Utilization of foreign aid

6.56 Information available with the Controller of Aid, Accounts and Audit (Ministry of Finance) indicates that, as on March 31, 2007, the total foreign aid available in the pipeline was Rs. 89,805 crore (US$ 20.6 billion), comprising loans of Rs. 80,724 crore (US$ 18.5 billion) and grants of Rs. 9,081 crore (US$ 2.1 billion). The amount of loans and grants to be utilized by the Government account was Rs. 84,503 crore (US$ 19.4 billion) and by the non-Government sector Rs. 5,302 crore (US$ 1.2 billion).

6.57 A major part of aid available in the pipeline pertained to infrastructure sector which was Rs. 57,222 crore (US$ 13.1 billion) or around 64 per cent of total aid available in the pipeline. Within infrastructure, aid available for development of roads was 23 per cent, urban development 27 per cent and power sector 14 per cent of the total undrawn balance as at the end of March 2007. In terms of the share of the Centre and States in the total undrawn balance at end-March 2007, the Centre accounted for Rs. 28,822 crore (US$ 6.6 billion) and States Rs. 55,681 crore (US$ 12.8 billion). Amongst States, six States (Karnataka, Tamil Nadu, West Bengal, Maharashtra, Madhya Pradesh and Andhra Pradesh) accounted for 35 per cent of undrawn balance at end-March 2007.

6.58 While the country is basically an aid recipient, at the same time limited amounts of aid are given to friendly developing countries, which appear on the debit side of external assistance. Until 2003-04, the loans given by India were in the form of Lines of Credits (LOC) and in the nature of government to government transactions. Accordingly, the whole amount of loan assistance was provided for in the Union Budget. The amount outstanding under the loans extended by the Government to foreign governments stood at Rs. 3,502 crore (US$ 802 million) at the end of March 2007 as per the revised budget estimates.

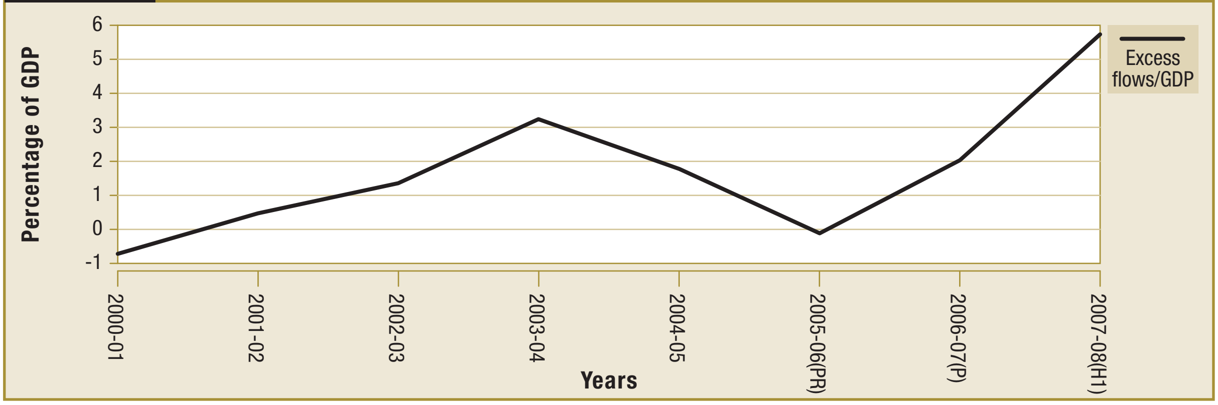
6.59 Since 2003-04, LOC are extended to foreign governments through EXIM Bank of India which are supported by the Government. The EXIM Bank extends such LOC on concessional terms – in rate of interest and repayment period. The interest differential is made good by the Government. The rate of interest charged by the EXIM Bank and the repayment period of the loans vary among different categories of recipients, which are classified into Heavily Indebted Poor Countries (HIPC), Low Income High Level of Debt (LIHD) Countries, Middle Income High Level of Debt (MIHD) Countries and Middle Income Low Level of Debt (MILD) Countries by the World Bank. So far, the Government supported LOC through EXIM Bank of India for about US$ 3.2 billion have been approved.

6.60 In addition to loans, the Government also extends grants to the needy developing countries mainly in the nature of technical assistance under the Colombo Plan. Under this programme, the Government provides comprehensive and integrated training to personnel for strengthening their human resources. At present, the training programme has been extended to 18 countries. Towards this end, the Union Budget has made a provision of Rs. 5.5 crore for the year 2007-08.

Management of capital flows

6.61 The excess of capital inflows (reserve change on BoP basis) over the current account deficit has been on a clear uptrend since 2003-04 rising to 7.72 per cent of GDP in the first half of 2007-08 (Figure 6.7). There was a small dip below trend in 2004-05 and 2005-06 because of special

Figure 6.7 Excess of capital flows over current account deficit



Box 6.2 Management of capital flows

The excess of net capital inflows over the current account deficit posed newer problems in macroeconomic management, particularly that of managing the contradictions in the trilogy of objectives. The policy response was a mix of intervention to smoothen volatility, the build up of the level of reserves and appropriate liquidity management with a focus on maintenance of healthy financial market conditions with financial stability. Sterilization operations were resorted to after an assessment of the nature and extent of surplus foreign exchange flows involving considerations like trade-offs between the short term and the long term; judgement on whether capital flows are temporary or enduring; as well as on the operation of self-correcting mechanisms in the market and market responses in terms of sentiments.

As capital flows are reversible at a future date and in view of the potential volatility embedded in certain types of flows, the liquidity at risk rule and the monetary policy considerations weighed on the level of intervention and reserves. Volatile flows, defined as short-term credit and portfolio investment were 76.3 per cent and 46.7 per cent of the total capital flows in 2003-04 and 2004-05. The proportion subsequently declined to 29.9 per cent in 2006-07 and was placed at 47 per cent in 2007-08 (April-September). The "Annual Report on Exchange Arrangements and Exchange Restriction 2007" of the IMF indicated this as a global trend and stated, "While capital inflows are often beneficial to recipient countries and an indicator of increased integration of these economies in the global market, the sheer magnitude of the flows, their more volatile nature, and recent episodes of market turbulence have led to some concerns about the risks. Risk are seen as arising not so much from growing foreign direct investment, but from significant surges in short-term and more volatile flows, particularly portfolio equity investment flows, and in certain countries, bank's foreign borrowings". A second feature that weighed in the policy responses was the fact that exchange rates were increasingly determined by gross flows and expectations. The steady supply and lumpy demand conditions, and lack of appropriate depth in foreign exchange markets also were factors that were considered. In the event, with considerable appreciation of the rupee, the pass through of capital flows to the monetary sector was partial.

In view of the rapid pace of accretion to reserves and the high levels of appreciation of the rupee, liquidity management requirements set in motion the higher limits for outstanding balances under the market stabilization scheme. This was progressively raised. The fiscal costs of sterilization of flows mounted and the supplementary demand for grants placed the outgo for 2007-08 at Rs. 8,200 crore. The current policy mix to resolve the contradictions in a relatively open capital account, monetary policy independence and flexible exchange rate remain contextual policy responses. The commitment to greater openness and fuller convertibility remains; but the movement in this direction would continue to be gradual, sequenced and calibrated. A number of measures have been taken already in this regard like: liberalization of outflows; due compensation for sections affected by the flows like exporters; prudential norms for market participation; and a rejigging of the hierarchy of conditions on ECBs. A view has been expressed by some analysts that certain measures are harking back to capital controls, which could send wrong market signals. The only measure that could be construed as controls is the end-use conditions on ECBs, which were not fully liberalized in the first place and which had periodically been reviewed and regulated. The end-use conditions on ECBs notified in August 2007 modified the pre-existing controls or limits by only prioritizing the use of such an option for rupee expenditure beyond a threshold limit.

conditions — a reversion to deficits on the current account and the maturing and repayment of IMD bonds. Such high levels of reserve change were due to a combination of factors including the strong growth performance and potential together with high returns on equity, robust financial markets, interest differential, and rising expectations including on the value of the rupee.

6.62 Both investment and debt flows have surged in 2006-07. Such net flows into India were 18.2 per cent of the total net capital flows to emerging market economies in Asia in 2006. Though, unlike other economies in the region running huge surpluses, the Indian economy had moderate levels of current account deficit, these excess flows posed some new challenges (Box 6.2).

6.63 Rapid capital inflows have implications on the macroeconomic policy setting. Given the RBI's policy of intervening to dampen volatility and maintain orderly conditions in the foreign exchange market, the capital inflows have also reflected in the growth in net foreign exchange assets (NFA) of the RBI. As a part of its monetary management, RBI has been sterilizing a part of the rupee funds consistent with its monetary policy stance. RBI's overall monetary policy stance factors in the objective of price stability, reducing inflationary expectations while remaining supportive of growth, ensuring regular flow of credit and maintaining

Table 6.16 Foreign exchange flows and sterilization

(Rs. crore)

Items	2004-05	2005-06	2006-07	2007-08
1. Forex flows	1,28,081	1,02,969	2,02,235	
2. Forex purchased by RBI	91,105	32,884	1,18,994	1,58,206 US$ 38.7 billion (April-Sep.)
3. Sterilization				
a. MSS	64,211	-35,149	33,912	80,376 (Up to Oct 5)
b. RBI OMO	2,899	3,913	4,901	N.A.
c. CRR impound	19,108	34,077	53,161	33,320 (April-Sep.)
Total Sterilization (a+b+c)	**86,218**	**2,841**	**91,974**	

Source: Calculations based on RBI data.

orderly conditions in financial markets. The extent of sterilization in two of the last three years above 75 per cent of RBI's purchases of foreign currency indicates the policy stance (Table 6.16).

Foreign exchange reserves

6.64 In the wake of surge in capital flows and build-up of current account surpluses, foreign exchange reserves comprising external assets like foreign currency assets (FCA), gold, SDRs and Reserve Tranche Position in the IMF that are readily available to and controlled by monetary authorities for management of BoP, scaled new highs in recent years. India's levels of accretion were higher in comparison with many countries, but not unique.

6.65 Foreign exchange reserves of India, denominated in US dollars, rose from a level of US$ 151.6 billion in end-March 2006 to reach a level of US$ 199.2 billion, implying a reserve increase of the order of US$ 47.6 billion. Though there is no one-to-one correspondence between sources of capital flows and reserves, the major sources of capital inflows (and implicitly of reserve accretion excluding valuation gains) were ECBs and foreign investment in 2006-07. The appreciation of other major currencies against the US dollar resulted in a valuation gain of the stock of reserves of the order of US$ 10.9 billion in 2006-07. The downturn in the securities market and net outgo of FII flows in the initial months and later again in March 2007 moderated the otherwise rapid pace of accretion to reserves in 2006-07. As per the BoP data released by the RBI for the current financial year (April-September), reserves rose by US$ 48.6 billion including a valuation gain of US$ 8.2 billion (Table 6.17).

Table 6.17 Sources of foreign exchange reserves accretion

(US$ billion)

Items	2005-06	2006-07	April-September 2006-07	April-September 2007-08
I. Current account balance	**-9.2**	**-9.6**	**-10.3**	**-10.7**
II. Capital account (net) a to f	**24.3**	**46.2**	**18.9**	**51.1**
a. External assistance	1.7	1.7	0.4	0.7
b. External commercial borrowings	2.7	16.1	5.7	10.6
c. Foreign investment	17.2	15.5	6.1	22.2
d. Short-term credit	1.7	3.3	3.9	5.7
e. Banking capital	1.4	2.1	3.3	5.3
Of which : NRI deposits	*2.8*	*3.9*	*2.2*	*-0.1*
f. Other items in capital account	-0.4	7.5	-0.5	6.6
III. Valuation change	**-5.0**	**10.9**	**5.1**	**8.2**
Total (I+II+III)	**10.1**	**47.5**	**13.7**	**48.6**

Source: Reserve Bank of India.

6.66 The sources of reserves were broad-based. Foreign exchange reserves on stock basis at the end of Febuary 8, 2008 were US$ 290.9 billion, implying an accretion of US$ 91.6 billion in the current financial year so far over end-March 2007. Of the four items that constitute the foreign exchange reserves, FCA continued to be the main variable. The annualized return on the multi currency-multi asset portfolio of the RBI was 4.6 per cent in 2006-07. The fiscal costs of sterilization went up and against a budget estimate of Rs. 3,700 crore for 2007-08, the supplementary demand for grants revises this upwards to Rs. 8,200 crore. While fiscal costs are indicated by the benchmark G-sec yield, the cost to the exchequer would be the difference between this and the return on deployment of FCA. The level of foreign exchange reserves at present provides an import cover of over 13 months.