly, as part of structural reform there is greater emphasis on autonomy to public enterprises and participation of private enterprises even in core sectors like power. Further, as part of such reform and reduction in the fiscal deficit, a policy of disintermediation of the Government is being encouraged. Secondly, as regards the quantum, the approach is to keep a cap and restrict the quantum of borrowings on commercial terms. Moreover, it is necessary to introduce mechanisms by which the use for commercial borrowings is linked to the borrowing itself to avoid recourse to such borrowings for balance of payments support. Under the circumstances, recourse to sovereign borrowing would be warranted only if it is established that the enterprises are unable or unwilling to raise requisite amount of commercial borrowings to sustain the balance of payments. Thirdly, as regards the cost, experience so far shows that leading players in the market have been able to get reasonable terms. With the diversification of ownership of some of the leading entities, the cost would be slightly more than the cost for sovereign borrowing. Fourthly, the major issue in regard to control and management relates to the approval procedures and proper monitoring of decentralised, enterprise-oriented borrowing. The systems that have been in place have worked satisfactorily so far. Fifthly, in terms of signals, recourse to sovereign borrowing may give an impression to the international financial community that India wants to be active in raising external commercial debt while in reality the attempt should be to try and curtail such borrowings. But, most important, sovereign borrowings could demonstrate the strengths of presence of larger player on a more continuing basis. Under the circumstances the **Committee recommends that there is need to keep the option of sovereign borrowing in external commercial markets open, but exercise it when the need and cost-advantage are established.**

(d) Suggestions have been received that the gold available in the country should be mobilised and such gold should be used for purposes of raising foreign currency loans. Implicit in the proposal is the assumption that gold is used as a collateral for raising foreign currency resources. First, some assessment has to be made as regards the quantum of gold that can be raised from the public in India either by the Government or by RBI for purposes of raising foreign currency loans. Given the not so satisfactory experience of gold mobilisation in the past, even during periods of war, when patriotic fervour was expected to contribute to the success of the scheme, it is doubtful whether substantial quantities can be mobilised now. Second, provision of gold as a collateral may or may not provide additional access to commercial borrowings. In fact, if the general approach is to contain the commercial borrowings there is no reason to devise mechanisms for additional access. In fact, providing gold as a collateral may give an indication that India is not in a position to raise loans on commercial terms without the collateral of gold. Fourthly, purely as a financial proposition, it may be difficult to sustain the operation of using gold as collateral unless the cost of commercial borrowings without collateral is significantly higher than what is currently indicated in the markets. Fifthly, the gold already available with the RBI itself can be used in the first instance for raising foreign currency resources before taking recourse to raising of gold from the market. Finally, at a time when import of gold is being liberally permitted through the NRI mechanisms, the special status of gold ceases to exist. The Committee, however noted that there is a substantial body of opinion in favour of mobilising gold not only for the large quantities expected but also for changing attitudes of people to gold. **Hence, the Committee recommends that (a) caution be exercised in creating permanent institutions or corporate bodies for mobilising gold; (b) gold bonds may be launched immediately as an experiment by Government as part of public debt; and (c) a review be made of the economics of such a scheme in 1993-94.**

(e) Liability management is an important area. Given the globalisation of the financial markets, liability management has acquired significance since it is possible to take recourse to currency swaps, etc., which are mutually beneficial to the parties involved. Some progress has already been made in regard to liability management and, in particular, these have been decentralised to some of the experienced and leading players. **The Committee recommends that the practices of liability management be encouraged.**

(f) Entry into bond markets and loan markets is technically possible even now by Indian entities in selected markets. However, the Committee feels that unless the balance of payments situation requires an urgent entry, effort should be made to encourage the enterprises to make an entry into these markets only when the circumstances are favourable to establish a good effective market. Mere enthusiasm of lenders and excess liquidity in international markets or cash compulsions of a borrowing entity should not be the major considerations in approving re-entry into these markets. **The Committee thus recommends adequate preparation and assessment before permitting reentry of large players.**

(g) The level of external commercial borrowings is an important consideration. It is necessary to ensure that the total amount of commercial borrowings is fixed in advance and every effort made to restrict commercial borrowings to that level. Adopting such an approach and making that approach fairly transparent would ensure greater confidence in international markets about the management of external debt apart from ensuring controlled and *sustainable balance of payments* transactions. **The Committee therefore recommends that on average the disbursements of external commercial borrowings should not exceed US$ 2.5 billion per year during the Eighth Five Year Plan.**

(h) In addition to the quantum, the **Committee recommends a deliberate policy of prioritising the use to which external debt is to be put.** Priority for non-tradables such as power, core sectors like oil and fertilizers, and liberal access to units with export obligation is called for. In particular, the Committee recommends that commercial borrowings be prohibited for balance of payments support unless it is for very long maturities and funds are obtained for special purposes or under somewhat concessional terms.

(i) As regards maturities, given the current repayment obligations whereby over half of the outstanding debt on account of commercial borrowings will have to be discharged in the next four years, the Committee **recommends that no approval be accorded for any commercial borrowing with a maturity of less than five years for the present; and every effort be made to seek borrowings with an average maturity of at least five years.** Exceptions could, however, be made in regard to the consolidation and conversion of short-term debt into medium-term debt.

(j) The question of guarantees in respect of borrowings has to be examined in terms of the policy of extending sovereign guarantee, charging guarantee fee, offering counter guarantee and guarantee by public sector Development Financial Institutions or Banks. In the past sovereign guarantee was extended to public sector institutions only, though an exception was made for a World Bank lending to the private sector. However, wherever possible Public Sector Institutions were encouraged to obtain borrowings without guarantee. There was no uniform policy of levying guarantee fee to public sector, inviting a comment from Comptroller and Auditor General that this meant a hefty subsidy. More recently, in respect of Public Enterprises which are being restructured and privatised, lender's consent was made conditional on extending sovereign guarantees even when originally there was no such guarantee. In the recent past, public sector banks/DFI's are seeking counter guarantee from Government so that their capital adequacy norms which are now being insisted upon could be fulfilled more easily. In any case, some of the lenders were content, in the past, with DFIs/Public Sector Banks guarantee since they were wholly owned by Government/RBI. However, with the proposed reform, lenders' attitude to such guarantees is uncertain. Overall, given the recent downgrading of credit worthiness, and uncertainties due to reforms, lenders may be inclined to insist on guarantees in the near term. Borrowers would tend to seek such guarantee not only to ensure access but also to gain on cost even if access is available without such a guarantee. Yet another aspect of reform is encouraging private foreign investment in the power sector. In view of the difficulties of ensuring payments by SEB's for power supplied, lenders are seeking repayment guarantee, though there are no doubts about transformation of rupees into foreign currency for servicing debt or equity. On a careful consideration of all these factors, **the Committee recommends the following approach to guarantee for external borrowings:** (i) Sovereign guarantee should continue to be available only to public enterprises and in exceptional cases to private sector limited to the financing by multilateral agencies like World Bank/ADB - as in the past; (ii) PE's should continue to be encouraged to approach the market without guarantee though in the very near term it may be difficult due to credit worthiness criteria; (iii) to enable reform, where lender's consent requires continuing or extending guarantees in respect of existing loans to PE's, such gurantees should be available; (iv) to encourage disintermediation in administration of external assistance, guarantees may be extended to PE's to replace direct intermediation; (v) in all cases of guarantees, guarantee fee should be levied broadly aligned with market practices (i. e. about 2.75%) and exceptions should be made only for specified reasons; (vi) Government should refuse counter guarantee for any guarantee by DFIs/public sector banks; (vii) public sector financial institutions should explicitly recognise the importance of capital adequacy norms and additional capital needs before entering into large scale commitments on guarantees; (viii) In regard to power sector, suggestions are made that sovereign guarantee should be extended in respect of private sector also. No such guarantees should be considered since issues of adequate control over management/performance and discrimination between domestic and foreign companies will arise. However, firm arrangements to ensure payment for power supplied by all power generating companies (domestic or foreign, public or private) have to be devised. These may include opening of escrow accounts in a mutually agreed Bank and pledging receivables of select area.

9. NRI DEPOSITS

9.1 The policy during the Eighth Five Year Plan and beyond in respect of NRI deposits will have to clearly draw from the past experience of excessive reliance on them to finance external funding requirements with adverse consequences. Three important approaches were adopted to attract NRI deposits in the past: (a) Maintaining a liberal interest rate differential over the prevailing international interest rates for dollar and other currencies with a view to providing an incentive; (b) RBI assuming full exchange risk on FCNR deposits in all maturity brackets; and (c) extending fiscal concessions to the NRI transactions. The combined effect of the policies has been that a substantial inflow of NRI deposits has been in FCNR account. The large interest differential between international interest rate levels and FCNR rates has over the years provided a built-in incentive to banks to arbitrage the funds, so that the original objective of NRI deposits mobilising the genuine savings of the working Indian population abroad has receded to the background. Since the funds were attracted by interest differential and prompted by temporary opportunities, as soon as the first sign of difficulties appeared in the economy, there was a reverse flow. During April-December, 1991, there was a net outflow of US$ 1.5 billion under FCNR account alone besides about $ 30 million under the NR (E) R deposits, as against an inflow of about $397 million under FCNR Account and outflow of $ 31 million under NR (E) R Account, in the corresponding period of the preceding year. The total outstanding balance under FCNR account dropped sharply from $10.6 billion at end-March, 1991 to $8.5 billion at end-December, 1991.

9.2 **The Committee, therefore, recommends that there is need for a deliberate policy shift with regard to FCNR deposits with a view to reducing the volatility and the cost and to make it attract the genuine savings of NRIs. To this end the Committee suggests that the NRI deposit scheme be modified on the following terms:**

(a) FCNR deposits should have a minimum maturity of one year; and

(b) The differential between international interest rates and FCNR rates should be progressively reduced to ensure that the scheme benefits only the genuine savers.

9.5 The Committee noted that the RBI introduced in April 1992 a new scheme for attracting non-repatriable deposits where there is complete freedom of banks from the CRR and SLR requirements which at present stand at 15% and 30% respectively on the funds mobilised. There are no priority sector financing obligations also. The Committee noted that there is need to accelerate this trend and broadbase the instruments for tapping the NRI funds.

9.6 The Committee also noted an important aspect of FCNR deposits whereby the foreign exchange risk is presently borne exclusively by the RBI. There are no precise estimates available on the impact of the exchange risk on the RBI over the last several years. It is necesssary that this practice yields place to a system whereby banks are encouraged to mobilise deposits based on competitive rates and their credit standing and the funds are retained by them for onlending in foreign currency for the clients' needs.

9.7 **The Committee is also of the opinion that a market for NRI Bonds should be developed to satisfy the investor appetite among NRIs for some form of medium-term investments in India with facility for secondary trading.** A series of NRI Bonds issued over a period of time would also provide the much needed stability in the quantum of NRI resources available to the country. With necessary approvals from the regulatory authorities in various countries, the bonds could also be issued as general bonds targeted at both NRIs as well as foreigners. The Committee, however, feels that NRIs should be treated as a separate and distinct investor segment because (i) the concerns and aspirations of NRIs are quite different, (ii) the fiscal concessions in India provided in the NRI bond schemes would not be of interest to the foreigners, and (iii) the interest that we pay on NRI bonds even if it is marginally higher than normal, will not become a benchmark for the general borrowings of Indian entities in the international financial/capital markets. Besides, Indian entities like ONGC, IDBI, SBI, etc., could always access the international capital markets with bond issues targeted at all investors (such as Yankee Bonds, Samurai Bonds, Eruo Bonds, etc.) whenever specific needs arise.

10. SHORT-TERM DEBT

10.1 **The Committee noted that serious concerns have been expressed about the level of short-term debt and its contribution to the crisis situation.** However, in the view of the Committee, the problem was not so much the magnitude of short-term debt since its level as a percentage of imports or as a percentage of total debt is less than that of other comparable countries. The problem, however, arose due to the fact that short-term debt was used not for purely trade financing purposes, but as a means of protecting the reserves. Secondly, short-term debt which was normally incurred for a period of six months was rolled over more than once because of the inability of the country to release foreign exchange reserves for discharging such debt. Thirdly, most of the short-term debt was incurred by a single canalising agency, viz., the Indian Oil Corporation and the bulk of the burden was borne by one bank, viz. State bank of India. Finally, there was a mismatch in terms of receipt of rupee resources by the canalising agency and corresponding discharge of its liabilities with the result that there were substantial rupee resources available with the canalising agencies which were placed in the short-term money markets. These agencies had, of course, to bear the burden of exchange risk fluctuations.

10.2 **In the light of past experience, the Committee recommends that the policy of the Government and the Reserve Bank of India in regard to the management of short-term debt should be:- (a) Short-term debt should be permitted only for trade-related purposes and under normal terms. Normal terms may be defined as trade-related debt permissible through routine procedures of authorised dealers under the Exchange Control Regulations. (b) Recourse to short-term debt should not be taken as an instrument for protecting the reserves. (c) No rollover beyond six months should be agreed in regard to any short-term facilities without careful consideration of the implications. (d) Any short-term debt not governed by the above considerations should be specifically approved by RBI after satisfying itself that recourse to such debt was on genuine cost considerations or trade-related considerations. (e) Reserve Bank of India should set up a monitoring system for short-term debt so that it is possible to ascertain with reasonable amount of accuracy the extent of such debt that may be outstanding at any point of time.**

11. STRUCTURE OF EXTERNAL DEBT

11.1 The broad characteristics of structure of external debt of India can be summarised as follows:

(a) Debt outstanding as a percentage of GDP may appear relatively large but a substantial part of it is on concessional terms and, therefore, the burden of such debt is in reality less than what is apparent.

(b) The average maturity of external debt and, in particular of external commercial borrowings is longer than in regard to many of the developing countries.

(c) However, external debt on account of Non-Resident Indians, which so far has not been treated as part of external debt, has a maturity of three years and below.

(d) The NRI sources which account for a significant part of debt on commercial terms is characterised by volatility and relatively high cost.

(e) Since commercial borrowings commenced in the late eighties and some of them have bullet maturity, about half of the total external commercial borrowings outstanding are due for repayment during the Eighth Five Year Plan itself. In addition, India Development Bonds amounting to 1.6 billion dollars along with most of the interest is due to be repaid in the terminal year of the Plan. Further, repayments on account of IMF are bunched in the last two years of the Eighth Plan.

(f) In addition to the treatment of non-resident deposits as part of external debt, there is a special liability of external debt owed to the erstwhile USSR.

(g) The total debt servicing needs, viewed as a percentage of exports, is still moderate compared with most developing countries. In fact, since the dividend liability is still at very low levels, the total liabilities to service debt and equity for India would be far less than those for most other developing countries.

(h) While strict control has been kept on the approval of *individual loans, in terms of* cost, maturity and instruments, the policy frame available for ensuring the productive use of such external debt has proved to be inadequate. In other words, the large receipts on account of NRI deposits and a part of external commercial borrowings have turned out to be more in the nature of balance of payments support than addition to the productive capacity of the country.

11.2 **The Committee noted with satisfaction the Reports of the Policy Group and Task Force on External Debt Statistics of India and its adoption by the Government and the Reserve Bank of India. The Committee also noted that a Standing High Level Committee on external debt has been constituted by the Government.** These would facilitate improvements in the structure management of external debt.

11.3 **In regard to the future directions on the structure of debt, the Committee recommends necessary policy and procedural changes to bring about the following:** Quick disbursement of concessional and semi-concessional flows; disintermediation of Government to the maximum extent in aid flows; absorption of aid only when it is consistent with the requirements of the enterprise concerned or department/State concerned; and continuation of NRI deposits at a level that would ensure no net outflow but with longer maturities profile; insistence on a minimum maturity of five years, for commercial borrowings except for purposes of consolidation of short-term debt; recourse to commercial sources of financing essentially to meet foreign currency expenditures, particularly for non-tradeable goods, priority sectors like oil and fertilizer, export oriented units etc. or borrowings linked with inflow of equity; and a prudent policy of extending guarantees by Sovereign or public sector financial and banking institutions.

12. FOREIGN INVESTMENT

12.1 Foreign investment has played a very limited role in the Indian economy so far. Total direct foreign investment approvals during the years *1986 to 1990 amounted barely to Rs. 180 crores* per annum on an average when other comparable developing countries managed to register foreign investment of enormous magnitudes. Thailand had an average foreign investment flows of US$ 1.6 billion during the last three years, while China registered an inflow of US$ 3 billion in 1990-91. Other countries like Indonesia and Malaysia have also been receiving foreign investment of substantial amounts.

12.2 The Committee noted the major changes in the Government's policies towards attracting foreign investments, which have been put in place since July, 1991, to create a favourable climate. The new foreign investment policy has, apart from addressing the irritants in the old regime, brought about a new impetus towards upgradation of technology levels, integrating Indian industry into global economy, and, more importantly, bringing in non-debt resources (as a favoured option compared with debt flows).

12.3 **The Committee felt that the following steps already taken would go a long way in**

promoting the confidence of foreign investors for investing in India.

(a) Signing of the MIGA convention by India.

(b) Allowing foreign brand names to be used in India.

(c) Removal of the condition of dividend balancing (for all except industries in the consumer goods sector).

(d) Removal of licensing of industrial capacities.

(e) Simplification of import-export procedures.

(f) Relaxation of exchange controls and removal of the rigours of FERA, specially regarding hiring of foreign technicians, and purchase of immovable property in India.

(g) Opening up of Indian stock markets for the foreign institutional investors.

(h) Partial convertibility of the rupee.

(i) Emergence of SEBI as an effective watchdog institution.

12.4 **In considering our approach to attract foreign investment the Committee felt that we have to draw lessons from the experience of other countries.** Briefly stated, these are:

(a) Government has played a crucial role in attracting foreign investment to desired sectors and was not simply liberalising in a passive way.

(b) Foreign investment policies were used as instruments of technological upgradation. For example, a 'pioneers status' in Singapore was accorded to foreign investment units linked to high technology. In particular, technologies in which the country was either backward or technologies which were considered essential in a strategic way were encouraged.

(c) There has been a link between multi-national companies' activities and foreign trade. To this extent, MNCs play an important role. However, the tax-regime had to be so arranged to ensure that there was no negative flow through transfer pricing.

(d) In the recent past, there is a rapidly expanding role for smaller and medium enterprises. Further, the growth of investment in service sector is far higher than investment in manufacturing sector.

(e) A modern financial sector, combining efficiency and proper regulation is increasingly perceived as an important element of encouraging investment flows.

12.5 **The Committee further noted the following important parameters of a global nature that would determine the scope and limits for foreign investments in the immediate future.**

First, since several developed countries are facing recession, the immediate scope for investment flows into the Indian Economy may be constrained;

Second, even if such flows occur, there may be a tendency for West Europe concentrating in East Europe (and Russia); North America concentrating on South Asia and China;

Third, while Indian liberalisation is impressive with reference to the past, relative to other countries the status of liberalisation and social commitment to liberalisation in future are inadequate; Fourth, the inherent competitive strengths; policy framework such as existing infrastructure (Power, Telecommunications) are still far from adequte to interest foreign investors;

Fifth, the "story" that existing foreign investors have to tell about Indian regulatory framework has to turn positive.

12.6 **The Committee gathered that the current concerns of foreign investors are:**

(a) The dividend repatriation is governed by FERA. While the investors appreciate our impeccable record of automatically permitting repatriation of dividends once the conditions are satisfied, they have a feeling of discomfort because this is in the nature of relaxation of a regulation rather than a right available under law. They are also concerned about complex reporting needs and long-winding procedures becasue this is governed by exemption from regulation.

(b) As regards disinvestment, they appreciate the progress made from the earlier CCI guidelines. However, even though the liberalised framework has been incorporated under FERA, as amended on 8-1-1993, the disinvestment guidelines are still in the form of an administrative decision, and a press release. They have no doubt about transformation into foreign currency once the procedures are followed. However, a transparent formalised policy through law, incorporating the existing status, would be preferred.

(c) While, because of the constitutional and legal provisions in the country, no discrimination is made between an Indian company and a foreign company, unless specified as part of the condition of clearance of such foreign equity, the foreign investors would prefer non-discriminatory element to be codified. No doubt special conditions can be prescribed under such a code.

(d) The restrictions of FERA on employment of foreign nationals have been liberalised on 8-1-1993. It would be easier to transact business if such permissions are codified into a formal law rather than making them permissible by non-restriction.

(e) The policy framework and institutional set up currently in vogue for clearing foreign investment under non-automatic route are in the nature of administrative arrangements. A clear-cut idea about priorities, preferences and procedures would be essential. Hence institutional arrangements for non-automatic route can be formalised and made transparent through a law.

(f) While it is generally appreciated that India does not indulge in nationalisation unless it is in public interest and that too with adequte compensation, a formal incorporation of that provision into a law or treaty would provide the necessary assurances to shareholders of the investing companies.

(g) Certain institutions such as IFC (Washington), have sought and obtained domestic investor status. Instead of passing separate legislation for according such status, this could be incorporated into an investment law, enabling according such status by gazette notifications.

(h) While there are discussions about new instruments of flow of foreign investments such as BOT (built, operate and transfer) there is no clear-cut legal framework governing such operations.

(i) In regard to commercial borrowings, it is appreciated by the informed investors that Government of India's approval is required for every borrowing of a duration of more than one year. This is a requirement under FERA. After such an approval, registration with the Reserve Bank of India is enough to provide the right to the borrower to pay interest and principal on schedule as per the agreement straightway through the authorised dealer. However, there is no formal statement of such rights automatically accruing, though this is the current practice. A formal provision would enable the foreign investors to be convinced about the superfluity of seeking guarantees against transformation or assurance of preferred credit status.

(j) The applicability of laws and the arrangements are governed by individual agreements which are cleared by RBI or filed with RBI. There is no recognised policy and procedural framework so far.

(k) There is no provision for special treatment for foreign investors bringing in high technology. In other words, there is no provision in the existing legal framework which could determine the parameters for according formally a 'pioneer status,' and benefits that could flow.

(l) There are concerns about high rate of taxes, especially capital gains. These should be comparable with other developing countries.

(m) There are, above all, doubts as to whether India can provide reliable infrastructure (given persistent shortages) and skilled labour force (not simply skilled professionals),

(n) Finally, there are, what are described as 'hassle factors' viz., cumbersome procedures for entry, operations and exit.

12.7 **In the light of the above, the Committee recommends the following approach to foreign investments:**

(a) There is a need to have a strategy for attracting investments by country, sources, technologies, size of companies and sectors.

(b) Our growth process is substantially determined by domestic savings and investment; foreign investment plays quantitatively very small but qualitatively a significant part (in terms of foreign trade, technology, competition inducements). The strategy, policy and procedures should reinforce the qualitative aspects.

(c) Government policy towards direct foreign investments has to be discriminating. An open door policy is not likely to produce optimum results unless supported by checks and balances.

(d) Competitive granting of concessions by way of tax or subsidies is neither necessary nor adequate. Government should maximise the benefits from the technology brought in by foreign investors. This can be done by identifying the thrust areas/ sectors for foreign investments, and working out the linkages so that technology gets absorbed at the earliest.

(e) It may be advisable to deemphasize cheap labour availability alone as an incentive for foreign investments — what we should emphasize is skilled and semi-skilled labour, information services, etc. which have better chance of being competitively provided by our economy. This implies focus on services sector.

(f) Our policy of attracting foreign investment into India should be matched by a well worked out policy of encouraging Indian companies to invest in joint collaboration/ takeovers and promote companies in other countries especially in trading blocks like EEC. However, given the balance of payments implications, efforts should be made to emphasize less capital intensive, skill or service oriented activities for Indian investments abroad.

(g) Government policy for foreign investments is perhaps best set in the context of a stable macro economic policy with manageable fiscal deficit, moderate rate of inflation, realistic exchange rate and above all a system of accountability in which the basic economic and legal framework of the country is reliable and adequate.The foreign investors expect the system to guarantee enforcement of contracts and the flexibility to shift investment with the minimum of difficulty. The importance of simple and unified legal framework, limited but effective contact institutions in India and transparent (rather than case by case) approaches should be recognised.

(h) Evolve necessary legal and institutional framework to meet the concerns of foreign investors, in particular, a positive statement of our policies and practices rather than through exceptions.

12.8 **The Committee, having recognised the concerns of the foreign investors, recommends that a National Investment Law be seriously considered codifying the existing policy and practices relating to dividend repatriation, disinvestment, non-discrimination subject to conditions that may be specified, employment of foreign nationals, non-expropriation, and sanction and servicing of external commercial borrowings. Such a law could also provide for enabling policy procedures and institutional framework for approval of investments under non-automatic route, according pioneer status or domestic-investor status, new instruments of private commercial flows, and applicability of local or international laws etc. Such an Investment Law need not in any way exclude consideration of bilateral investment treaties.**

Indian Investments abroad

12.9 Till recently, the effort was to link clearance of Indian equity abroad with export of Indian equipment. Further, we had proceeded under the assumption that capital-flight can occur if we liberalised Indian investments abroad. However, a few months ago there was a relaxation. According to the relaxation, all cash remittances upto US $ 500,000 were approved on automatic basis. The scheme was administered by the inter-Ministerial Committee in Commerce Department. Individual cases in the past and cases other than automatic route in the recent past required approval of Finance Minister and Commerce Minister. FERA was the legal instrument throughwhich this policy and procedure was implemented. The Committee emphasises need to review this policy due to a number of developments. Firstly, when we are liberalising direct foreign investment, we should encourage Indian joint ventures abroad. Secondly, with partial convertibility of rupee, the idea that capital flight has to be controlled through regulatory administration may have to be given up.Thirdly, with increasing opportunities for services sector and skills in India, it should be possible to encourage Indian investments of a less capital-intensive and more skill intensive nature abroad. Fourthly, strategic presence may be needed because of emerging trade blocks such as EEC. Finally, globalisation would involve close interaction between Indian and foreign companies on a global scale. **The Committee noted with satisfaction the most recent liberalisation measures in FERA and recommends that an appropriate framework be evolved to promote Indian investment abroad in desired directions, countries and sectors in addition to liberalising procedures.**

13. EXPORTS

13.1 The viability of the balance of payments and the economic reform programme rests on a robust export performance in the coming years. The macro economic balance in the Eighth Plan suggests an export growth of 13.6% per annum in volume terms which translates into about 15-16% in dollar terms at 1991-92 exchange rate and prices. The achievement of this target is beset with several problems. The world economy is yet to recover from the recession experienced in the past two years. The Indian exporters are still adjusting to the collapse of the erstwhile Soviet Union which was a major market for their products. The domestic industrial production scene is not encouraging. The Indian industry which has been protected far too long is yet to acquire export culture. Infrastructural and other constraints still plague exporters. Procedural complexities, having their origins in an environment where import prevention was of higher priority than export achievement, continue to bedevil the aggressive push that is needed on the export front.

13.2 **Nevertheless, the export targets set forth in the Plan are achievable provided a package of export incentives is appropriately designed. There has to be full recognition that till the end of the Eighth Plan period at least, export incentives should not only remain, but would need to be reinforced. In fact, the export incentive package should form an integral part of the economic reform programme.**

13.3 The experience of successful exporting countries including the East Asian economies expansion, export incentives are required to complement exchange rate and import liberalisation policies to enable exporters to compete effectively with foreign competitors in world markets on an equal footing. This is also necessary to make exports as profitable as domestic sales. Hence, there is a case to provide incentives to the export sector to neutralise the effects of high tariffs, high interest rates, inflation and high infrastructural costs.

13.4 It is, however, recognised that direct export incentives are temporary arrangements and, over the medium to long-run, the export environment must be stimulated by exchange rate policy; rationalised tariff system where protection is based only on tariffs and not quantitative restrictions; product specific and market specific promotion and marketing strategies; and macro-economic stability.

13.5 To achieve the targets set forth in the Eighth Plan and reflected in the Balance of Payments projections in this Report, the Committee recommends the following:

(a) Movement towards fuller convertibility of the rupee since partial convertibility imposes a tax on exports;

(b) Reforms in interest rates on export credit to ensure reasonable costs to exporter;

(c) Stability of existing export incentives i.e. an assurance that the incentives would continue;

(d) Encouraging deemed exports by measures such as freedom for Indian bidders to bid in foreign currency when they bid under ICB procedures; (since implemented)

(e) Simplification of Export-Import Policy especially replacing quantitative curbs on exports with duties; and

(f) Procedural Reforms; including removal of the procedural complexities that still exist in our customs, banks, ports, import licensing in DGFT's organisation, and various departments/agencies of the Central and State Governments to align them with the practices prevailing in the rest of the world.

13.6 Given such an export environment, the targets set forth in the Five Year Plan and reflected in the Report, though formidable, is well within our reach. This is so since the share of Indian exports in total world exports is abysmally low at 0.5% and major items of our export form a small proportion of the imports of these goods by our trading partners (0.2%). Moreover, the share of exports to GDP at around 6-7% is not fully compatible with the capabilities of the country.

14. BOP PROJECTIONS FOR MEDIUM-TERM

14.1 In line with the considerations and proposed approach on the different elements in the balance of payments, projections have been made for the medium-term time frame coinciding with the Eighth Plan period.

14.2 In making the balance of payments projections the Committee has kept in view (a) the macro-economic parameters as envisaged in the Eighth Plan, (b) likely impact of the policy changes, (c) outlook and prospects of international trade, and (d) updated estimates for 1991-92 and the latest available estimates for 1992-93.

14.3 The BoP projections for the period 1992-93 to 1996-97 mainly suggest that, to sustain the level of foreign exchange reserves considered necessary minimum by the Committee over the medium-term, to maintain on average a current account ratio not exceeding 1.6 and to control the external debt level, the different components of the BoP will have to be targeted and realised in a manner consistent with the medium-term projections estimated by the Committee.

Exports

14.4 An average annual growth in exports of at least 15 per cent in dollar terms over the

medium-term is considered necessary as well as feasible. The Committee considers the export component as the most crucial one to meet the sustainable level of CAD. In projecting the 15 per cent growth rate for export, the Committee has assumed recovery in international trade from 1993-94 onwards on the basis of the latest available indications from the growth prospects as well as trade outlook for the developed countries, the envisaged growth in industrial sector during the Eigth Five Year Plan, impact of changes in trade policy and exchange rate policy and likely influence of direct foreign investments particularly in the export-oriented sectors. **The Committee, therefore, strongly recommends that the trade policy and exchange rate regime be managed not only in a stable manner but also induced towards export orientation.**

Imports

14.5 Growth in imports during the medium-term is estimated to be higher than what the Plan estimates assume because of the large decline in the base. Thus in dollar terms the imports are estimated to grow by about 12% per annum compared with a volume growth of 8.4% assumed in the Eighth Plan estimates. Reducing the scope and control on imports through the Foreign Exchange Budget mechanism with an objective to finally eliminate the FEB mechanism, free access of foreign exchange to PSUs, measures to decontrol the imports through trade policy changes, increase in export-related imports, and a likely slow recovery in domestic output of crude and petroleum products at least in the next one or two years lead the **Committee to believe that the imports growth rate may be marginally higher than what has been estimated on the basis of import elasticity to GDP at 1.5 for the past.**

Invisibles

14.6 **Net inflows in the 'Invisibles' component of the current account are estimated to contribute almost a negligible share even though there would be a turnaround from a net outflow within a year or two.** Travel receipts can contribute to a limited extent only in increasing net receipts in the 'invisibles' account. A 10 per cent growth in dollar terms through travel receipts on a recovered base for 1992-93 should be possible once the policy changes in tourism sector are implemented. However, there are reasons to believe that travel payments may also increase by about 9 per cent per annum as a result of liberalisation in exchange controls, abolition of travel tax and other related policy measures. Net receipts on transportation account based on export related transactions for inflows and the time trend for outflows do not suggest any significant contribution. Another major component under invisibles account, viz., interest payments has been estimated on the basis of projections of debt servicing on the loans outstanding as at end-March 1991, transactions with IMF as included in the capital account and estimated borrowings during the medium-term as incorporated in these projections. As for private transfer receipts, a 10 per cent growth in dollar values has been assumed considering that reconstruction activities in the Gulf region would lead to increased emigration, the proportion of skilled and professional labour force emigrating would increase and remitting money through this channel would continue to remain attractive consequent upon the exchange rate policy changes.

Current Account Balance

14.7 The projections for different components in the current account would result in a declining Current Account Deficit (CAD)/GDP ratio from estimated 2.9 per cent in 1992-93 to 0.5 per cent in 1996-97 and an average of 1.6 per cent during the five year period. **The Committee feels that this order of current account deficit viz 1.6 per cent of GDP can be met through a sustainable level of net capital receipts.**

Capital Account

14.8 Medium-term projections for the different components in the capital account are mainly based on the considerations and recommendations made by this Committee in respective chapters.

14.9 Based on the estimates for current account and capital account components over the

medium-term it is clear to the Committee that the need for exceptional financing arrangements of the order of $ 3 billion per year on gross basis would be necessary during the medium-term. However, this would be reduced somewhat through better export performance, better 'invisible' receipts and higher investment inflows all of which is not impossible.

15. BALANCE OF PAYMENTS — STATISTICAL ISSUES

15.1 A reference was made by the Government to the Committee to give its recommendations on the discrepancies between the value of imports as reported by the DGCIS and those reported by the Reserve Bank of India. The Committee had the benefit of preliminary notes and discussions held by a separate Committee appointed by RBI for the purpose sometime ago. The Committee had the benefit of the Report of the Policy Group on External Debt Statistics constituted by the Reserve Bank of India.

15.2 In the light of these, it has been possible to identify the reasons for the discrepancies:—

(a) The single largest item accounting for the difference appears to be the payments on account of defence. Some of the imports by the Ministry of Defence and the Defence public sector undertakings pass through customs and they are incorporated in the data accordingly. However, other purchases on account of defence are paid through deferred payment arrangement. These are not formally recorded as debt in the Ministry of Finance, Government of India, and these are also not recorded as external commercial borrowings by the Reserve Bank of India. Under the circumstances, all payments made towards discharging the past obligations by the Defence Department both to rupee payment area and general currency area get reflected in the difference between the DGCIS statistics and the balance of payment data.

(b) In addition, some imports made by Defence and other security organisations claim exemption from customs declaration and as such do not get reflected in the DGCIS statistics.

(c) There are differences in the valuation methods of foreign currencies between the Reserve Bank of India and Customs.

(d) There are leads and lags in physical imports and payments. They distort the picture in particular years when there are large transactions.

(e) Some cases, where payments are made by ONGC for acquiring material for its overseas operations, may not be reported to Customs. Similarly, acquisition of ships, civilian aircraft and other assets offshore by shipping companies and airlines may not get reflected in the customs data.

15.3 **Having identified, the major reasons, the Committee recommends the following changes in the compilation and presentation of the balance of payment statistics.**

(a) All defence debt may be formally registered as commercial debt whenever it is for more than one year, and trade-related debt whenever it is for one year or less as is the normal practice.

(b) Debt in respect of rupee payment area may be reflected separately in the capital account without making a distinction between principal and interest, consistent with recently concluded Rupee-Rouble agreement.

(c) In respect of defence debt to general currency area, differentiation may be made between principal and interest according to loan agreements. All such agreements may be treated on par with other commercial borrowings in regard to procedures of registration with the Ministry of Finance and the Reserve Bank of India. Consequent changes in presentation of balance of payments statistics to show interest under invisibles and principal under capital account will have to be made.

(d) Where imports do not pass through Customs declarations, concerned agencies may be requested to report in a consolidated form, the value of imports on a routine basis for purposes of incorporation into the customs data.

(e) *Information system may be established* through Ministry of Shipping and Ministry of Petroleum to obtain information on payments made but not reflected in Customs in respect of shipping companies and ONGC, since goods do not enter the country.

15.4 **The Committee further recommends that a Technical Group be appointed by Reserve Bank of India with representatives from the Ministry of Finance and the Ministry of Commerce similar to the Policy Group on External Debt Statistics, to review in detail the *timeliness, the compilation methods and the* suitability of reporting systems for purposes of management of balance of payments.**