Outlook

63. One of the continuing challenges of exchange rate management in emerging markets is the balance between the two objectives of responsiveness to market fundamentals and the need to dampen volatility. The former requires a flexible exchange rate. Experience has shown that, though a fixed/pegged exchange rate may be as acceptable as a flexible one when market fundamentals are favourable, the former is more likely to end in explosive change when market fundamentals worsen. On the other hand, annual movements of the kind seen between the major currencies, with rates changing up and down by 25 per cent to 50 per cent may be too disruptive for emerging markets with relatively unsophisticated financial systems. Thus managing the trade-off between exchange rate flexibility and exchange stability (minimisation of volatility) will remain a continuing challenge.

64. With the globalisation of emerging markets, exchange risk has become an important part of the market and of the economic agents and institutions, which operate in the economy. Economic agents and institutions in India, perhaps like their counter parts in other emerging markets, have been slow to understand and incorporate the full implications of exchange risk into their economic decisions. One reason is that in the past controls (explicit and implicit) and directions transformed individual risk into systemic risk. Individual agents either faced little risk or it manifested itself as systemic risk, which had to be dealt with by the government and the Central bank. Recent events in other parts of the world have in a rather dramatic fashion highlighted the need to monitor, analyse, incorporate and manage different types of risk, particularly exchange risk. A successful transformation of institutions and their internal functions along these lines poses an important challenge for both economic agents and market regulators.

65. One of the major impediments to appropriate management of risk is the legacy of our past. In days gone by when both financial markets and financial regulation was relatively primitive, the concept of hedging barely existed in the public mind. Risk related activities were seen as synonymous with speculation or gambling, despite the fact that India can probably boast of some of the oldest forward markets (for commodities) in the World. Modern well regulated, forward and futures markets are essential for efficient management of risk. Without such markets, our firms and institutions are handicapped vis-à-vis their competitors across the world. Un-hedged foreign exchange exposure if widespread can also snowball into system failure through a vicious cycle of technical bankruptcy. The time has come to remove the numerous controls and impediments to the setting up and functioning of derivative markets in India. Similarly, constraints on hedging of exposure on international markets must be phased out, as this has the additional benefit of providing a hedge against systemic (or country) risk.

66. The balance of payments outlook in the medium term will depend on several factors. A rapid growth in exports remains one of the most critical factors in the long term viability of external sector. The sharp deceleration in export growth in 1996-97 and 1997-98 has, fortunately, not affected the short term viability of external sector, because import growth also decelerated in these years and, on the other, net invisible receipts and net capital flows were buoyant. With the expected pick up in domestic investment and recovery of economic growth, growth of imports will pick up. Vigorous efforts would, therefore, be required to achieve a rapid growth of exports, especially in the context of the difficult international trading environment brought about by the recent currency crisis in Southeast Asia. Second, POL accounts for a relatively large share of total import bill and there is considerable uncertainty surrounding the future movements of international prices of petroleum. Efficiency of use must be encouraged and distorting policies eliminated.

67. Tourism has been a major source of invisible earnings on the current account of balance of payments. Growth of tourist arrivals and earnings has received a sharp set back in 1996-97 and 1997-98. There have been serious efforts at the Centre and State levels to accelerate the growth of tourism in India. These efforts are to be sustained and intensified.

68. Capital flows in the form of direct foreign investments have been a major strength of capital account of balance of payments in recent years. Large inflow of direct foreign investment will enable us to sustain a higher current account deficit without imposing an excessive burden on the external debt management. The financial crisis in Southeast Asia has affected foreign investment flows to emerging market economies and other developing countries. Capital flows

are expected to be sustained in India and there remains considerable potential for higher direct foreign investment. But, India needs to maintain a positive stance towards direct foreign investment in order to strengthen the balance of payments and to garner more foreign savings to support the investment needs of the economy.

69. The financial crisis in Southeast Asia has re-emphasised the significant challenges and risks involved in moving to free international capital movements. The lessons of crisis demonstrate that capital account liberalisation should be carried out in a phased and deliberate way so as to minimise the risks of disruption during a period in which all participants learn to deal with new challenges and uncertainties.