India has managed its external sector well

Forex reserves are healthy and CAD is sustainable, thanks to encouraging long-term non-debt creating capital inflows

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India has faced two major crises in a span of three decades — the 1990-91 balance of payments (BoP) crisis and the Covid-19 pandemic in 2020-21. While the origins and interplay of economic factors of the two crises are totally different, there is one notable differentiating factor.

India's foreign exchange reserves at $4.7 billion in June 1991 were just adequate to finance 15 days of imports. On the other hand, as at June 4, 2021, despite facing a turbulent year of the pandemic, these reserves at $605 billion cover imports of more than 18 months.

The journey between these two milestones is a valuable case study of calibrated management of the external sector in India. It evinces that lessons learnt from a crisis are an opportunity to strengthen the ability of structural systems to weather another crisis better.

The BoP crisis of 1990-91 had its roots in a widening current account deficit in the 1980s, financed by debt-creating commercial borrowings — especially of short-term nature, NRI deposits and exceptional financing in the form of IMF loans as the conventional official concessional sources of finance waned.

Drawing from these lessons, it was recognised that current account deficits were to be maintained around sustainable levels and short-term debt-creating flows were to be de-emphasised, while long-term non-debt creating flows, encouraged. It was also recognised that market-determined exchange rate, acting as an automatic stabiliser, was critical for ensuring the sustainability of current account balance. The intellectual blueprint for reforming India's external sector was laid by the Rangarajan Committee Report, 1993. It made far-reaching recommendations including, but not limited to (i) restrictions on size, maturity and end-use of ECBs; (ii) LIBOR-based interest ceiling on non-resident deposits to discourage the volatile component of such deposits; (iii) pre-payment and refinancing of high-cost external debt; and (iv) measures to encourage non-debt creating financial flows such as foreign direct investment (FDI) and foreign portfolio investment (FPI).

The transition to the market-determined exchange rate was done in two stages with putting in place of the dual exchange rate system viz., Liberalised Exchange Rate Management System (LERMS) in March 1992 and eventually replacing it with a unified market-determined exchange rate regime in March 1994.

These exchange rate reforms were accompanied with the adoption of current account convertibility in August 1993.

Capital account convertibility

The Rangrajan Committee recommended the compositional shift of the capital account from essentially financing the current account deficit in 1980s to emerging as the pillar of support for the external sector.

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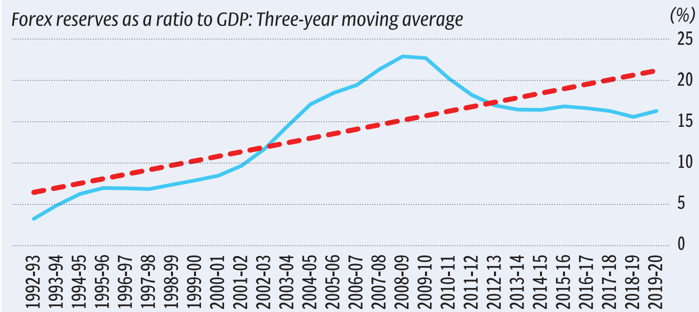
Capital account convertibility was viewed as a graduated process rather than a one-time event. This Indian approach and experience contrasts that of many other emerging market economies, which liberalised their capital accounts in haste and had to revert them in the wake of adverse macroeconomic outcomes. The Indian stance on capital account was also at odds with the IMF's 'Washington Consensus'. It may not be out of place to mention that the IMF has recently supported the Indian approach to capital account convertibility.

Sustained accretion to foreign exchange reserves

Forex reserves as a ratio to GDP: Three-year moving average



Source: Authors' calculations

The New Industrial Policy Statement of 1991 heralded a new push towards attracting FDI in India. At present, FDI is permitted under automatic route in most sectors except for a small negative list.

There has been a gradual approach towards liberalisation of the policy governing FII investments with (a) liberalisation of investment limits, (b) relaxation of eligibility conditions, (c) expansion of instruments eligible for FII investments, and (d) procedural simplifications.

It has been India's long-standing policy to encourage capital inflows with a bias towards flows that are stable, long term and least prone to sudden stoppages/reversals. The ECB framework has also evolved over the years with calibrated regulations on quantum of loan, end use, tenor, lender credentials and cost of borrowing.

Reflecting the above-mentioned policy regime, the ratio of current account deficit to GDP has had a downward trajectory and averaged 1.2 per cent during 1990s and fell to 0.5 per cent during 2000s, before rising to 2.2 per cent in 2010s.

On the other hand, the ratio of capital account surplus to GDP witnessed an upward trajectory during the period under review, while the ratio averaged 2.3 per cent during the 1990s, rose to 3.4 per cent during the next decade of 2000s, before moderating to 3.1 per cent during 2010s.

Foreign investment as a ratio to GDP averaged 0.9 per cent during 1990s, rose to 2.7 per cent during 2000s, before moderating to 2.5 per cent.

On the contrary, the debt-creating inflows, viz., ECBs as a ratio to GDP witnessed a downward trajectory as it remained at 0.5 per cent during the 1990s and 2000s and fell to 0.3 per cent in 2010s. The consistently increasing surplus on the capital account, larger than the current account deficit over the years, culminated in steady accretion to foreign exchange reserves.

Now, the adequacy of the stock of foreign exchange reserves is more than satisfactory, measured in terms of a host of external vulnerability matrices — leading to debates that we have 'surplus'!

Stress test

Thus, learning from the BoP crisis, India created an opportunity and reworked its external sector management.

A sustainable level of current account deficit, financed predominantly by non-debt creating longer-term capital inflows underpinned by a market-determined exchange rate regime emerged as the cornerstones of the external policy-framework.

The Covid-19 pandemic has served as a stress test for the current policy framework and enabled the external sector to emerge as a much-needed cushion for stability during these pandemic times.

The above case study reinforces the credibility of India's reform process, capable of turning crisis into opportunity, the relevance of which could hardly be over-emphasised in the current pandemic situation.

The writers are Adviser and Director, respectively, at the Ministry of Finance. Views are personal