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ADB INDIA Economic Bulletin

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India: Key Economic Indicators

Variables	Unit	Period/Date	Current	% Change[1]
GDP at Factor Cost (1999-00 prices)	Rs. Billion	FY2005*	25,866	8.1
● GDP in Agriculture	Rs. Billion	FY2005*	5,086	2.3
● GDP in Industry**	Rs. Billion	FY2005*	6,787	9.0
Of which GDP in Manufacturing	Rs. Billion	FY2005*	3,949	9.4
● GDP in Services***	Rs. Billion	FY2005*	13,993	9.8
Industrial Production – General (1993-94=100)	Index	April 2005 – February 2006	218.6	8.0
Industrial Production – Manufacturing (1993-94=100)	Index	April 2005 – February 2006	242.3	9.0
Wholesale Price – All Commodities (1993-94=100)	Index	FY2005	195.6	4.4
● Primary Articles	Index	FY2005	193.8	3.0
● Manufactured Articles	Index	FY2005	171.5	3.1
Consumer Price (Industrial Worker) (1982 =100)	Index	April 2005 – January 2006	540	4.2
Broad Money (M3)	Rs. Billion	17 March 2006	26,241	16.5
RBI's Credit to Commercial Sector	Rs. Billion	24 March 2006	13.9	-0.2
RBI's Credit to General Government	Rs. Billion	24 March 2006	160.54	-
Consolidated Fiscal Deficit / GDP	%	FY2005	-7.7	-
Domestic Public Debt	Rs. Billion	July-September 2005	13,702	2.3
Exports	$ Billion	April-December 2005	73.6	27.7
Imports	$ Billion	April-December 2005	115.1	36.9
Trade Balance / GDP	%	April-December 2005	-7.1	-
Current Account Balance / GDP	%	April-December 2005	-2.3	-
International Reserves	$ Billion	24 March 2006	148.7	-
External Debt	$ Billion	30 September 2005	116.0	9.8
External Debt to GDP Ratio	%	31 March 2005	17.3	-
Debt Service Ratio	%	FY 2004	6.2	-
Foreign Exchange Rate, Spot	(Rs./$)	24 March 2006	44.67	-1.9
Nominal Effective Exchange Rate (FY1993 =100)	Index	April-November 2005	90.2	-
Real Effective Exchange Rate (FY1993=100)	Index	April-November 2005	103.1	-

Note: FY stands for the financial year (1 April to 31 March).
[1] Percentage change over the corresponding reporting period in the previous year.
* Advanced estimates by Central Statistical Organization (CSO), Ministry of Planning, Government of India.
** Industry includes manufacturing; mining and quarrying; electricity; gas and water supply; and construction.
***Services sector comprises of trade, hotels, transport and communication; financing, insurance, real estate and business services; and community, social and personal services.

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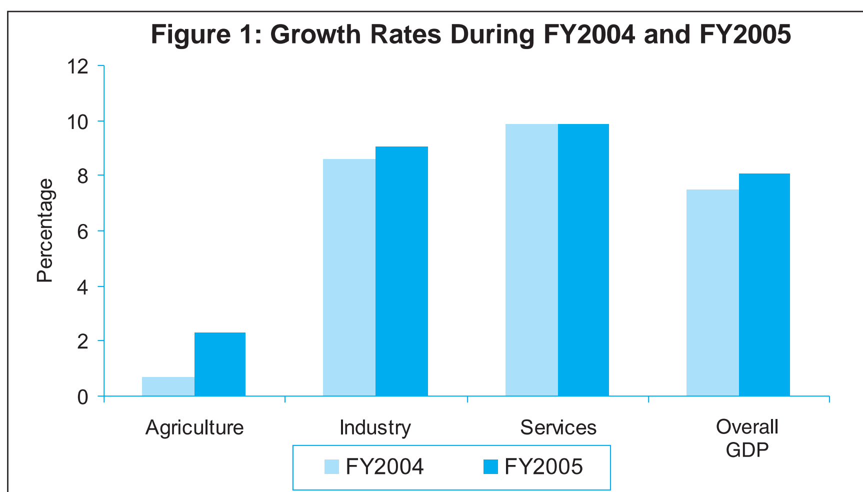
I. Growth Performance

High growth for third successive year

1. Moderate recovery in agricultural growth and a steady expansion of industry and services have contributed to a high GDP growth in FY2005 (8.1 %) (Figure 1). High growth during the past three years, coupled with a strong pick up in industrial investment and modest inflation, has given rise to expectations of continued growth momentum in FY2006. However, despite strong growth momentum in recent years, it is expected that average annual growth will be around 7%, during the 10th Plan period (2002-2007), below the target of 8% growth due to a low growth rate of only 3.8% in FY2002.

Figure 1: Growth Rates During FY2004 and FY2005



Service sector led growth

2. Over the last decade, the growth of the Indian economy has been propelled primarily by the services sector. The performance of agriculture has been marked by significant volatility, particularly since 1997-98. Industry though registering a buoyant growth, has been unable to increase its share in the total domestic product over the years. Only the services sector, which now collectively accounts for more than half of GDP, showed not only remarkable stability but also significant growth acceleration from an already high base. The contribution of the services sector to GDP growth during the 1980s was 47.2%. The contribution

increased to 56% during the 1990s and further to 62.3% during FY2000 to FY2004.

3. A breakdown of service sector activities into subsectors (Table 1) shows that trade accounts for slightly over a quarter and their share has declined between the 1980s and early 2000. Within the aggregate of real estate and financial services, the share of financial services has increased sharply, and in the transport sector, the railways losing some share to transportation by other means.

Table 1: Shares of Service Activities in Aggregate Service Sector GDP (%)

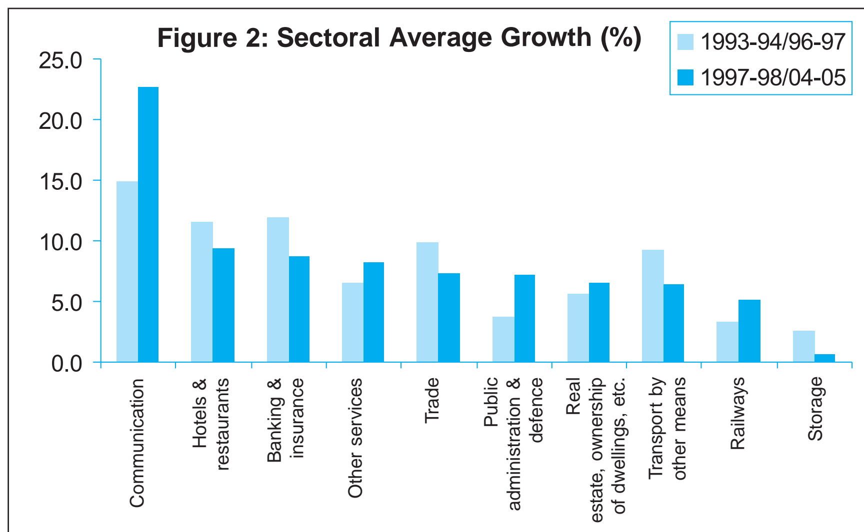
	1970s	1980s	1990s	2000-01/ 2004-05
Trade	26.1	29.4	28.4	26.9
Real estate, ownership of dwellings & business services	21.3	16.0	13.3	15.7
Public administration & defence	14.2	14.3	13.2	12.1
Banking & insurance	6.9	8.9	12.7	11.5
Transport by other means	7.2	8.2	9.4	9.9
Communication	1.7	1.9	2.9	3.3
Hotels & restaurants	1.6	1.8	1.9	2.6
Railways	3.4	3.1	2.6	2.0
Storage	0.2	0.3	0.2	0.1
Other services	17.2	16.1	15.4	15.8

Source: National Accounts Statistics

What drives service sector growth

4. Over the last decade, the categories that have shown buoyant growth are communications; other services; and real estate, ownership of dwellings and business services (which includes the IT and IT enabled services). While services as a whole has registered a pick up in growth rate over the two periods, this acceleration was dampened by decelerations in several subsectors, the most significant of these in trade, which is also the largest sector (Figure 2). Banking, insurance and financial services also saw a deceleration. While some of these patterns are sensitive to the choice of the dividing line between periods, the decline in growth in value added in trade as well as in hotels and restaurants

may well reflect increasing competition in these activities. Other services, which include health and education, also showed a noticeable acceleration in the later period. These patterns suggest that even though there has been overall buoyancy in the services sector, that buoyancy has not impacted all the activities uniformly. Such a pattern is attributable to a mix of sector specific macroeconomic and microeconomic factors such as infrastructure bottleneck, and lack of a comprehensive policy for the services sector. Competition from the low cost airlines is one of the important factors affecting railways.



Agricultural growth remains unsatisfactory

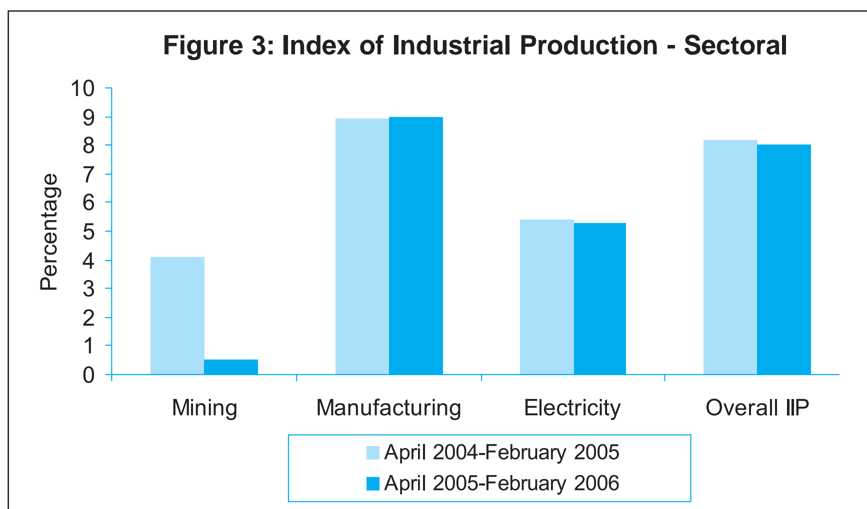
5. The performance of agriculture however has remained unsatisfactory. Agricultural growth (2.3%) has been higher in FY2005 but is much less than the targeted annual growth rate of 4% envisaged in the 10th Plan.

Manufacturing drives industrial growth

6. Despite a drop in the growth rate of the Index of Industrial Production (IIP) during April-February FY2005 when compared with the similar period in FY2004, robust growth momentum continues in industrial production (Figure 3). This gives rise to expectations of an industrial resurgence. The manufacturing sector continued to show high

growth (9%) but fell short of the 10th Plan target of 10%. The broad manufacturing groups which registered over 10% growth during this period were beverages, tobacco and related products; cotton textiles and textile products; basic chemicals and chemical products; non metallic mineral products; basic metal and alloy industries; machinery and transport equipment. In general, manufacturing industries which were either technology intensive or export intensive showed higher growth. The manufacturing groups that showed negative growth include food products, wool, silk and man-made textile fibers; wood and wood products; leather and leather products and metal products. Various studies have shown that though there has been an impressive increase in the volume of production and exports in Indian manufacturing, the growth in total factor productivity was negligible in the 1990s (see *Economic Survey 2005-06*; p.136). The Federal Government is attempting to initiate structural reforms to increase the industrial growth rate over 12% in a sustained manner. Recent policy announcements to bring about modernization and efficiency gains include the decision to allow large players in 180 industries currently reserved for the small scale sector. These include auto components, chemicals and transport components.

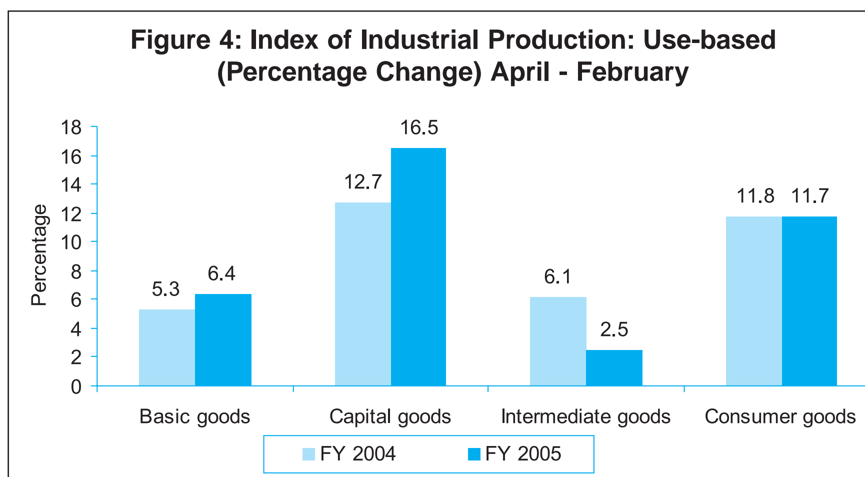
Figure 3: Index of Industrial Production - Sectoral



7. The use-based classification shows that the capital goods sector is the prime mover of industrial growth in FY2005, followed by consumer goods (Figure 4). Within the capital goods sector, higher contribution to growth came from the machinery and equipments sector. Production of power and distribution transformers; and locomotives also registered strong growth. Judging by the growth profile of capital goods, it is expected that the investment rate will surpass the FY2004 level of 30% of GDP.

Capital goods sector prime mover of industrial growth

Figure 4: Index of Industrial Production: Use-based (Percentage Change) April - February



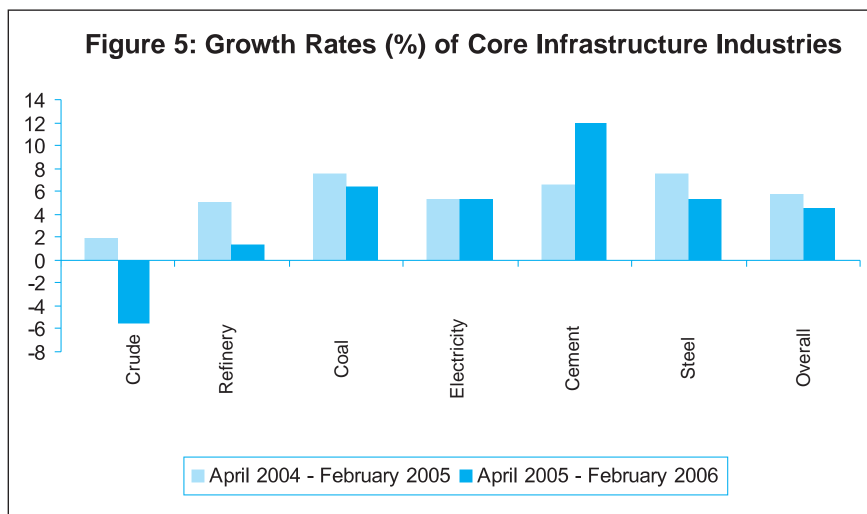
8. Poor performance of mining and electricity continued. The index of industrial production was dampened due to poor performance of the electricity and mining sectors which together contribute to a little more than 20% of the index.

Poor performance of mining and electricity

9. The six critical infrastructure industries grew by 4.5% in FY2005 (April-February), which is lower than in the corresponding period last year. High negative growth in crude oil production (-5.5%) and low growth in the refinery sector (1.4%) were responsible for lower growth in infrastructure industries. Coal and steel grew at much lower rates during this period. There was a marginal decline in the growth of electricity

Slower growth in infrastructure industries

(5.3%) during this period. However, cement production showed a very high growth of 11.9% (Figure 5) supported by booming construction activities.



II. Money, Equity Market and Inflation

Strong growth in money supply

10. Money supply continues to maintain a strong growth of around 16% in FY2005, attributable primarily to a strong demand for bank credit by the commercial sector. The domestic interest rates are now rising. The State Bank of India (SBI) raised interest rates on term deposits of maturity between one and three years, and three and five years by 25 basis points to 6.25% and 6.50% respectively. The interest rates on term deposits of maturity of five years to ten years have been raised by 50 basis points to 7%. Consistent to this development, SBI has also raised the benchmark prime lending rates (PLR) by 50 basis points to 10.75%. The home loan rates - both fixed and floating - have also been raised by 25-50 basis points. The main policy stance of the recently announced Monetary and Credit Policy for FY2006 is to ensure a monetary and interest rate environment that enables continuation of the growth momentum with

price stability. Although the bank rate has not been changed in the annual policy statement, it is expected that the monetary policy stance of RBI will be less accommodating in the coming months. The secondary equity markets rallied strongly during FY2005. The Bombay Stock Exchange's Sensitivity Index (SENSEX) crossed 12,000 marks in April. The rally in the stock market was broad based across sectors and the buoyancy in the stock market is attributed to strong fundamentals of the economy, liquidity support from the mutual funds and strong FII flows.

Moderate inflation

11. The overall rate of inflation remained at a very moderate level of 4.5% in FY2005, despite an acceleration in the rate of inflation of primary articles (Figure 6). This was mainly due to costlier food articles especially pulses, meat and fish which registered the highest rise. The percentage increase in the fuel group price index registered a sharp decline in November 2005, and remained relatively stable thereafter. The rate of inflation in the manufactured group has registered an overall declining trend in FY2005.

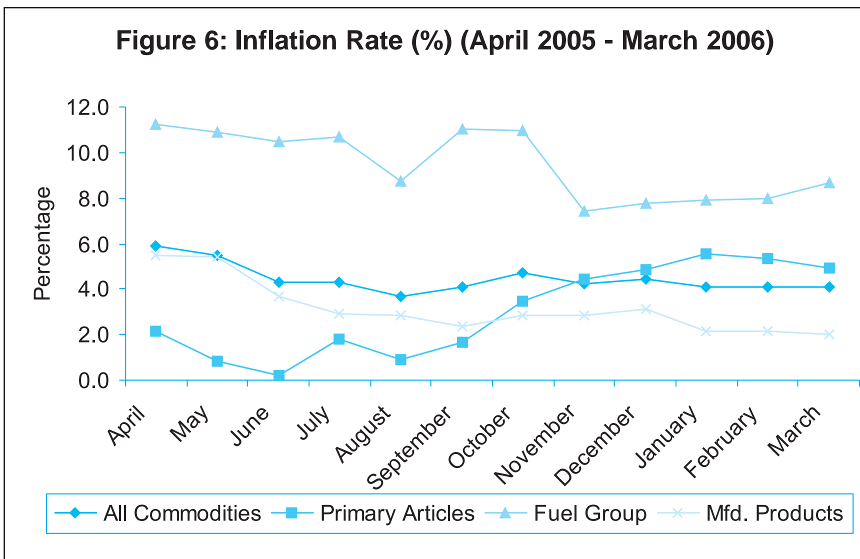
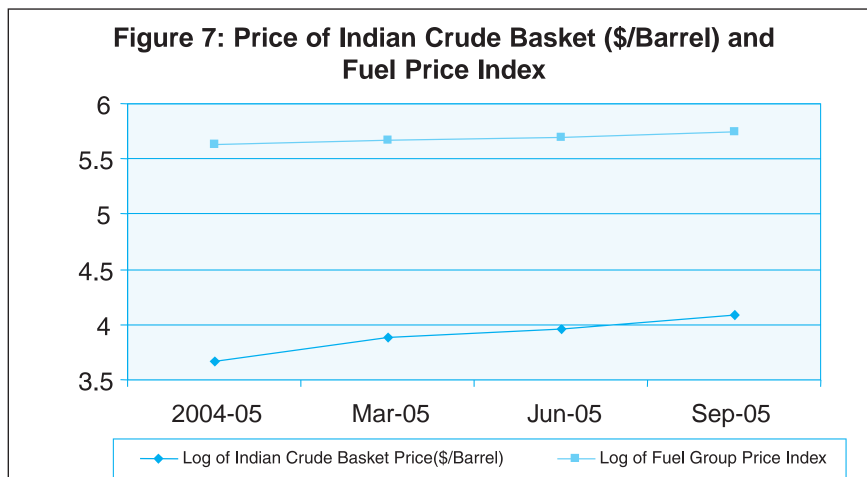


Figure 6: Inflation Rate (%) (April 2005 - March 2006)

12. However, incomplete pass-through of international oil prices remains a cause for concern, especially given the reemergence of volatility in prices. Thus, despite a rapid rise in international crude prices, domestic inflation has been contained at a moderate level in FY2005. For example, the average price of the Indian basket of international crude varieties (comprising Brent and Dubai Fateh) remained at around US $60.0 per barrel in October-January, which was 3.8% lower than in the preceding quarter but 41.5% higher than a year ago. However, rises in domestic prices of petrol and diesel have been proportionately much less. Thus, pass-through remains incomplete in respect of petroleum products, and, therefore, remains a source of build-up of inflation expectations in FY2006. The incomplete pass-through is also revealed in Figure 7.

Incomplete pass-through

Figure 7: Price of Indian Crude Basket ($/Barrel) and Fuel Price Index



III. Federal Budget

13. The Federal Budget for FY2006 has been prepared against a background of strong growth, moderate inflation, rising tax to GDP ratio, and a comfortable foreign exchange reserve position. Inflation of around 4% and expected GDP growth of 8% in FY2005 have provided significant fiscal space to increase spending without a further deterioration of the deficit. Despite additional expenditure commitments for various social

Strong macro fundamentals

sector programs, the process of fiscal consolidation continued in FY2006. Both revenue deficit as well as fiscal deficit are targeted to be lower in FY2006 as a percentage of gross domestic product (GDP). This is primarily attributable to better tax efforts. The gross tax revenue to GDP ratio rose from 8.3% in FY1998 to 10.5% in FY2005. It is further projected to rise to 11.2% in FY2006. Expenditure rationalization was also achieved leading to a stagnant expenditure to GDP ratio at around 14.3% between FY2005 and FY 2006. Consequently, deficit indicators for FY2006 are in line with the Fiscal Responsibility and Budget Management (FRBM) roadmap, which envisages an annual reduction of at least 0.3 percentage points in fiscal deficit. Fiscal deficit as a percentage of GDP is projected to decline to 3.8% in FY2006 from 4.1% in FY2005 (Table 1).

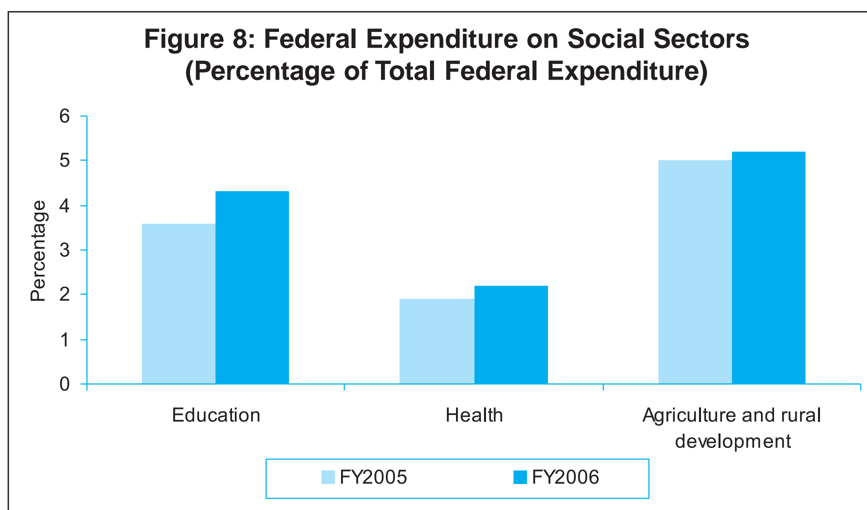
Higher allocation for social sectors

14. On the expenditure side the budget has attempted to facilitate implementation of some of the goals of the Common Minimum Programme (CMP), the vision statement of the UPA government. It is envisaged that the bulk of spending will focus on eight flagship social sector programs. These programs are Sarva Siksha Abhiyan, Mid-day Meal Scheme, Rajiv Gandhi Drinking Water Mission, Total Sanitation Campaign, National Rural Health Mission, Integrated Child Development Services, National Rural Employment Guarantee Scheme and Jawaharlal Nehru National Urban Renewal Mission. The total allocation for these programs has been raised by 43.2% from Rs349 billion in FY2005 to Rs500 billion in FY2006. Larger budgetary support has also been provided for the *Bharat Nirman Program*. A separate corpus of Rs40 billion has been created under the Rural Infrastructure Development Fund (RIDF) for rural roads.

15. The significant push to social sector programs resulted in an increase

in priority spending relative to total expenditure (Figure 8). Thus, total federal expenditure on education is 4.3% of total expenditure in FY2006 as against 3.6% in FY2005, and federal expenditure on health program at 2.2% of expenditure is higher than 1.9% in FY2005. Similarly, federal spending on agriculture and rural development amounts to 5.2% of total expenditure in FY2006 as compared to 5% in FY2005. Expenditure in this year's budget appears to be more geared towards targeting non-income dimensions of poverty.

Figure 8: Federal Expenditure on Social Sectors (Percentage of Total Federal Expenditure)



No new tax proposal

16. On the revenue front, no new tax proposals are being proposed. However, an attempt has been made to rationalize indirect taxes, and remove some of the ineffective indirect tax exemptions. Major revenue proposals in the budget include a reduction in the peak rate of customs duty on non-agricultural products from 15% to 12.5%, and reduction in the duties on raw materials and intermediates in a consistent manner. As a result of the proposed changes, simple average tariff for non-agricultural goods has been reduced from 14.45% to 12.12%. On the excise side, the major thrust is to expand the tax base, rather than increasing the rate. An attempt has also been made to converge all excise rates to the Central

VAT (CENVAT) rate which is now 16%. Therefore, some rates have been reduced, especially on cars and aerated drinks. However, the cess on domestically produced crude has been raised from Rs1800 per ton to Rs 2500 per ton. The Finance Minister has assured that this increase will be absorbed by the oil producing companies. To promote manufacturing, excise duty on several processed food products, shoes, and small cars are either abolished or significantly reduced. The service tax rate has been enhanced from 10% to 12%, with some extension of coverage. A new tax on fringe benefits was introduced in the last year's budget. Following initial reactions from the industry, some features of the new tax have been redesigned. Tax rates for both personal income tax and corporation tax remain unchanged. Major thrust is also provided on modernizing tax administration. It is proposed that the Department of Income Tax and Customs and Central Excise will undergo Business Process Reengineering (e.g., registration of taxpayers, rationalization of forms, improved scrutiny/auditing etc.).

17. Other policy statements made in the budget are:

Other infrastructure proposals

Telecommunication: More than 50 million rural connections will be given in three years, and thereafter telephone connection will be available on demand.

Power: Five ultra mega power projects (Chhattisgarh, Madhya Pradesh, Gujarat, Karnataka and Maharashtra) will be awarded by 31 December 2006. It is also proposed that 50,000 additional villages will be electrified by FY2006.

Road Transport: 1,000 km of access controlled expressways are being proposed. Construction of these roads will be based on the design, build, finance, and operate (DBFO) model. The sections that have been identified are Vadodara-Mumbai, Delhi-Chandigarh, Delhi-Jaipur, Delhi-

Meerut, Delhi-Agra, Bangalore-Chennai and Kolkata-Dhanbad. It is also proposed that the National Highway Authority of India (NHAI) will be restructured and will be made more effective to process public private partnership (PPP) projects.

Ports: The budget highlights the need for massive investment (Rs558 billion) for the port sector including inland waterways. A proposal to build a deep draft port in West Bengal is currently being considered.

Tourism: Tourism development proposals include (i) 15 tourist destinations and circuits following an integrated area development approach will be promoted; (ii) 50 villages with core competency in handicrafts, handlooms and culture will be developed for enhancing tourist attractions; and (iii) 4 new institutes of hotel management will be set up.

Irrigation: A mega project to repair and restore water bodies is currently ongoing through pilot projects in 23 districts of 13 States. The design of the program has been finalized in consultation with the States, and 20,000 water bodies with a command area of 1.47 million hectares have been identified in the first phase. The cost of the project is estimated to be Rs45 billion. Multilateral agencies' participation in these projects has been sought by the Government.

Microfinance: A Bill to promote, develop and regulate the microfinance sector will be introduced in Parliament soon. A credit enhancement proposal for Self Help Groups (SHGs) has also been introduced in the Budget.

Other Proposals: Important among these are plans for setting up of a Pension Fund Regulatory and Development Authority; increasing the limit of FII investment on government securities; allowing a limited number of qualified mutual funds to invest in overseas exchange traded funds cumulatively upto $1 billion; creation of a single, unified exchange-

traded market for corporate bonds; guaranteed short-term credit for farmers at 7% rate of interest; promoting public-private partnership to set up terminal markets for horticulture and fisheries; dereservation of 180 items from the list of small scale industries; and launching of National e-governance plan in FY2006. Another major policy decision is the intention to move to an integrated goods and service tax by 2010.

Table 2: Budget at a Glance

Figures in Rs. Billion		FY2004 Actual	FY2005 Revised Estimate	FY2006 Budget Estimate
I.	**Revenue Receipts**	3,060	3,485	4,035
	Ia. Tax revenue	2,248	2,741	3,272
	Ib. Non-tax revenue	812	743	763
II.	**Non-Debt Capital Receipt**	665	141	118
	IIa. Recoveries of loans	620	117	80
	IIb. Other receipts	44	24	38
III.	**Total Expenditure**	4,977	5,087	5,640
	IIIa. Revenue expenditure	3,844	4,403	4,882
	IIIb. Capital outlay	1,133	684	758
IV.	**Revenue Deficit**	783	918	847
V.	**Fiscal Deficit**	1,252	1,462	1,487
VI.	***Memo*: Revenue Deficit to GDP (%)**	2.5	2.6	2.1
VII.	***Memo*: Fiscal Deficit to GDP (%)**	4.0	4.1	3.8

18. Overall, the Federal Budget fares reasonably well in terms of containing the deficit and improving macroeconomic management. The main strategy of this year's Federal Budget is to ensure that the pace of consensus based reform, as required in coalition politics, is maintained.

IV. Balance of Payments Developments

Current account deficit moderated in the third quarter

19. The current account deficit has reduced to $3.85 billion in the third quarter of FY2005, against $5.44 billion in the corresponding quarter of FY2004, and $5.05 billion in the previous quarter of the current year. This is primarily attributable to a sharp decline in imports growth in the third quarter (Table 3). Import payments showed a moderate growth of 18% during the quarter. Oil import during the third quarter remained

steady; however non-oil imports witnessed a slowdown. The structure of non-oil imports shows that imports of manufactured goods and capital goods have accelerated while imports of export related items, raw materials and intermediates have decelerated. Overall imports grew by 37% during the first three quarters of FY2005 (April-December). Exports maintained a buoyant growth of 27% in the third quarter leading to a growth rate of 28% for the period April-December 2005. The exports of agriculture and allied products, and manufactured goods have accelerated during the first three quarters of FY2005 (April-December). Within manufactured goods, exports of readymade garments and handicrafts have shown strong growth. The trade deficit for the third quarter of FY2005 decreased to $12.02 billion from $14.6 billion in the second quarter. Trade deficit remains at $41.5 billion for the entire period of April-December 2005.

20. The net invisibles grew by 30% to $8.17 billion, reflecting the pace of growth in travel earnings; business, professional, and software services; and remittances. Despite the large trade deficit, the growth in the net invisibles helped in moderating the current account deficit.

Table 3: India's Current Account Situation (April - December 2005)

US $ mil.

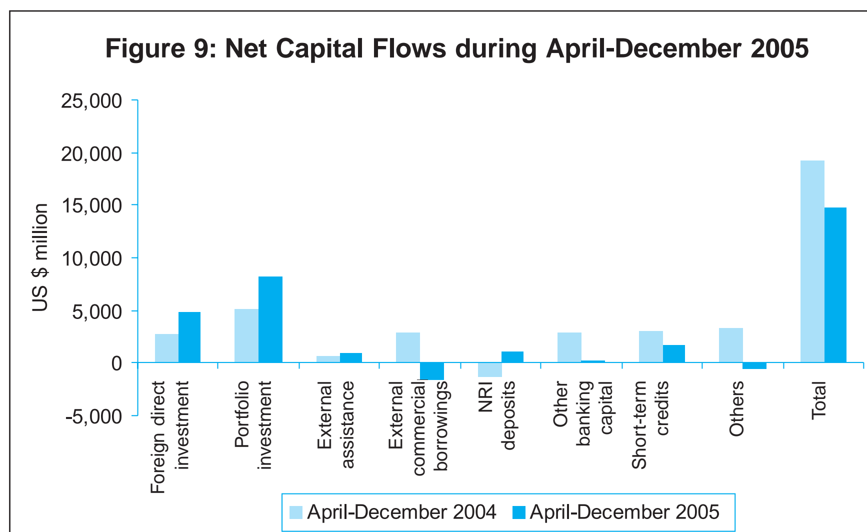
	April-June	July-September	October-December	April-December
Exports	23,180(29.9)	24,001(27.2)	26,400(26.4)	73,581(27.7)
Imports	38,040(65.5)	38,643(34.6)	38,429(17.8)	115,112(36.9)
Net Invisibles	10,297(26.3)	9,584(56.4)	8,175(30.0)	28,056(36.4)
Current Account Deficit	-4,563	-5,058	-3,854	-13,475

Figures in the parentheses show the percentage change over the previous year.
Source: Reserve Bank of India.

Strong flows in capital account continue

21. A steady increase was recorded in most items of capital inflows, except for external commercial borrowings (ECBs) and banking capital (Figure 9). Net FDI inflows to India picked up due to strong economic activity and continued strength of the corporate sector with inflows channeling into manufacturing, business and computer services. The FII inflows remained buoyant in the third quarter. The resumption in FII inflows that began in June 2005 continued through December 2005, except for some slack in October-November 2005. The strong corporate earnings growth over the past several quarters and expectations of continuance of high growth phase sustained FII interest in the Indian markets. Net accretion to foreign exchange reserves was US $1.8 billion (excluding valuation) despite sizeable current account deficit and outflows due to redemption of India Millennium Development Bonds.

Figure 9: Net Capital Flows during April-December 2005



22. The Government of India has expressed its desire to remove remaining controls on capital movements and move to full capital account convertibility (CAC). A short note in the Special Feature of this bulletin will cover some issues pertaining to CAC.

Special Feature

Capital Account Convertibility: Where Does India Stand?

Capital Account Convertibility: Where Does India Stand?

1. Introduction

The Government of India has recently expressed its desire to move to full capital account convertibility (CAC). This note makes an attempt to examine various issues pertaining to CAC.

2. Working definition of CAC

CAC refers to the freedom to convert local financial assets into foreign financial assets and vice versa at market determined rates of exchange. It is associated with changes of ownership in foreign/domestic financial assets and liabilities and embodies the creation and liquidation of claims on, or by, the rest of the world.[1]

3. The rationale for opening the capital account

Dismantling capital controls generates economic benefits through increased opportunities for trade and cross-border portfolio diversification in both assets and liabilities. It also imposes macroeconomic discipline on national governments.[2] Allowing assets and liabilities portfolio diversification across borders enables a country's borrowers to access lower borrowing costs and its savers to earn higher yields. Moreover, competition among financial intermediaries will squeeze intermediation margins; as a result, costs of funds to borrowers will decrease and returns to lenders will rise. However, there is another school of thought which argues that asymmetric information—a situation in which one party to a transaction has less information than the other—pervades financial markets, and that this greatly

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[1] Report of the Committee on Capital Account Convertibility, Chairman S.S.Tarapore, Reserve Bank of India, 1997. It may also be noted that RBI in consultation with the Government of India has set up another committee under the Chairmanship of Mr. S.S. Tarapore to set out the framework for CAC and submit the report by 31 July 2006.

[2] Kim (2000) argues that unrestricted capital movements can prevent governments from pursuing policies that might lead to higher budget deficit. (See Woochan Kim, *Does Capital Account Liberalization Discipline Budget Deficit*? Mimeo, Korean Development Institute.)

undermines their efficiency as mechanisms for allocating resources. There is, moreover, good reason to think that asymmetric information is particularly prevalent internationally, because geography and cultural distance complicate the acquisition of information.[3] However, with the spread of internet and IT enabled services, this argument must have become weaker in recent years.

4. Where does India stand?

The process of liberalization of the capital account had been gradual in India (Box 1). Currently the priority is to liberalize inflows, especially on corporate account. However, all outflows of capital from non-corporate residents remain restricted in India. Foreign capital inflows on the other hand are granted full freedom of repatriation.

5. Preconditions for full CAC in India

The first Tarapore Committee had recommended that certain preconditions should be achieved before moving to full CAC. Some of the important conditions are as follows:

Fiscal Consolidation

i. Reduction in gross fiscal deficit (GFD) to GDP ratio to 3.5%.

ii. A consolidated sinking fund (CSF) to be set up to meet government's debt repayment needs to be financed by increase in RBI's profit transfer to the government and disinvestment proceeds.

Mandated Inflation Rate

iii. The mandated inflation rate should remain at an average 3-5% for the three-year period.

Consolidation in the Financial Sector

iv. Gross non-performing assets (NPAs) of the banking sector (as a percentage of total advances) to be brought down to 5%.

v. A reduction in the average effective Cash Reserve Ratio (CRR) for the banking system to 3%.

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[3] Barry Eichengreen, and Michael Mussa (1998). Capital Account Liberalization and the IMF. *Finance and Development,* Vol.35.

Exchange Rate Policy

vi. RBI should have a Monitoring Exchange Rate Band of plus minus 5% around a neutral Real Effective Exchange Rate (REER). RBI should be transparent about the changes in REER.

Balance of Payments Indicators

vii. Reduction in Debt Servicing Ratio to 20%.

Adequacy of Foreign Exchange Reserves

viii. Reserves should not be less than six months of imports.

ix. The short -term debt and portfolio stock should be lowered to 60% of level of reserves.

x. The net foreign exchange assets to currency ratio (NFA/Currency) should be prescribed by law at not less than 40%.

The current status of these preconditions is reported in Box 1.

Box 1: Preconditions for full CAC: A Status Report

Preconditions	Current Status
i	Almost achieved
ii	Not achieved
iii	Achieved
iv	Not achieved (5.84% for the nationalized banks in FY 2004)
v	Not achieved (currently 5%)
vi	Not achieved
vii	Achieved
viii	Achieved
ix	Achieved
x	Achieved (there is no legal restriction)

6. Conclusion

There is an Asian consensus on CAC, emerging from the Malaysian experience of a retreat from prudently liberal capital account in 1997.[4] There are two principal targets embedded in the September 1998 package: liberalize inflows with associated outflows and impose stricter control over outflows. There is also another consensus that has emerged after the

[4] Indira Rajaraman (ed.) (2003). Management of the Capital Account: A Study of India and Malaysia, in *Management of Capital Flows: Comparative Experiences and Implications for Africa.* Geneva: UNCTAD, pp. 109-183.

Asian crisis that prefers stability at the cost of efficiency.[5] Higher prudential regulations would raise the cost of intermediation and lower efficiency but it will bring stability in the economy and that will impart efficiency in the long run.

However, the role of better supervision and prudential regulations do not end with controls on capital outflows. This is especially true when short-term inflows are intermediated through the financial system thus exposing them to both currency and maturity mismatches. Sudden shifts in market sentiment can cause a massive reversal of inflows, and therefore, may trigger a crisis.[6]

Thus, an efficient financial sector is one of the important prerequisites for CAC. Financial sector consolidation in Malaysia has received very careful policy attention with a four-pronged approach encompassing asset management, bank recapitalisation, loan management and debt restructuring, and bank consolidation.[7] Despite several reforms initiated in recent years, the Indian financial sector is yet to achieve a very high level of operational efficiency, and remains very crisis prone. One important indicator of efficiency of banks is net interest margin (NIM), defined as the excess of interest income over interest expense, normalized by total bank assets. This ratio reflects the allocative efficiency of financial intermediation, a lower ratio being indicative of higher efficiency. Historically the NIM of Indian banks is rather high. The NIM of Indian banks was about 3.3% in the early nineties. Thereafter, it declined marginally to around 3%.[8]

Therefore, India has to assess the situation carefully before moving to CAC. Some preconditions are yet to be met. Moreover, a lot more care needs to be taken to strengthen and streamline the operations of the domestic financial market. The debt market ought to

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[5] Y.V. Reddy (2000). *Operationalising Capital Account Liberalization: Indian Experience*. Presentation at the Overseas Development Institute, London.

[6] Asian Development Bank Institute (2000). *Policy Recommendations for Preventing another Capital Account Crisis.*

[7] Rajaraman op. cit.

[8] Rakesh Mohan (2005). "Reforms, Productivity and Efficiency in Banking: The Indian Experience" 21st Annual General Meeting and Conference of the Pakistan Society of Development Economists, Islamabad, 21December 2005.

be deepened to ensure that increased inflows or outflows do not create excessive volatility in yields. The East Asian crises, and the earlier Latin American debt crisis of the 1980s, highlight the importance of strengthening the financial system, particularly the incentives for prudent behavior, the regulatory and supervisory framework, and the long term capital market.[9] There are several binding constraints - both structural as well as institutional - that should be addressed immediately to reap the full benefit of CAC (Box 2).

Box 2: Capital Account Controls in India

- *Loans.* Indian Residents are generally prohibited from borrowing from nonresidents. The maximum amount of external commercial borrowing (ECB) which can be raised by an Indian corporate is US $500 million during a financial year without prior approval. However, there are caps on LIBOR-based interest rates.
- *Portfolio flows.* Portfolio outflows by residents are subject to prior approval. Qualified Indian mutual funds are allowed to invest in overseas exchange traded funds, cumulatively up to US $1billion. Portfolio inflows by registered foreign institutional investors (FIIs) are allowed subject to certain limits. In particular, the holding of a single FII or the concerned FII group in any company would be subject to a ceiling of 10% of total paid-up equity capital. Indian companies, however, are permitted to raise the ceiling limit provided it has been approved by the Board of Directors of the company and a Special Resolution is passed to that effect by the General Body. Portfolio investments by nonresident Indians are permitted. In both cases, there are no restrictions on repatriation. In addition, resident corporations are permitted to raise equity abroad by issuing Global or American Depository Receipts.
- *Foreign direct investment.* Inward foreign direct investment is now permissible practically to all sectors subject to prior notification and approval, as well as restrictions on the foreign ownership of projects. FDI is not permitted in gambling and betting; lottery; atomic energy; railways; multibrand retailing; and some specific agricultural and plantation activities. Restrictions on outward direct investment by residents were eased in 1999. Indian corporates can now invest up to 200% of their net worth overseas under the automatic route.
- *Bank deposits.* Deposits by Indian residents in banks abroad and resident deposits in foreign currency are permitted, subject to prior approval. Deposits to Indian banks by nonresident Indians (NRIs) and overseas corporate bodies (OCBs, i.e. corporations owned by NRIs) are permitted, both in rupees and foreign currencies with free repatriation.

[9] See the introduction in J. A. Hanson and S. Kathuria (eds), 2000. *India: A Financial System for the Twenty First Century.* New Delhi, Oxford University Press India.