

Outlook

56. The balance of payments outlook in the medium term will depend on several factors. Foremost, the international environment carries several potential downside risks that could further curtail global output and trade. The risks include, but are not limited to: (i) substantial equity market corrections in U.S. and Western Europe, which will not only adversely affect investment flows to emerging economies, but also affect aggregate demand in these countries (*i.e.* in U.S. and Western Europe) due to adverse wealth effects; (ii) deeper and longer recession in Japan, which will further constrain the scope of the crisis-ridden economies of the region to export their way out of the current steep contraction; (iii) international efforts are not wholly successful in preventing contagion from spreading to Latin America and elsewhere.

57. Secondly, as indicated in previous Surveys, a sustained rapid growth in exports remains the most crucial ingredient for ensuring long-term external viability. Vigorous efforts will, therefore, be required to reverse the current deceleration and achieve a rapid growth of exports, especially in the context of the difficult international trading environment brought about by the economic and financial crisis in East Asia. Some studies indicate that in the East Asian countries there is a likelihood of some reorientation of economic activity away from capital-intensive industries towards labour-intensive ones, which will further intensify competition in markets of importance to us. To achieve our export targets in light of the difficult external environment, we should also endeavour to reduce various transaction costs faced by our exporters. Studies based on surveys of exporters indicate that transaction costs emanating from implementation of various rules and regulations pertaining to obtaining licenses, customs clearances, refund of duties, infrastructural constraints etc. impinge adversely on export performance. Although progress has already been made to simplify rules and regulations, further efforts need to be made to smoothen export transactions.

58. Thirdly, POL accounts for a relatively large share of the total import bill. International prices of POL have softened significantly, reflecting general world recessionary conditions; but there is considerable uncertainty surrounding the future movements of international prices of petroleum. If the trend were to be reversed, there are significant downside risks to the BOP. Therefore, efficiency of use must be encouraged

and remaining distortionary policies in the energy sector need to be phased out.

59. Tourism in the past had been a major source of buoyancy for invisible earnings. However, more recently, growth of tourist arrivals and earnings have not been so healthy. This has occurred despite efforts at the Centre and State levels to accelerate the growth of tourism in India. These efforts need to be sustained and intensified. Airport system and procedures need to be greatly improved.

60. Capital flows in the form of foreign investments have been a significant support to the overall balance of payments in recent years. Large inflow of foreign investment will enable us to sustain a higher current account deficit without imposing an undue burden on the external debt management. The financial crisis in East Asia has affected foreign investment flows to all emerging market economies. However, there is considerable potential for much higher direct foreign investment, provided we maintain a positive stance towards direct foreign investment. In this regard, the Government has to accord the highest priority to eliminating red tapism, which continues to be cited as the main complaint of potential foreign investors. Equally importantly, policy impediments in the infrastructure sectors, which can absorb large FDI, need to be ironed out on a priority basis.

61. The financial crisis in East Asia has re-emphasised the significant challenges and risks involved in moving to free international capital movements. The lessons of the crisis demonstrate that capital account liberalisation should be carefully calibrated to minimise the risks of disruption against the backdrop of new challenges and increased uncertainty.

62. Exchange rate management should continue its focus on smoothing excessive volatility in the exchange rate and maintaining orderly market conditions to ensure that the exchange rate remains consistent with economic fundamentals. Furthermore, in light of exchange rate developments in competitor countries, we would need to monitor closely the value of the Rupee to ensure that our exports continue to be price competitive in the international market place. The key priorities for macro-economic policy in the present environment will have to be control of fiscal deficit, careful monetary management, a pragmatic and flexible exchange rate policy, continued tight controls on short-term external indebtedness and accelerated reform and strengthening of the financial sector.