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## **CAPITAL ACCOUNT CONVERTIBILITY OF THE RUPEE CAN WAIT**

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### **Some Random Reflections**

by

**D. R. Pendse**

(1) On February 28, 1997, The Finance Minister in his Budget Speech announced that Capital Account Convertibility of the Rupee (CAC-R) was his cherished goal and a RBI appointed committee will submit its Report by June 1, and lay out the road map for achieving it. Mr. Tarapore, ex-Dy. Governor is the Chairman of the Committee. In an article published on CAC-R, one month prior to the Budget announcement, he has already stated his views. So we broadly know what the committee will say, except to the extent that Mr. Tarapore agrees to modify his views in deference to those of other members.

(2) To use a workable but unsophisticated definition, a full and true CAC-R means that Indian nationals will be free to convert their rupees into the currencies of any foreign countries with a view to acquiring assets (like real estate, financial instruments, gold, jewellery, etc.). Foreign nationals will be free to convert their local currencies (if convertible), into rupees to acquire such assets in India, and there will be freedom to sell such assets and repatriate funds into any other currency of their choice. Thus, transactions by foreigners in India and by Indians abroad in money market, treasury bills, CDs, bills of exchange, derivatives etc. will be all be permitted.

With CAC, Indian nationals will also be free to retain their converted rupees in the form of currency or in bank accounts in any country and foreign nationals will be free to keep rupee accounts or rupees in currency and with full repatriation rights. Current account transactions involving foreign exchange, e.g., for travel, education, health etc. will of course continue to be permitted freely.

(3) But any transaction has two sides. Some countries have laws prohibiting or restricting foreigners from acquiring real estate (e.g. Dubai). So merely making the Rupee CAC does not mean that Indians will be able to buy property in Dubai. Similarly some countries may freely permit acquisition of real estate by foreigners. But that does not mean that Indians can acquire it unless and until the Rupee is CAC. \*

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\* [Full text of the article published in all editions of **The Economic Times** on Monday, June 2, 1997.]

(4) India has already declared the rupee to be convertible on current account. However there are in practice numerous cumbersome procedures and restrictions and obstacles even in respect of current account transactions. Policy should first address itself to eliminating these, so that rupees for all current account transactions can be exchanged for foreign currency across the counter (like postage stamps). To those of us who see how simply such transactions take place abroad, the difference is amazing.

(5) We have known our own 'Hawala' market too, which is active, efficient and trusted by those who use it. Practically any amount of rupees can be exchanged for practically any foreign currency. No questions asked; no forms to be filled in; no declarations; no documents. Just like buying postage stamps. So, for the patrons of the Hawala market rupee is already fully convertible on current account as well as on capital account.

(6) The world's foreign exchange market does business of over US\$ 1.2 trillion per day. If the rupee were truly CAC, we expose ourselves to the whims and fancies of the operators in this market. Fluctuations in the rupee can be wild (to use a mild word). Our reserves at US\$ 23 billion are peanuts. Why expose ourselves?

(7) True, other countries with CAC also expose themselves similarly. But some of these currencies are used as reserve currencies. So other countries are equally interested in their stability and come to their rescue if there is a run. Another example is Mexico: the Peso is CAC. It is now generally recognised that the root of the Mexican crisis was primarily in the CAC of the Peso and massive outflows. But then Mexico had the US as a great deep pocketed friend to come to Mexican rescue. Does India have such deep pocketed friends who can be counted on coming to our rescue? Are there any other significant countries which are interested in the stability of the Indian rupee?

(8) CAC has to be an irreversible decision. If there were a run on the rupee or if for any other reason we suddenly reverse and declare that the rupee is no more CAC, it will be most unfortunate indeed. The world will not like to look at India after it. So we have to make ourselves doubly sure that the decision for CAC is fully sustainable.

(9) We already allow inflows of foreign currency for capital account transactions with full repatriation such as buying real estate, buying shares and other financial assets etc. In that sense the rupee is partially CAC already.

(10) Many industrialists and their associations plead for CAC. Why? What is it exactly that Indian businessmen and industrialists need and are at present not getting because the rupee is not yet CAC? They would probably like to buy shares of foreign companies, or land and property for their foreign operations. If so, why don't they plead for

permission to do just that instead of pleading for CAC? If you are thirsty ask for a glass of water to drink; don't ask to open the floodgates of a dam.

(11) In fact, I notice that some, particularly from trade, industry and their associations - ask for CAC simply because they want to be seen as asking for something interesting with media sex-appeal. Asking for instant CAC is more likely to win you newspaper headlines than asking for removal of poverty!

(12) A quick look around to see if there is any common denominator among the countries whose currency is CAC, leaves us with no definite clues. What is common in Indonesia, Germany, U.K., Singapore, Dubai, U.S.A.? They have all currencies that are CAC. Period.

(13) One point is clear, however. For India some sort of macro economic stabilisation is a pre-requisite before we jump on the CAC band wagon, For example:-

- (i) Inflation under control [Average annual WPI increase to be less than 5% for at least two consecutive years].
- (ii) Sustainable high growth rate.
- (iii) Low and lowering of fiscal deficit.
- (iv) Globally competitive interest rates.
- (v) Sustainable growth of exports of goods and services.
- (vi) Reliable infrastructure facilities, particularly regarding communications and a world class financial system apparatus.
- (vii) Clear direction, experience and credibility regarding government policies moving towards freer market orientation and globalisation.

We are no where near fulfilling all these conditions. In fact, the current situation has an explosive potential. CAC is certainly not an overriding priority in these circumstances.

(14) It is misleading to say that the IMF insists on CAC. IMF would of course love to see currencies of as many countries as possible to be CAC. That eases their task of getting their loans repaid in time. But they have not, emphatically not, insisted on CAC as a pre-condition for their 'assistance'.

(15) CAC will certainly activate the foreign exchange market and it is no wonder that foreign exchange operators lead the pack of those that plead for instant big bang CAC.

(16) A related important question is of liberalising imports of gold. Some have pleaded for imports of gold on OGL basis. OGL imports of gold are equivalent to CAC. I am therefore not in favour of OGL imports of gold. I have been pleading for considerable liberalisation of gold imports - but under baggage rules and/or against exports of jewellery only. Not OGL. It is not impossible that one hand of government will favour a

gradualist approach to CAC, while another hand will permit imports of gold on OGL basis! We must guard against this.

(17) May be, like the present current account convertibility, we may officially declare CAC, and then load it with all sorts of limits, cumbersome procedures and bureaucratic restrictions. That will be self-defeating. If the rupee is to be CAC, it must be truly CAC. Since that is going to be difficult, it is best not to merely declare CAC 'officially' - unless the [understandable] objective is to assuage the clamour from foreigners.

(18) The EURO, Europe's proposed common currency will of course be CAC. It may probably, one day, compete with the US\$ as a reserve currency. But just look at the stringent pre-conditions imposed for countries to join the EMU, particularly regarding fiscal deficit, low inflation etc. Most countries are finding it difficult to comply, and will not join the EMU, until 2001.

(19) Mr.Tarapore's article proposes a specific date; April 2000 A.D., for declaring CAC-R. It suggests various prior steps to be taken and a time table. The steps are important; perhaps a bit too many and rigorous too to complete them by that date. The idea of a well-defined time table is praiseworthy but there need be nothing sacred about it all. Our approach should be simply to lay down the steps or the pre-requisites. When we have complied with them all, we will have CAC-R. It may happen in 2000 A.D., it may happen earlier; or it may happen later.

(20) On current reckoning I for one see very little chance of India being ready for CAC by 2000 A.D. The reason is well known. The runaway government expenditure, financed by borrowings at high and higher interest rates, has created a major fiscal imbalance and that in turn has resulted in high inflation, high interest rates,etc. There is no evidence of government expenditure being reined in. CAC is nice and we want it, but committing ourselves to it to-day can be harmful. Respectfully, I do not think CAC-R is our 'cherished goal'. Rapid improvement in the standard of living of India's masses is. CAC-R is merely one of the stations on our long journey towards achieving that cherished goal. The station will come at its own time.

(D. R.Pendse)

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Author contact:

1, Seaglimpse Building; P. K. Atre Road; Worli; Mumbai 400018.

Phone: 24939056. Fax: 24910632; email: [dadapendse@gmail.com](mailto:dadapendse@gmail.com)

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