Capital account amnesia

Kaushik Das, Business Standard, 31 May 2006
The roadmap to full convertibility was sabotaged by the Fifth Pay Commission the last time around, and the same folly is being repeated again

Two policy announcements made by Prime Minister Manmohan Singh clearly indicate that his government is not at all sincere about economic reforms. In the first place, he has announced the setting up of a Sixth Pay Commission to raise the wage bill of babudom further. On the other hand, he has also urged the Reserve Bank of India (RBI) to prepare a “roadmap” to guide the policy such that the rupee can achieve full capital account convertibility (CAC) soon.

The two policy announcements indicate rank hypocrisy combined with policy myopia, since further increases in the government’s wage bill through yet another pay hike for our bloated and dysfunctional bureaucracy would make the fiscal deficit hit the roof; whereas it is common knowledge that the most important pre-condition for attaining full CAC is to have a very low fiscal deficit.

The government also seems to be suffering from an acute case of amnesia. This was exactly what happened a decade ago. Then, the government decided to implement the Fifth Pay Commission’s pay hikes for babus, while also preparing a “roadmap” for full CAC in 1997-98. The “roadmap” prepared under the chairmanship of S S Tarapore was a good one, and provided work for economists and economic journalists, but we never reached the destination because the same government had also potholed the road by letting its wage bill skyrocket, thereby ensuring that the most important pre-condition for achieving full CAC, that is, a low fiscal deficit, could not be met.

The necessary pre-conditions recommended by the 1st Tarapore Committee Report in May 1997, for having a smooth transition towards full CAC by 2000, are summarised in the table.

It is clear from the table that although some criteria such as maintaining a benign inflation climate, reduction in NPA and debt-servicing ratios have been met (although in 10 year’s time rather than the prescribed three-year period), other critical important pre-conditions such as low fiscal deficit and CRR are yet to be met, even though an entire decade has passed us by.

A high fiscal deficit is the biggest obstacle in attaining full CAC. In this respect, India’s performance has been dismal. The centre’s fiscal deficit as a per cent of GDP, instead of coming down from 4.1 per cent in 1996-97, to the prescribed 3.5 per cent by 2000, has remained unchanged, ending at 4.1 per cent in 2005-06 (after deteriorating sharply to 6.2 per cent in 2001-02, mainly due to the strain imposed by the Fifth Pay Commission’s recommendations).

To give some idea of how badly the public finances of both the Central and state governments were affected due to the implementation of the Fifth Pay Commission recommendations, it suffices to note that the collective wage bill of the states increased from Rs 515.5 billion in 1997, to Rs 898.1 billion in 1999: a whopping 74 per cent rise in just two years. In fact, even today, 90 per cent of revenues of the states go towards paying salaries. Even in the case of the Central government, the wage bill, which stood at Rs 218.9 billion in 1996-1997, went up by nearly 99 per cent to Rs 435.7 billion in 1999-2000, when the Fifth Pay Commission’s recommendations were implemented.

It does not require much intellectual aptitude to appreciate that it was impossible for the Indian economy to meet the prescribed pre-conditions for achieving full CAC by 2000, given the damage done by the Fifth Pay Commission. Then, as now, the intention was never sincere. This shows clear policy hypocrisy.

Unfortunately, it is this very hypocrisy and double-talk that marks the current situation. Capital account convertibility would destroy capital controls by the government, leading to a situation wherein every Indian would be able to globalise his portfolio and participate freely and meaningfully in the global economy. Keeping CAC indefinitely postponed through such contradictory and conflicting policy announcements shows that the government is not at all sincere about economic reforms and is only paying lip service to please voters. Under such circumstances, the essential requirement of "sound money", stressed in the writings of all true liberals, can never be attained.

(The author is an economist at SBI Capital Markets Ltd. Views expressed are personal)