WHAT IS CONVERTBILITY ALL ABOUT ?

UL Pai

Are India’s financial markets mature enough to face the rupee’s full float by 2000 AD? The report on Capital Account Convertibility (CAC) stresses that political commitment is a must and proposes severe fiscal discipline which no government in India in the foreseeable future is likely to accept. CAC has generated tremendous interest among many in India and other countries related to India, including the lay public.

Six years after the first step in liberalization in India was taken, there is a definite time-frame for capital account convertibility (CAC). And many who have been waiting for it are enthused about the recent report of the Tarapore Committee, which outlines what has been called the roadmap to CAC. The publication of the report has generated a wide debate among various sections of the economic community in the country.

Several issues are being raised, from the preconditions to the question of whether India is actually ready for it. The report itself is a lucidly written document that appears to go beyond the brief of the terms of references and presents an entire macro economic outlook.

To start with, the advantages of free convertibility are several. There will be wider opportunities for the wealth holder. In the process of identifying the areas of higher return, capital will flow to countries suffering from resource shortage and thus there will be a tendency for equalization of interest rates. This will help to improve standards of financial intermediaries as these are required to deal with international players demanding higher levels of efficiency. What does CAC envisage for corporate houses? For starters, companies will find it easier to go for External Commercial Borrowings (ECBS) or other borrowings from abroad.

For countries like India, being a capital scarce-economy, a large amount of resources will become available to supplement domestic savings. It is well known that, by the standards of Asian countries, India’s domestic savings rate is quite

unsatisfactory at 23.5% against 35-45% for these countries.

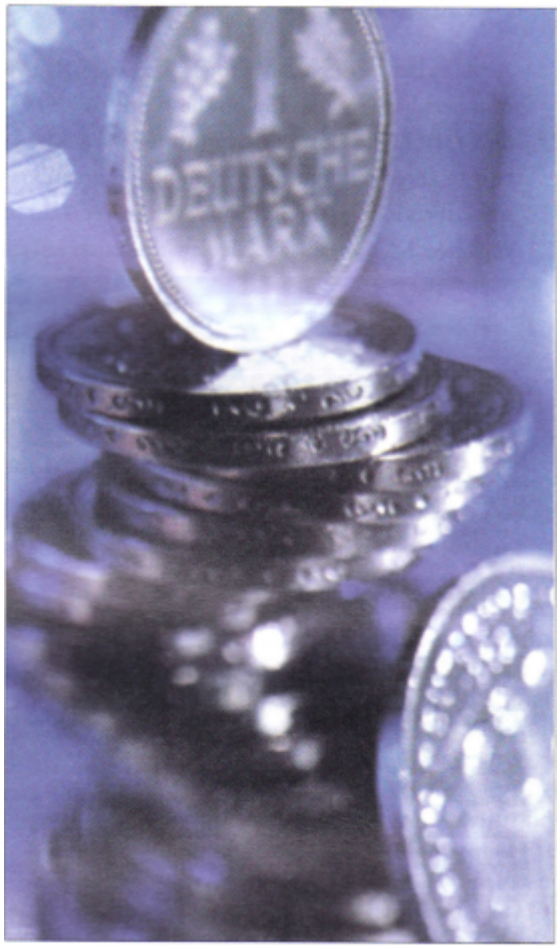
The recent recommendations on CAC in India, tabled by the S S Tarapore Committee, envisages a three-year three-phased schedule, which will empower all economic agents to convert their local financial assets into foreign ones and viceversa. The recommendations of the Tarapore Committee, if implemented, will give unprecedented autonomy to the Reserve Bank of India (RBI), speed up the financial sector reforms and introduce greater fiscal discipline. The recommendation would also make it easier for Indian Corporates to tap foreign funds as they would not require prior approval by the government. On the flip side, the CAC will have undesirable and disastrous effects on the Indian economy if certain conditions are not met.

While some have expressed doubt about the feasibility of introducing CAC by year 2000, others have felt that it need not necessarily be considered to be an important objective given other economic compulsions. While presenting the budget, the union finance minister announced that CAC was an important part of the economic reforms which the country should introduce. The RBI fol.

lowed up this announcement by appointing the expert group headed by S S Tarapore, former deputy governor, RBI. But few had expected that at that time the committee would submit a unanimous report recommending CAC in such unequivocal terms. It should not be a surprise that the committee has attached so many pre-conditions before the country can think of introducing full CAC.

In pursuit of its recommendations for fiscal transparency, the committee recommended that RBI should not support the government’s borrowing programs. It wanted the establishment of a public debt office to handle the government’s borrowing, thus ending the practice of magnetizing the deficit together. The government has to reach fiscal deficit target by cutting expenditure on so-called social sectors. It stresses the need for reducing the center’s deficit from 5% of 1996-97 further to 3.5% by the end of 1999-2000. Given the current scenario in India it would be a near-impossible task for the government to keep budgetary deficit under control as political compulsion of coalition will put pressure against it. The government is not in a position to reduce fiscal deficit because it wants to give out liberal subsidiaries and support public sector units. The leftist-socialist regime will not allow cutting down the governmental expenditure. It is a well known factor in India that pro poor and secular policies are a failure in a real sense but it keeps politician- bureaucratic circles going ahead. Thus, Tarapore proposes to impose

severe fiscal discipline which no government in the foreseeable future is likely to accept.



Secondly, the committee says that the rate of inflation should be maintained at around 3- 5%, when the current inflation rate is around 8%. So far so good. The third condition is that the public sector banks will have to lower their non-performing assets (NPA). The committee projects a decline in the rate of NPA's total advances from 13.7% in 1996- 97 to 12%, 9% and 5% in the subsequent three years. In the three short years, the banks' profit and loss accounts would leapfrog to that of those in the global markets. The banks have to develop expertise in a range of new financial instruments as CAC nears. If new instruments like swaps, futures and options are introduced and regulations are not in place, India could be in big trouble, potentially.

However, the only opposition party in India, the Bharatiya Janata Party, while

admitting the inevitability of full convertibility in a globalised atmosphere, says the right time to usher in CAC would be when India is in a position to hold the value of the rupee. Thoughtless plunge into full convertibility would result in the asset value in the country declining. “In a country where 50% of consolidated funds are based on borrow- DEUTSCHE MARK ings, one must be very careful before taking any step in this direction. Right now asset production against borrowing is not even commensurate, but it is less. Hence my word of caution is not to act in haste,’ says prof Murli Manohar Joshi, the former chief of BJP.

The phasing out of controls on the capital account will greatly depend on how effectively the Government of India keeps inflation on a leash, coupled with a cap on the fiscal deficit and strengthening of the financial system.

The author is a senior journalist based in India with 12 years experience in creative writing and media industry