Chapter 3

The Establishment of Preconditions/Signposts for Capital Account Convertibility in India

3.1 Taking into account the lessons from the international experience outlined in the preceding Chapter and the specifics of the Indian situation, this Chapter sets out the preconditions/signposts which are a necessary concomitant in the move towards CAC in India.

3.2 The firm establishment of the preconditions need to be viewed as processes rather than as one time indicators. A phased introduction of CAC implicitly provides for taking stock of the degree of success achieved in the establishment of preconditions. Based on the authorities' perception of macro economic developments, contemporaneous with the attainment of these milestones, the timing and sequencing of the move to CAC would need to be modulated i.e., speeded up or delayed depending on the success or failure in the attainment of preconditions. It is under this framework that the Committee has attempted to outline the road map of CAC.

Need for Preconditions/Signposts

3.3 The present macro economic environment in India ' is characterised by signs of resilience and strength. As set out in Chapter 1, structural reforms undertaken in the wake of the payments crisis of 1990-91 have led to a strong revival of growth in the economy. The recovery has been accompanied by distinct signs of stability and the momentum of growth of an average of 7 per cent in the past three years, appears sustainable. The gross fiscal deficit of the Centre has declined from 8.3 per cent of GDP in 1990-91 to 5 per cent in 1996-97, the lowest level in decades. The rate of inflation on a year-on-year basis has dropped from a high of 16 per cent in September 1991 to below 6 per cent in early May 1997. The current account deficit in the balance of payments has narrowed from the then unsustainable level of 3.2 per cent of GDP in 1990-91 to a little over one per cent in 1996-97. Between 1990-91 and 1995-96 there has been a reduction in the external debt - GDP ratio from 30.4 per cent to 28.7 per cent and in the debt service ratio from 35.3 per cent to 25.7 per cent. Furthermore, there has been a healthy build up of foreign exchange reserves to US $ 26.4 billion by the end of March 1997 which is equivalent to 7 months of imports. Despite signs of fragility and incipient weaknesses in the financial system, reforms launched in the financial sector have begun to yield positive results. Interest rates have been progressively deregulated and reserve requirements substantially reduced to enable the banking system to function competitively. At the same time, prudential accounting norms introduced since 1992-93 have been strengthened. As a result, 19 out of 27 public sector banks have attained the benchmark of 8 per cent capital adequacy by the end of March 1996. Furthermore, non performing assets (NPAs) of public sector banks as a proportion of total advances declined from 23.6 per cent in March 1994 to 17.3 per cent in March 1996 and are expected to show a further decline to 13.7 per cent in March 1997.

3.4 Based on an assessment of macro economic conditions, the Committee is of the considered view that the time is now apposite to initiate a move towards CAC. The Committee, however, recognises that the initial conditions do contain certain weaknesses, particularly, the structural drag in the fiscal accounts and the quasi-fiscal deficit, the size of non performing assets in the banking system, the persistence of visceral aspects of financial repression in terms of high cash reserve requirements and the vestiges of administered interest rates. While exchange rate management has moved towards a market determined system, further refinement of the policy would be required in the context of a move towards CAC. The entrenchment of preconditions can be achieved in the Indian context only over a period of time. The Committee, therefore, recommends that the implementation of CAC be spread over a three year period 1997-98, 1998-99 and 1999-2000. The institution of measures contemplated for each phase should be based on a careful and continuous monitoring by the authorities of the ongoing entrenchment of preconditions/ signposts which should be considered in the nature of traffic signals in the road map for CAC. The Committee stresses that implementation of measures towards CAC should be sequenced

along with the authorities making an assessment of the progress towards the attainment of the preconditions/signposts stipulated for the relevant year and depending on this assessment the implementation of measures could be accelerated or decelerated.

3.5 In the view of the Committee, the initial impact of a move towards CAC could well induce large capital inflows which in turn could result in real appreciation of the exchange rate. The financial system would be exposed to external competition and could face difficulties. In this context, it is necessary that CAC should be preceded by, or at least accompanied with, certain policy actions which help to strengthen initial conditions in the financial system. The phased introduction of CAC could minimise risks of the need to reimpose capital controls. While recognising this, the Committee is of the view that certain overall conditions, not envisaged at the present time, could emerge where reintroduction of capital controls could become necessary, but the strategy set out by the Committee is by and large intended to avoid back-tracking.

Preconditions/Signposts

3.6 As set out earlier, the Committee views the establishment of certain precondition s/signposts as concomitants in the move to CAC and the authorities' perception of the progress achieved in entrenching these preconditions would act as a speed regulator for the evolution of CAC in India. The Committee recommends that fiscal. consolidation, a mandated inflation target and strengthening of the financial system should be regarded as crucial preconditions/signposts for CAC in India. While the progress in achieving these essential preconditions should be carefully monitored, a few important macro economic indicators should also be assessed on an on-going basis. These are: the conduct of exchange rate policy, the balance of payments and the adequacy of foreign exchange reserves.

(a) Fiscal Consolidation

3.7 The most important precondition for CAC is a stable macro economy including a sustainable fiscal deficit. Accordingly, successful efforts to liberalise the capital account have typically been preceded by a strategy of fiscal reforms which significantly reduces the fiscal deficit and finances the remaining deficit with a minimal recourse to the inflation tax. In this context, a large fiscal deficit even when financed by bond issuances may not be compatible with an open capital account if it undermines the credibility in servicing debt.

3.8 In the Indian context, the Centre's gross fiscal deficit could be used as a summary measure for assessing fiscal performance. It is equally applicable in the federal framework of the Indian economy since a significant part of financing of States' fiscal deficits occurs through Central assistance. More importantly, the Centre's gross fiscal deficit (GFD) highlights the problem of the growing burden of internal debt. At the end of March 1997, total liabilities of the Centre accounted for about 54 per cent of GDP with over one half of the stock consisting of internal marketable debt. Large borrowings of the Centre preempt resources for the rest of the economy with crowding out effects. Furthermore, large market borrowings have kept nominal and real interest rates at high levels, thereby constraining overall economic activity. For 1997-98, gross interest payments of the Centre are budgeted at 44.4 per cent of revenue receipts. The mounting interest burden has prevented the consolidation of revenue deficits while repayment obligations have interacted with interest payments to impose cut-backs in capital expenditures. The Annual Report of the Reserve Bank of India, 1995-96 observed:

> "It, is, therefore, imperative that the growth in interest payments should be arrested over the medium-term through further reduction in GFD/GDP ratio so as to achieve a perceptible decline in the debt-GDP ratio". (Paragraph 4.25)

3.9 Following the move towards market related rates of interest, there has been a significant shortening of the maturity structure of debt. The proportion of loans of maturity below five years accounted for 65 per cent of the Centre's total loans in 1995-96. The shift towards short-term debt has meant an acceleration of repayment obligations thereby accentuating the amortisation burden. The Annual Report of the Reserve Bank of India, 1995-96 notes in this regard that :

"... the increase in Government debt point to the emergence of debt management problems which have been accentuated by the significant shortening of the maturity structure of fresh issues of Government Securities together with the generally high interest rates being paid on Government paper. Large and persistent deficits would militate against the objective of pursuing growth along with non- accelerating inflation". (Paragraph 7.26)

3.10 The practice of financing the amortisation of Government borrowings out of fresh borrowings is clearly unsustainable and this practice would inevitably result in a crisis. The Tenth Finance Commission has recommended the institution of a Consolidated Sinking Fund (CSF) for the public debt and the Committee strongly endorses this recommendation. While it is sometimes argued that a CSF is not meaningful when there is a revenue deficit as contributions to such a fund would merely increase the revenue deficit, the Committee is of the view that a CSF must be introduced as part of a more transparent fiscal system. The Committee urges that any increase in the profit transfer from the RBI to the Government as well as the proceeds from disinvestment should be used entirely towards building up a CSF. The Committee feels that any attempt to achieve fiscal consolidation would not be meaningful if the problem of the repayment of the public debt is not satisfactorily addressed. Hence, the Committee stresses that the institution of a CSF is an important ingredient in achieving the precondition on fiscal consolidation.

3.11 There is an imperative need to work towards a reduction in the GFD. Drawing from the initiatives taken in the Union Budget for 1997-98, the Committee recommends a reduction in the GFD/GDP ratio from a budgeted 4.5 per cent in 1997-98 to 3.5 per cent in 1999-2000. The reduction in the Centre's GFD should be accompanied by a reduction in the States' deficit as also a reduction in the quasi-fiscal deficit. Any slackening in the pace of fiscal adjustment would render the task of opening up of the capital account fraught with dangers of slippages, rollbacks and reversals of capital flows. The Committee, therefore, regards adherence to the projected track of fiscal consolidation as a critical precondition for CAC.

3.12 Monetary management is often clouded by the monetary authority's concern about the Government's borrowing programme and therefore, the Committee recommends that steps should be initiated to separate the debt management policy from monetary management and to this effect the Government should set up its own Office of Public Debt. The RBI should totally eschew from participating in the primary issues of Government borrowing. The Committee is of the view that these measures would go a long way towards better fiscal management and also enable vastly improved monetary management which will be necessary in the context of CAC.

3.13 The Committee also recommends transparent and internationally comparable procedures for fiscal accounting which do not blur the true magnitude of the GFD/GDP ratio as also the constituents of the budget as a whole. The financial management regime that has been put in place in New Zealand under the Fiscal Responsibility Act, which is of considerable relevance to the Indian situation, has produced major advances in the transparency and accountability of fiscal policy decisions. The Act specifies that information and policy documents should be made public and establishes statutory accountability for the Government for fulfilling these requirements. In addition, it specifies principles of sound fiscal policy with the intention that any fiscal strategy proposed by the Government can be assessed in relation to these criteria through the information provided. It also provides for more open budgetary processes. The Committee recommends that the Government of India should consider an early introduction of a system of fiscal transparency on the lines of the New Zealand Fiscal Responsibility Act.

(b) Mandated Inflation Rate

3.14 There is an increasing convergence of views among central bankers that an inflation rate in the lower reaches of a single digit is a desired objective. In a number of countries a formal mandate is given to the central bank to contain inflation within the stipulated band. This in turn requires that the central banks be given a greater degree of independence to attain the desired objective. The inflation rate in the OECD countries has averaged less than 3 per cent during 1991-96. In an increasingly integrated and inter-dependent world economy and in the

context of a progressive liberalisation of capital flows it will be necessary to break inflationary expectations in India and to put in place a mechanism for attaining an inflation rate not too far out of alignment with inflation rates in the industrial countries. As India moves towards CAC, an unduly high rate of inflation would be destabilising and would inevitably require very high nominal as well as real rates of interest which would adversely affect the overall growth of the economy. If interest rates are kept artificially low, there would be an exodus of capital out of the country.

3.15 India has always prided itself on being a low inflation country in the developing world. With a significant lowering of inflation rates in recent years in both industrial and developing countries, there is an imperative need to keep down the inflation rate in India.

3.16 There are clear advantages in having an explicit inflation target in that it provides a nominal anchor for monetary policy. While the RBI has, for years, advocated a strong line on inflation control, it has not as yet set out a formal demand for a mandate on inflation. The closest it comes to this is in its Annual Report for 1993-94 wherein it is argued :

> "...for a truly effective monetary policy, there must be a clear and unambiguous mandate and the central bank can then be required to be accountable for its actions. There are various viewpoints on what this mandate should be, but in most countries where the central banks have been given a higher degree of autonomy, the mandate has been the achievement of price stability. It is here that there is a need for a broader national consensus before prescribing a mandate for a central bank". (Paragraph 7.77, page 129)

3.17 In the Report on Currency and Finance, Volume 1, 1995-96, the RBI has explained the merits of inflation targeting :

> "...inflation forecasting has all the three attributes of an intermediate target viz. controllability, predictability and early leading indicator of final target i.e. price stability.
> ... Another major advantage is that a joint public commitment of inflation targeting by both the Central Bank and the Government will help in reducing inflationary expectations of economic agents thereby facilitating in lowering and stabilising the inflation rate. This makes the Central Bank as well as the Government more accountable to public scrutiny". (Box V11-1, Page V11-5)

3.18 In the monetary and credit policy announcement of April 15, 1997, it is stated that monetary policy would seek to maintain the expansion in M3 in the range of 15.0 - 15.5 per cent to keep the inflation rate at around 6 per cent in 1997-98. In the context of the move towards CAC, the Committee is of the view that it is necessary to take early and effective measures to evolve a more specific commitment on the inflation rate. The Committee recommends that there should be an early empowering of the RBI on the inflation mandate. There should be a medium-term inflation mandate approved by Parliament and only Parliament should alter that mandate. Once the mandate is given, the RBI should be given freedom to use the instruments at its command to attain the medium-term inflation target. Intensification or withdrawal of public intervention in price formation or a shock in the real sectors could warrant a review of the mandate but there should be clear and transparent guidelines on the circumstances under which the mandate could be changed.

3.19 The Committee recommends that the mandated rate of inflation for the three year period 1997-98 to 1999-2000 should be an average of 3-5 per cent. The Committee emphasizes that such a mandate would necessarily need to provide for greater independence for the RBI which would enable vastly improved monetary management which would be required in the context of CAC.

(c) Consolidation in the Financial Sector

3.20 The Indian financial system needs to be prepared to handle the structural changes that would emerge in the move to CAC. The financial sector in general and the banking system in particular is characterised by certain regulatory and operational constraints and these need to be addressed. The move towards CAC can be undertaken in measured steps commensurate with the strengthening of the financial system. While there are many weaknesses in the financial system which need attention, some of the key constraints are outlined below.

3.21 The banking system continues to face very high reserve requirements relative to international standards. Although measures are already afoot to reduce the reserve requirements in a phased manner, there are macro policy constraints in suddenly bringing them down to internationally acceptable levels without erosion of the effectiveness of monetary policy. It would, however, be necessary to reduce the tax on the banking system by quickly developing other instruments of monetary policy such as open market operations and interest rates.

3.22 In the area of interest rates, a significant element of deregulation has already been implemented and there is a need for removing the remaining areas of interest rate regulations. The main constraints on interest rates relate to market regulation and segmentation which stunt the development of an integrated financial market. Moreover, it is important that interest rate flexibility should emerge in the very near future and the transmission of interest rate signals needs to be more effective. The Committee recommends that interest rates should be fully deregulated in 1997-98 and there should be total transparency to ensure that there are no formal or informal interest rate controls -

3.23 The non performing assets (NPAs) of the public sector banks, estimated at 13.7 per cent of the total advances as at the end of March 1997, are still high. Quite clearly the load of such a level of NPAs cannot be borne by the banks if the financial system is opened up to forces of international competition. The Committee recognises that the strengthening of the financial system is the single most important precondition to the move to CAC. Drastic measures should be taken to reduce the level of NPAs Noting the systemic dangers of some of the weak banks growing at rates faster than the system, the Committee recommends that the weak banks should be converted into what are called 'narrow banks'; the incremental resources of these narrow banks should be restricted only to investments in Government securities and in extreme cases of weakness not only should such banks not be allowed to increase their advances but there would need to be a severe restraint on their liability growth. The Committee recognises that such measures are unavoidable if the financial system is to be safeguarded during the move towards CAC.

3.24 The Committee recommends the following sequencing and time frame for signposts which should be attained in relation to CRR and NPAs, as part of a progressive move towards CAC.

		Present Level	1997-98	1998-99	1999-2000
i)	Gross NPAs of the Banking sector (as a percentage of Total advances)	13.7* (as of March 1997)	12.0	9.0	5.0
ii)	Average effective CRR for the banking system	9.3 (as of April 1997)	8.0	6.o	3.0

* Tentative estimates for public sector banks.

3.25 It is estimated that with progressive reduction in CRR from the present average effective level of 9.3 per cent to 3.0 per cent and decline in NPAs from 17.3 per cent in 1995-96 to an estimated 13.7 per cent in 1996-97 and further to 5 per cent by 1999-2000 and with other costs/returns remaining unchanged the spreads available to the banking system would increase by approximately 1.8 percentage points. Taking into account that there would be a squeeze on spreads as a result of financial liberalisation, the successful implementation of these signposts would result in a Return on Assets (ROA) comparable to the internationally acceptable level of 1.0 per cent. These preconditions are not easily attainable but the Committee would emphasize that attainment of the signposts of reducing NPAs to 5 per cent and CRR to 3.0 per cent and complete deregulation of interest rates is an ineluctable necessity if there is to be a meaningful move towards CAC and therefore the Committee recommends that these three measures should be central policy objectives in the ensuing three years. Analogously, the financial institutions should also be made to function with a

targeted mandate to reduce the quantum of NPAs within a time -bound Programme.

Monitoring of Related Indicators

3.26 While the process of fiscal consolidation, the mandated inflation rate and financial sector preconditions need to be considered as crucial preconditions/signposts determining the move towards CAC as well as the timing and sequencing of measures, it is necessary to monitor certain important indicators, such as the exchange rate policy, the current account balance and the adequacy of foreign exchange reserves, with a view to assessing the viability of the country's external sector. These indicators, which would need to be given particular attention, must be regarded as vital attendant variables while determining the appropriate pace and sequencing of CAC.

Exchange Rate Policy

3.27 Exchange rate policy in the context of CAC assumes a role quite different, in both content and character, from that with comparatively lower capital mobility. To the extent CAC integrates both the real as well as the financial sectors with the international economy, the impact of external impulses would be felt more strongly as a consequence of which macro economic variables, both real and nominal, will have to respond expeditiously. With large capital inflows, the exchange rate would appreciate in both nominal and real terms, which would hurt India's international competitiveness. This also engenders larger borrowing abroad by domestic entities which further appreciates the currency, bringing in its wake more borrowing. A debt-led expansion in economic activity may emerge, but there is always a possibility that either on account of a loss of credibility or when the real appreciation becomes obviously unsustainable or as a result of any unforeseen event, a reversal of the process could take place leading to reversal in exchange market sentiments causing a sudden and uncontrollable spiral of depreciation of the currency. An excessively overvalued exchange rate may trigger capital flight resulting in a crisis. Persistent overvaluation of the currency would militate against viability of the export sector. It would be desirable to evolve a system under which any corrections of the real effective exchange rate (REER) which may be necessary are brought about smoothly to avoid any sudden volatility in the exchange market. While sterilization as an exclusive instrument for dealing with excess liquidity is not feasible, sterilization along with monetary policy measures, relaxation of capital outflows and other measures can be effective. More specifically, in 1997-98, the Government's borrowing programme could be put through without recourse to the monetisation projected in the Budget and thereby, in effect, a sizeable portion of the large inflows can be sterilised quite effectively.

3.28 On the specific aspect of exchange rate policy, the Committee recommends that the RBI should have a Monitoring Exchange Rate Band of +/-5.0 per cent around the neutral REER. The RBI should ordinarily intervene as and when the REER is outside the band. The RBI should ordinarily not intervene when the REER is within the band. The RBI could, however, use its judgment to intervene even within the band to obviate speculative forces and unwarranted volatility. The Committee further recommends that the RBI should undertake a periodic review of the neutral REER which could be changed as warranted by fundamentals.

3.29 The Committee stresses that credibility of the exchange rate policy would be vital in the context of CAC and to this extent there must be transparency in exchange rate policy : (i) the neutral REER i.e., the base period should be announced (ii) the REER Monitoring Band should be declared (Iii) the REER should be published on a weekly basis with the same time lag as the publication of the reserves and (iv) changes in the neutral REER should be made public.

3.30 The exchange rate regime proposed by the Committee would provide greater transparency which would greatly enhance the efficacy of the exchange rate policy by encouraging orderly market behaviour. A Monitoring Band, built around the neutral REER could be expected to provide an environment to the market participants for anchoring their expectations. Also, an element of discretion in intervention by the RBI would be necessary. Ultimately, the RBI would need to use its best judgement in the evolving situation and operate its exchange rate policy as warranted by these circumstances.

3.31 The move towards CAC would logically ensure that the forward premia in the forex market reflect interest rate differentials between overseas and domestic markets. The Committee recommends that as part of exchange rate management greater attention should be focussed on ensuring that the forward exchange markets reflect interest rate differentials.

Balance of Payments Indicators

3.32 Most developing economies rely on global saving to supplement domestic resources to achieve desired levels of investment and growth. Therefore, current account deficits (CADs) are run in the balance of payments as a means of overcoming the domestic resource constraint in the pursuit of growth.

3.33 While the current account subserves the final target of growth, lessons from international experience underscore the need to set prudent limits on expanding CADs. The mirror image of the CAD is the accretion to external liabilities, and as the stock of external debt rises, debt servicing begins to preempt an increasing proportion of current external earnings,. As a result, resources which would have been otherwise available for imports are absorbed by the servicing of debt. The contraction in import purchasing power ultimately retards growth. Thus, an unbridled expansion in the CAD to support growth can lead to the external constraint choking the growth process.

3.34 In the Indian context, the experience of 1990-91 showed that a CAD of 3 per cent of GDP rendered it unsustainable in terms of the availability of financing and triggered off the most severe external payment crises since Independence. The unsustainability of the CAD was reflected in a rising proportion of current receipts preempted by debt servicing and in the reluctance of international creditors to extend new credits or roll over earlier loans to finance the CAD. The debt service ratio soared to 35 per cent in 1990-91. Thereafter, prudent external sector policies to contain the CAD and external debt resulted in a steady decline in this ratio. In this context, the High Level Committee on Balance of Payments (Chairman: Dr. C. Rangarajan) recommended in 1993 that the CAD must be limited to a level that can be sustained by normal capital flows. The High Level Committee then felt that a CAD of 1.6 per cent of GDP could be met through a sustainable level of net capital receipts.

3.35 In view of the growing degree of integration of the Indian economy with the rest of the world, it needs to be recognised that the CAD would need to be varied in the context of the opening of the economy. The size of the CAD which can be sustained without encountering external constraints is thus a function of the degree of openness of the economy which can be defined in terms of the ratio of current receipts (CR) to GDP. The size of this ratio is the crucial determinant of the ability of the economy to make current payments and meet the servicing of external debt. As the CR/GDP ratio rises, it would be possible for the economy to expand the CAD/GDP ratio without rendering the external debt unsustainable.

3.36 For India, the CR/GDP ratio is at present around 15 per cent. This would allow the economy to run a CAD/GDP ratio of about 2 per cent while holding the debt service ratio at around 25 per cent. This configuration. is consistent with the economy's requirement of external resources as well as a sustainable debt servicing burden. The CAD/GDP ratio can be modulated in accordance with the movements in the CR/GDP ratio, so that the debt service ratio gradually declines from the present level of 25 per cent. Accordingly, the Committee recommends that as a broad rule of thumb, over the three year period 1997-98 to 1999-2000, external sector policies should be designed to ensure a rising trend in the CR/GDP ratio from the present level of 15 per cent and the endeavour should be to reduce the debt service ratio gradually from 25 per cent to 20 per cent. The Committee views the decline in the debt service ratio as a necessary concomitant of a sustainable balance of payment position as non-debt liabilities are expected to show a significant increase in the next few years. The CAD/GDP ratio would need to be consistent with the above parameters.

The Adequacy of Foreign Exchange Reserves

3.37 In the context of CAC, an adequate level of foreign exchange reserves is essential to

withstand cyclical changes in the balance of payments as well as unanticipated shocks which lead up to reversals of capital flows. Sufficient foreign exchange reserves strengthen the pursuit of a stable macro economic environment and anchors credibility in domestic policies. Furthermore, in recognition of the general acceptance of a stable and transparent exchange rate policy, the adequacy of foreign exchange reserves needs to be assessed in terms of the amount of foreign assets deemed necessary in the context of CAC.

3.38 Defining the adequate level of reserves in terms of a quantifiable norm is difficult and necessarily country- specific, depending on structural aspects of the country's balance of payments, the nature of shocks, the degree of flexibility in the exchange rate regime and access to international capital markets. A rule of thumb which has evolved in the context of developing countries with current account deficits is that foreign exchange reserves should be equal to at least three months of imports at any point of time. Measuring the adequacy of reserves exclusively in terms of imports or payments cover is more useful in a situation where capital flows are strictly controlled. In the context of a move towards CAC, since capital flows would have a more significant effect on the balance of payments, the conventional indicator in terms of import cover does not provide a good measure of the adequacy of reserves.

3.39 In situations where import payments can be advanced or locked into financing facilities due to exchange rate expectations (analogously, export receipts could be delayed or even advanced through recourse to export credit facilities), the simple measure of three months of imports does not capture the role of expectations and the contingent charge on the reserves. Against the backdrop of the large volume of debt servicing impacting on India's balance of payments , and the lessons of the crisis of 1990-91, the High Level Committee on Balance of Payments recommended that payments liabilities in addition to imports should be taken into account while determining the target level of reserves. In recent years, the Annual Report of the RBI has been monitoring the level of reserves in terms of import cover and debt servicing liabilities. Thus, it may be desirable to have an indicator of adequacy of reserves derived as a combination of import cover, debt servicing and leads and lags.

3.40 Guarding against volatility of capital flows and possibilities of sudden reversals assumes priority in the objectives which are served by holding stocks of foreign exchange reserves. Accordingly, reserve adequacy can be measured in terms of a ratio of short-term debt and portfolio stocks to reserves. In the event of reversal of capital flows, the central bank would be able to prevent a precipitous depreciation of the exchange rate.

3.41 Another measure could be the net foreign exchange assets to currency ratio. In countries which have a Currency Board system this ratio is 100 per cent, while some countries have had a proportionate ratio prescribed by law. In India up to 1956, a foreign securities to currency ratio of 40 per cent was prescribed by law. Subsequently, in the context of the Plans this ratio was abandoned in the mid fifties ostensibly because the authorities wished to have greater flexibility in the creation of currency. With the abandoning of this stipulation in the RBI Act, the floodgates for automatic monetisation were opened up. While a full Currency Board would safeguard against any problems of shortage in foreign exchange there is the attendant problem that the exchange rate would get pegged to another currency and any discretion in policy, however desirable, would not be possible. As a pragmatic policy there are advantages in prescribing under law a minimum net foreign exchange assets to currency ratio which would ensure that an unbridled expansion of currency would not be possible and remedial measures would necessarily need to be put in place long before a balance of payments deficit reaches crisis level .

3.42 As a broad guideline, the Committee recommends that the following four indicators be used in the Indian context for evaluating the adequacy of reserves**:**

(i) Reserves should not be less than six months of imports; this ratio is higher than earlier norms as it would take into account the uncertainties and volatility in capital flows which can arise in the context of a move to CAC. Under this formulation, the foreign exchange reserves would, at present need to be about US $ 22 billion.

(ii) Reserves should not be less than three months of imports plus 50 per cent of annual

debt service payments plus one month's exports and imports to take into account the possibilities of leads and lags. On this basis the present requirement would be US $ 24 billion. When more accurate data on leads and lags are available, the requirement for reserves could be adjusted appropriately.

(iii) The short term debt and portfolio stock which is equivalent to 70 per cent of the level of reserves should be. lowered to 60 per cent by using a formulation that incremental short term debt and portfolio liabilities should be accompanied by equivalent increases in reserves which would ensure that this ratio would decline to the desired extent. On this basis the reserves would need to rise from the present level of US $ 26 billion to US $ 31 billion.

(iv) The net foreign exchange assets to currency ratio (NFA/Currency ratio) should be prescribed by law at not less than 40 per cent . The present ratio is 70 per cent and the objective should be to maintain. it around the present ratio. The implication would be that at the present time the stipulation under the proposed ratio of a minimum of 40 per cent would be around US $ 15 billion; under the desired ratio of 70 per cent, the requirement would be a little over US $ 26 billion.

3.43 The advantage of alternative indicators would be that the authorities would have enough safeguards to ensure against any contingency. The Committee therefore recommends that the RBI should use four alternative measures of the adequacy of reserves and in particular it recommends that a minimum NFA/Currency ratio of 40 per cent be stipulated in the RBI Act to ensure against an unbridled increase in currency without adequate backing of foreign exchange reserves.

Strengthening of the Financial System

3.44 Certain vital preconditions for CAC relating to the financial system have been outlined earlier. These relate to reduction in NPAs, reduction in CRR and complete deregulation of interest rates. A direct fall-out of CAC will be the increasing pressure on the margins of banks arising partly out of greater competition and partly due to the disintermediation process gathering momentum with strong domestic corporates accessing world markets directly. The resultant squeeze on the Return on Assets (ROA) of the public sector banks which was -0.07 per cent in 1995-96 is likely to render the banking system vulnerable. To minimise the impact of such vulnerability it is essential that close attention be given to preparing the financial system for CAC. This section therefore details the recommendations of the Committee for strengthening and developing the financial system in the context of the move to CAC.

(i) Level Playingfield between banks and non banks

3.45 The blurring of the distinction between banks and non banks and the entry of a large number of players in the country's financial markets opens up the obvious question of a level playing field amongst the players. The Committee has made several suggestions in Chapter 4 for removing the restrictions on non banks' participation in the financial markets thereby removing the existing market segmentation. Recently there has been relaxation of the restrictions on FIs' accessing the short-term segment of the market. While the banks are under a tighter regulatory regime, the FIs and non bank entities do not have any CRR and the prudential and supervisory regimes are less exacting than for banks. With the gradual dismantling of barriers, FIs will emerge as universal banks. In view of this, the Committee recommends that a uniform regulatory system needs to be put in place for banks and non banks particularly FIs in relation to prudential norms, market participation, reserve requirements and the interest rate regime. In particular, the Committee recommends that concomitant with a target of reduction in reserve requirements for the banking system, there should be a gradual introduction of reserve requirements on the total liabilities of FIs, and non banks with operations beyond a threshold size should be subject to more exacting reserve requirements than presently stipulated.

(ii) CRR- Treatment for non resident and resident liabilities

3.46 The present system of maintenance of cash reserve requirements (CRR) exempts a sizeable segment of liabilities of banks, or puts them on a concessional footing. The focus should be on reducing the average effective CRR. In particular non resident liabilities should be brought within the ambit of CRR; a step to this effect has already been initiated in the monetary and credit policy announcement of April 15, 1997. In the context of a move towards CAC, the Committee recommends that reserve requirements on banks' non resident liabilities and overseas borrowings should be at least on par with those on domestic liabilities. Furthermore, as one of the instruments for moderating capital inflows, the RBI should use the instrument of CRR to impose higher reserve requirement on non resident liabilities including overseas borrowings by banks. The graduation of reserve requirements could also reflect the policy preference as between different schemes of non resident deposits. To the extent financial institutions and other non bank entities have non resident liabilities, the Committee recommends that the question of reserve requirements for such entities should be considered in totality to ensure a level playing field between banks and non banks.

(iii) Risk Management in banks and non banks

3.47 As the economy gets more integrated with the world economy, the volatility of interest rates/exchange rates in international markets would get transmitted to the domestic markets and it is necessary to ensure that the domestic financial system is sufficiently equipped to withstand these risks. The banks are yet to put in place adequate asset liability management (ALM) systems even for the risks on the rupee books and inculcate treasury culture which views the money, forex and gilt markets in an integrated manner. The Committee is of the view that risk management is a critical area to which banks and FIs must bestow immediate attention. Towards this the Committee recommends:

(i) The RBI should prescribe prudential norms for mismatches in the rupee book of the banks and FIs and prescribe a reporting system for monitoring mismatches.

(ii) The banks and FIs should be required to move progressively to a 100 per cent marked-to -market investment portfolio by the year 2000.

(iii) The best practices of risk management as outlined in the Report of the Expert Group on Forex Markets (Chairman: Shri O.P. Sodhani) may be adopted by all entities including corporates. This will require strong internal control systems to identify, measure, monitor and manage all types of risks.

(iv) Introduction of internationally accepted accounting and disclosure norms for banks, financial institutions as also corporates simultaneous with the introduction of new instr'uments/products.

(v) Capital adequacy requirements for market risk for balance sheet and off balance sheet items should be stipulated immediately for banks and non banks including FIs and made effective from the year ending March 1998.

(iv) Effective Supervisory System

3.48 A successful move to CAC requires an effective supervisory regime the importance of which cannot be over emphasised. Since most banking crises owe their origins to insolvency rather than illiquidity and since the former have a tendency to assume serious proportions only after a sufficient length of time, a vigilant and alert supervisory structure cannot lose sight of these problems at the incipient stage itself. Such a supervisory regime needs to be able to pick up warning signals and the weaker entities need to be monitored more closely and frequently. The supervisory system should take quick, strong and deterrent action in cases of inadequacies/deviations from norms. The supervisory regime should be supported by an efficient off-site surveillance mechanism monitoring the financial soundness of institutions through certain well-defined prudential parameters.

3.49 As risks faced by the financial sector are much higher in developing countries, the Committee recommends that the RBI should consider the imposition of even more stringent

capital adequacy standards than the Basle norms and income recognition and asset classification norms should be tightened expeditiously. The tighter norms may be in the form of steeper capital requirements for banks with higher level of NPAs. The Committee recommends that all these prudential norms should be prescribed on the basis of an assessment of necessary safeguards to enable the Indian financial system to attain international standards and the norms should not be prescribed with a view to enabling the weakest segment of the financial system a cushion for survival. The prescription of more stringent capital adequacy norms for banks with higher NPAs would in effect mean that the weaker banks would not be able to increase their advances portfolio. As already stated the weakest segment would inexorably need to become narrow banks.

(v) Autonomy for banks and FIs

3.50 As the Indian banking system is still predominantly owned by the public sector, the lack of autonomy of these banks is a major constraint. Although there has been a significant degree of empowerment of banks in the recent period in managing their assets/liabilities, much more needs to be done in the internal management of public sector banks to enable them to operate with a greater degree of autonomy to cope with the rapidly changing environment. The public sector banking system can no longer function as a monolith. The Committee is of the view that while in the context of CAC competition from foreign banks and Indian private sector banks will increase, it is necessary to bring about a qualitative improvement in the Indian public sector banks. The Committee recommends that the more efficient public sector banks need to be allowed, nay actively encouraged, to break away from the pack and their activities should not be hemmed in by concerns for the weak banks. The Committee recommends that the FIs should also be given a greater degree of operational freedom within the framework of strict prudential norms. While issues of autonomy are often posed as one of the regulator/owner giving freedom to the entities, there is also the issue of entities taking on their rightful autonomy. The Boards should be so constituted that they effectively operate as autonomous entitities. The Committee emphasises that autonomy is never given, it is always earned.

(vi) Legalframework

3.51 The banking system in the country remains handicapped in the absence of an adequate legal framework to ensure expeditious recovery of loans as also enforcement of security. The Committee recommends that a comprehensive banking legislation and an enforcement machinery be put in place not only to reduce the quantum of NPAs but also to ensure that such a framework serves as a deterrent for future defaulters. In the context of CAC, a comprehensive review of all banking and finance related enactments needs to be taken up, which have engendered inflexibilities/rigidities in the system.

(vii) Upgradation of technology for risk management

3.52 The participants in the financial markets with greater deregulation are prone to face greater risks arising out of market fluctuations. In order to mitigate the gravity of systemic risks arising on this account, banks and non-banks should be encouraged to build up strong internal control systems to identify, measure, monitor and manage these risks. These systems should adopt an integrated risk management approach. The Committee is of the view that without a greater degree of technology absorption, the Market participants will be ill-equipped to build strong risk-management systems and management information systems. Although the initial costs are likely to be heavy, the Committee recognises that superior technology will considerably enhance the quality of customer service, increase the volume of business and offset the cost factor within a reasonable time span. The Committee is also of the view that upgradation of technology can pave the way for an efficient payment and settlement mechanism which will strengthen the financial system considerably.

(viii) Upgradation o skills

3.53 The Committee underscores the need for strong initiatives on the part of market participants to upgrade their human resource skills by appropriate training inputs. In the long run, only skilled manpower can withstand vigorous competition and add value to the products and

services rendered. In order that they attract the best talent and expertise, individual banks and FIs should have freedom to determine their personnel policies including recruitment and wage policies without being constrained by any rigidities. The Committee recognises that without appropriate changes in labour laws it will not be possible to create an environment conducive to operational efficiency which is a prerequisite for enabling Indian financial entities to compete meaningfully with their counterparts abroad.

3.54 The Committee has dealt with the financial sector in great detail as strengthening of the financial system should be high on the agenda of adjustments in preparation for CAC.

Gold and CAC

3.55 Gold is a surrogate for foreign exchange and because of its special features it is a hybrid between a commodity and a financial asset. Though imports and exports of gold fall within the ambit of trade policy, the Committee is of the view that CAC is inextricably linked with liberalisation of the gold regime in India. Countries like Indonesia, Malaysia and Turkey have freed imports and exports of gold prior to or concurrent with liberalisation on the capital account. The general experience in this regard has been that unless the premium on the domestic price of gold is brought down very significantly through removal of import restrictions, the illegal import route would continue to exist even when capital controls are relaxed.

3.56 Despite attempts in the past to restrict imports of gold and to curb private demand for gold, the consumption of gold in India has shown a rising trend over the years. According to the World Gold Council estimates, imports of gold (legal and illegal) increased from 190 tonnes in 1991 to 379 tonnes in 1996 and in value would be equivalent to about 12 per cent of the country's total imports in 1996. One noteworthy feature has been that in 1992, the NRI route was introduced and such imports in 1996 accounted for 44 per cent of total gold imports (legal and illegal).

3.57 Larger imports of gold in recent years do not appear to have put any visible pressure on the country's BOP or the exchange rate of the rupee. It is conceivable that a good part of the gold imports through the NRI route might be a return flight of capital to the country. Premium on the domestic price adds a strong element to demand for gold and a restricted import regime on gold, therefore, provides an added incentive for the parallel economy. In view of the foregoing, the Committee recommends that in the context of CAC there is strong case for liberalising the overall policy regime on gold. The Committee is of the view that its recommendations on gold are, to some extent, in the nature of a precondition as the measures on gold are vital to a successful move to CAC. The details of sequencing of measures on developing the gold market are set out in Chapter 4.

Concluding Observations

3.58 The establishment of preconditions/signposts set out in this Chapter assumes critical importance. In view of the assessment of the initial conditions, a phased three year path of the entrenchment of preconditions is contemplated, which would dovetail into the sequencing of measures of liberalisation. In this sense, the Committee views the establishment of preconditions as simultaneous with the progressive institution of CAC in India. The Committee emphasises that phasing the establishment of preconditions is not set out as a definitive time frame, but more as signposts and the time frame and the sequencing of the move towards CAC should be a function of the implementation of the preconditions; thus, the three year time frame of CAC could be speeded up or delayed, depending on the degree of success achieved in establishing the preconditions.