

# Nursing a nice kitty

With the inflows expected to be good in the coming weeks, months and years, there is unprecedented confidence among the captains of industry about the economic future of the country,

**Deepa Suryanarayan** reports

**T**HE Indian economy is in the pink of health, with a sustained growth rate of over 8 per cent (currently close to 9 per cent) for the third consecutive year.

The overall economic growth has been prodigious. The better part of the story is that the progression continues at a healthy pace, as borne out by the fact that for the first two quarters of the current fiscal the Indian economy has continued to sustain its growth momentum with the first quarter growth being a robust 8.9 per cent.

Sunrise sectors like services has improved its share in GDP from 41 per cent in 1990-91 to 54 per cent in 2005-06. The going is, therefore, definitely good.

With manufacturing sector growing at an accelerated 11.8 per cent for the first six months of the current fiscal and looking at the average year-on-year growth in capital and consumer goods segments (at 51.39 per cent and 29.58 per cent respectively), the writing on the wall is clear: that growth is not merely speculative but has been driven by both investment and consumption.

Interestingly though, the lesser

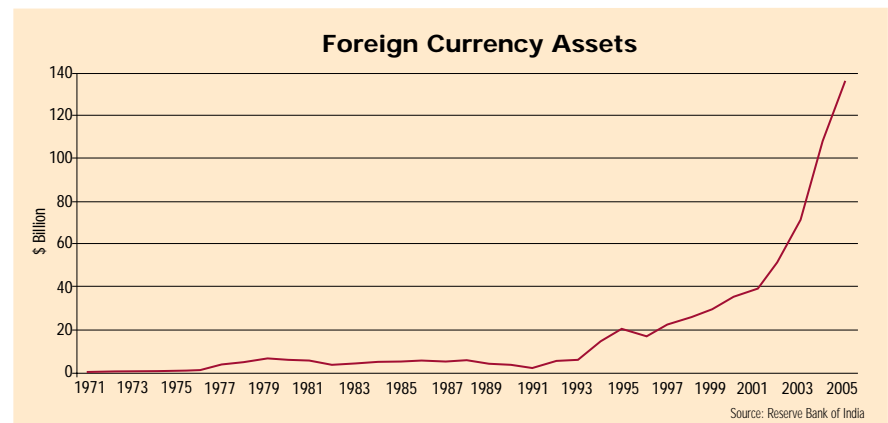
known fact for many is that, the Indian economy is not just shining from within, even on the external trade front it has been able to build up a huge currency chest, which can be used to back its global trade liabilities in the international markets for a long time to come.

Addressing an elite gathering of business and economic editors at the Economic Editors' Conference, 2006 Finance Minister, Palaniappan Chidambaram announced that Foreign Exchange Reserves (FER) as at the end of October, 2006 stood at a whopping US\$160.2

billion. Three months down the line these reserves are placed at over \$175 billion.

For those who want to play down this accomplishment, retired senior economist, Radhakrishna Pillai has this to ask: "If somebody says what's the great achievement in having such high reserves my poser would be.....Does anyone remember the horrifying days of 1990-1991 when the Indian treasury was so stretched that it had to actually pawn its gold to generate funds?"

Pillai recounted how the Government of India had to actually ship 47 tonnes





**YELLOW METAL:** All that glitters can be gold as well

of gold to the Bank of England in June 1991, to secure a loan of about \$415 million before funds could be arranged from the International Monetary Fund to ride out the financial crisis.

Cut to 1991, PV Narasimha Rao, who was elected Prime Minister took on board Dr Manmohan Singh as Finance Minister.

According to Srivatsa Joshi, senior

research analyst at Issues Analysis and Research, the major challenge faced by Manmohan Singh when he became the finance minister in 1991 was to review the balance of payments situation trying to minimise risk and volatility.

"Being an economist himself, Dr Manmohan Singh knew that the main objectives in managing a stock of reserves for any developing country, including India,

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are preserving their long-term value in terms of purchasing power over goods and services, while minimising risk and volatility. To begin with, he rightly identified that the increase in foreign exchange reserves can be achieved on account of capital and other inflows," Joshi added.

"India was virtually a closed economy until 1991 and what Dr Singh did was gradually open its frontiers to the entire world. With such an enormous population, rising consumer classes, the multinationals were just waiting in the wings to enter India, of course with their dollars. The current account was opened in August 1994, and the capital account, although cautiously, was gradually liberalised," said Pillai.

Until 1991, India followed a restrictive external sector policy which was mainly designed to conserve limited FER for essential imports like petroleum products and food grains, and it strongly discouraged the entry of multinationals.

"However Dr Singh changed all that. Though gradualistic in approach, he shifted the external sector strategy from import substitution to export promotion, with sufficiency of FER as an important element. As a result of the measures initiated to liberalise capital inflows, India's FER (mainly foreign currency assets) have gradually increased," said Joshi.

The acceleration in the trend first

emerged in 1993, as recorded by the rise in foreign currency assets, when India adopted the market-based system of exchange rates and then in 2001, when the current account recorded a surplus after a persistent deficit since 1978. As a result, in March 2005, FER exceeded 15 months of imports in value terms, against two weeks in June 1991.

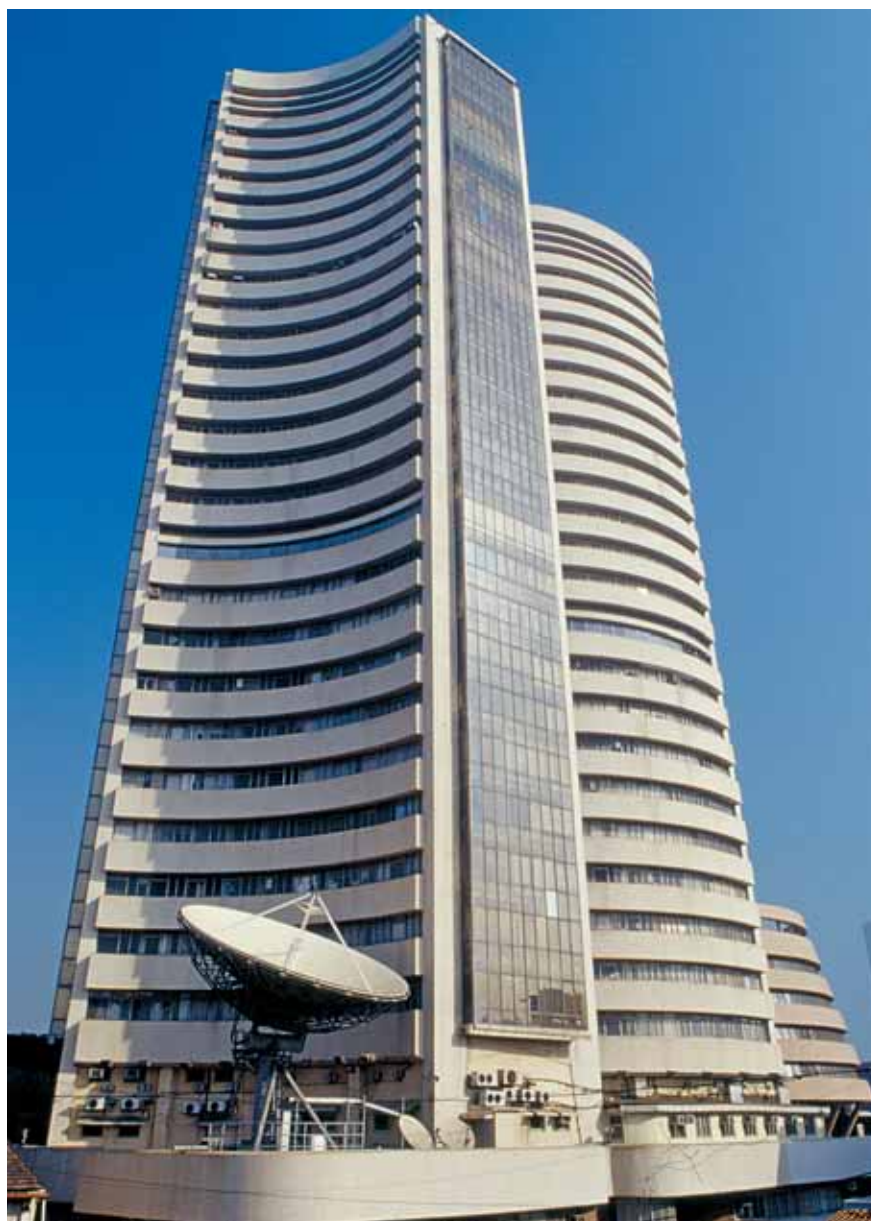
With the opening up of the economy foreign direct investments (FDI) started to trickle in, gradually adding to the pool of FER. The total FDI inflows into the country from 1990 till the financial year ending 2006, stood at \$45.274 billion, while outward flows were at \$9.569 billion.

As per the World Investment Report 2006 of the United Nations Conference on Trade and Development (UNCTAD), India received more than two-thirds of the total FDI coming to South Asia. Although FDI inflows into the country have risen, they are far less than China, which received \$72.406 billion in 2005. In fact, China was the largest recipient of FDI among all developing countries worldwide.

Addressing eminent financial experts recently at the Annual Indian Securities Infrastructure & Operations Forum, RBI Deputy Governor Dr. Rakesh Mohan said that following the phased liberalisation in the regime for Indian investments overseas, investments in joint ventures (JV) and wholly owned subsidiaries (WOS) abroad have emerged as important avenues for promoting global business by Indian companies.

“The openness of the Indian economy has nearly trebled between 1990-91 and 2005-06. The Indian economy is thus now much more intertwined with the global economy. Thus foreign investments have increased from negligible levels till the early 1990s to 2.5 per cent of GDP by 2005-06. Both direct and portfolio investment flows have recorded significant increases, although the inflows under direct investment remain relatively low compared to other recipient countries,” he said.

“Apart from merchandise trade in goods and services, this growing integration has taken the form of large scale cross-border merger and acquisition activities. Thus, not only is India a recipi-

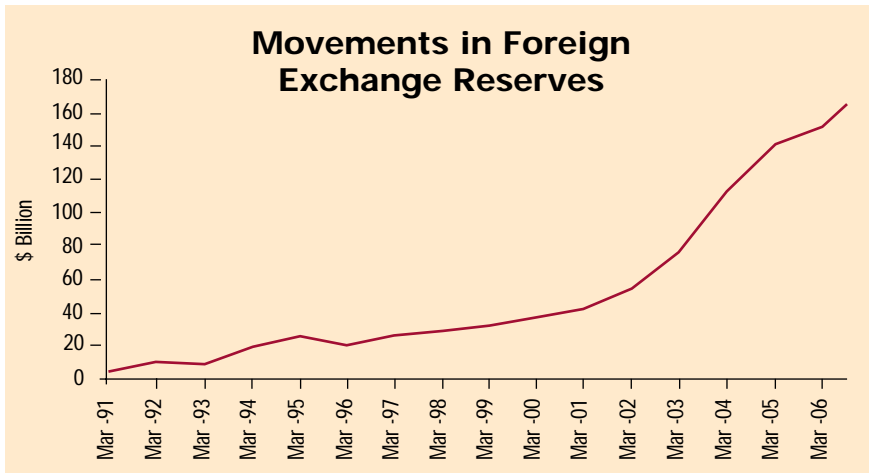


**LURING FOREIGN INVESTORS:** Indian stock markets have attracted significant foreign portfolio investment

### Sources of Accretion to Foreign Exchange Reserves since 1991

Items	1991-92 to 2006-07 (up to end-September 2006)
Reserve Outstanding as on end-March 1991	5.8
Current Account Balance	-36.2
Capital Account (net) (a to e)	186.2
a. Foreign Investment	99.6
b. NRI Deposit	27.3
c. External Assistance	12.4
d. External Commercial Borrowings	26.6
e. Other items in capital account	20.3
Valuation change	9.4
<b>Total (A + BI + BII + BIII)</b>	<b>165.3</b>

All figures in \$ billion Source: Reserve Bank of India



Source: Reserve Bank of India

ent of foreign direct investment, but the corporate sector is also exploring opportunities to invest abroad," Mohan said.

The global trade environment is so positive that Indian firms are acquiring firms abroad to leverage comparative advantage of foreign locations, to acquire appropriate technologies and to have a marketing and distribution base with the ultimate objective of attaining economies of scale and productivity gains.

According to Dr Charan Singh, director, department of economic analysis and policy, Reserve Bank of India (RBI), although the main sources of rising FER in India are inflows of foreign investment (more portfolio than direct), banking capital, including deposits by non-resident Indians also played an important role in building up reserves.

In the current account, a major contribution has been made by computer services and software exports, mainly banking, financial, and insurance, which increased from less than \$1 billion in 1995-96 to \$17 billion in 2006. In addition, inward remittances from workers abroad, mainly from Western Europe and the United States, more than doubled from \$8 billion to \$21 billion over a similar period.

M. Balachandran, chairman and managing director, Bank of India, opines that the major sources of increase in foreign exchange reserves have been foreign investment, external commercial borrowings, banking capital, and of course the items under the capital account. "The volume of FDI inflows into India is growing on the back of growing

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interest by many of the world's leading multinationals in the Indian markets. Not only the consumer base increased, the buying power of the people is also gradually increasing," he said. So how does the path ahead look like and what could be the ideal strategy? With a sustained growth rate economists feel that the inflow of foreign money will only grow.

Talking about future prospects, M V Nair, chairman and managing director, Union Bank of India, said that based on expectations of better economic growth, increased corporate earnings and policy liberalisation, FDI should continue to grow. He, however, added that factors such as high oil prices, interest rates and increased inflationary pressures, which restrain economic growth will have to be checked.

On the technical side of FER management, Charan Singh says that the related concern is the quantity and quality of inflows. In seeking to accumulate reserves as well as to globalise, India has been encouraging foreign participation by liberalising investment regulations in various economic activities, including banking and insurance. As a result, India has been able to attract more foreign portfolio investment than foreign direct investment.

"As foreign portfolio investment is considered less stable than foreign direct investment, with increasing levels of FER, it may become necessary to adopt a cautious approach toward capital inflows, especially inflows from tax havens, to ensure financial sector stability," he opines.



**MONEY POWER:** Adding up more currency to the treasury