AGENDA FOR REFORM: EXTERNAL

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by

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Any views expressed in this paper are those of the author and should not be attributed to the organization for which he works.

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Table of Contents

Page No.

I. OVERVIEW **1**

II. FIRST PHASE OF REFORM **2**

A. IMPORT LICENSING **2**

B. FOREIGN EXCHANGE CONTROL **3**

C. TRADE TAXES **3**
1 CVD to VAT 4
2 Customs Duty 4

III. UNFINISHED REFORM AGENDA **5**

A. EXTERNAL TRADE **5**
1 Canalised Imports 5
2 Agricultural goods 5
3 Consumer goods 5
4 Export control 6

B. TECHNOLOGY IMPORT **6**

C. CURRENT ACCOUNT CONVERTIBILITY **6**

IV. SECOND PHASE OF REFORM **7**

A. FOREIGN DIRECT INVESTMENT **7**
1 Airlines 7
2 Airports 7
3 Urban Infrastructure 8
4 Printing & Publishing 8
5 Electronic Media 9
6 Automatic Route expansion 9
7 Insurance 10

B. EXPORTS **10**
1 Export Production 10
2 Free Zone For Export 10
3 Free Ports 11
4 Service Export Zone 11

C. CAPITAL ACCOUNT **12**
1 Towards Convertibility 12
2 Transition: Capital Flow Tax 12
3 Indian FDI & Portfolio Outflow 13
4 GDR & ADR 13
5 ECB & FCCB 14
6 Derivatives: Futures & Options 14

D. STRATEGIC & DUAL-USE ITEMS **15**

E. FINANCIAL SYSTEM **15**
1 Venture Capital 16
2 E-Commerce 16

I. OVERVIEW

1. Economic reforms started in a slow, fragmented and limited way in the eighties and gathered momentum and clear direction in the nineties. These reforms have by and large focussed on removing the economic distortions created by earlier policies such as physical controls on economic activity and excessively complicated taxes. As a result of these reforms India will likely have a trend growth rate of over 6.1% per annum over the last two decades of the 20th century. This will rank India as the eighth fastest growing economy (excluding small countries) in the world over these two decades.[1] Despite this India remains one of the poorest countries in the World. As per the last comprehensive survey in 1993-94, about 36% of the people are still below the poverty line. As per the international poverty line, about half the people are still poor. The fiscal problem, arising from an excess of unproductive expenditure, increases the vulnerability of the poor (and the economy as a whole) to adverse shocks. The performance of other Asian countries that were in a similar situation three to four decades ago shows that we can solve these problems of poverty in a decade, if we can summon up the will and determination to do so.
2. Accomplishing this requires both a completion of reforms started earlier and new reform initiatives, which encompass fundamental fiscal changes, reform of relatively untouched sectors and factor markets and institutional and legal areas. The fundamental driving force behind the social benefits that accrue from a market economy is "competition". One of the important tasks of reform has been and remains, to identify and remove all the bottlenecks to competition arising from past government policies, colonial era laws, outdated rules, and bureaucratic regulations & procedures. This must encompass not only the product market but also factor markets, which are the source of productivity, technical change and sustained growth. In most parts of the economy de-control, de-bureaucratisation and correction of policy distortions is sufficient to generate competition.
3. The fiscal situation deteriorated during the eighties and culminated in the BOP crises of 1991. Though the sharp deterioration that immediately preceded the crisis was reversed equally quickly, the fiscal deficit remains at a high level. Underlying this deficit is a quality of expenditure, which is not sustainable. Too much is spent on unproductive subsidies, goods and services and too little on basic public goods & human needs and maintenance of capital. In the long term such a high level of fiscal deficit is not sustainable. It must be brought down over the next decade to sustainable levels. If this is not done, the vulnerability of the economy to adverse shocks

[1] Small countries are defined as those with a population less than 10 million and GDP less than US $ 40 billion. Among the small countries for which data was available two grew faster than India.

could increase, especially if the high fiscal deficit is coupled with a continuing deterioration in the quality of government expenditure. Higher growth could then be put into jeopardy. The fiscal problem must be tackled head on by the Central and State governments if high growth is to be achieved and sustained. This note focuses on the External Sector issues with particular focus on FDI policy.

II. FIRST PHASE OF REFORM

2. There was a vast increase in controls during the sixties and the first half of the seventies. By the end of the seventies many practical and pragmatic people not bound by ideology were beginning to notice that these controls were not only unable to achieve their professed objectives, but were also creating many other problems and distortions. This awareness permeated even the political sphere and manifested itself in the appointment of committees to look into the issue of controls. These included the committee on 'Controls and Subsidies' ("Dagli") and on Import-export controls ("Alexander"). As result of various reviews, de-control started in a gradual and limited way (mainly industry and exports) during the eighties. In certain areas such as taxation and foreign exchange control, however, there was continued deterioration. De-control accelerated in the wake of the BOP crises of 1990 and extended to include neglected areas of reform such as the financial sector and taxation.

A. IMPORT LICENSING

3. Import licensing has been another important area of reform. The import licensing system built during the sixties and seventies started undergoing change in the eighties with the primary objective of freeing imports for exporters. In the nineties change accelerated with the freeing of industrial and mineral raw materials, intermediates and capital goods. Gold imports have also been gradually freed, though imports of precious stones remain restricted or licensed (SIL). A certain amount of import de-licensing has also taken place for agricultural goods and manufactured consumer goods.

4. Though import duties for exporters were rationalised during the eighties there was no such move regarding general import duties. By 1990 import duties were 300% or more for several items and above 200% for many items. Peak rates were progressively reduced during the nineties to reach 40% in 1999-2000.[2] As a consequence the import weighted average tariff rate for all commodities declined from 87% in 1990 to 30% in 1998-99. Average

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[2] The additional duty (CVD) as the counterpart of domestic excise taxes and the Special additional duty (SAD) as the counterpart of state sales taxes are **not** protective duties.

collection rate of customs duties (including CVD) declined from 47% in 1990-91 to 27% in 1997-98.

B. FOREIGN EXCHANGE CONTROL

5. At the end of the eighties, the foreign exchange market was even more strictly controlled than imports, coming as it did under the draconian Foreign exchange regulation act (FERA). Only limited easing with respect to transfer of residence and non-resident Indians had taken place. The reduction of import licensing and reduction in protective import tariffs during the nineties was accompanied by de-control of the foreign exchange market. This was facilitated by a 24% depreciation of the rupee in July 1991. A dual exchange rate regime replaced the strict exchange controls in 1992. The dual rate was integrated into a single flexible rate in 1993. This was followed in 1994 by declaration of full current account convertibility, as per international norms. A number of steps have been taken to liberalise restrictions on current account transactions. These culminated in the introduction of new modern Foreign exchange management bill in parliament. The flexible exchange regime has responded well to changes in the flow of foreign exchange, with RBI intervening to ensure orderly market conditions and to dampen excessive volatility.

6. De-licensing of manufacturing investment and manufacturing imports, along with price de-control and tariff reduction, has introduced competition into many sub-sectors of manufacturing for the first time in decades. As exchange rate adjustments offset much of the effect of import duty reductions on domestic producers, much of the threat was in the form of potential competition and pressure to contain price increases. The threat of competition is the most potent force for promoting innovation, productivity and efficiency. Freedom to produce, price, invest and import goes a long way in ensuring this even when actual imports are minimal.

C. TRADE TAXES

7. In the context of the overall tax system, import & export duties and taxation of inputs into production are recognised by tax experts as the most distorting forms of taxation. In other words such taxes reduce the efficiency and productivity of the economy by diverting resources and effort away from value addition and growth. A reduction in import duties and the extension of MODVAT credit on taxes paid on inputs have therefore been important measures for improving the efficiency of the tax system. Similarly the wide dispersion of rates of customs duties and excise taxes increased litigation, rent seeking and corruption. It was only after the mid-eighties, when the differentiation of rates reached absurd heights (e.g. excise duties on cloth varied by count, denier and dimension) that the reduction in the number of rates started. Considerable progress was made in the nineties with the rates

on most products, particularly intermediate and capital goods, being reduced to three. Only a few intermediate goods such as polyester still have a separate higher rate. With the reduction in the peak rate the number of basic customs duty rates have also come down to about 5.

1 CVD to VAT

8. The move from a traditional excise tax to a Value Added Tax has taken almost two decades. Over 100 countries have already switched over to a VAT. Given the constitutional division of responsibilities, the central government can at least move over to, what may be termed a Central Value Added Tax (CENVAT). This will have under its purview all goods and services which come under the authority of the central government. The essential features of such a tax from the external perspective are:

- There would a single basic CENVAT rate applicable to all manufactured intermediate goods, capital goods and the bulk of consumer goods & services. A rate of 15% will probably ensure revenue neutrality.
- CENVAT and the **special excise duties (SEDs)** would be applicable to imports. Exports would be zero-rated and entitled to a refund on CENVAT paid.

2 Customs Duty

9. Customs duty rates remain among the highest in the world. Most developing countries have customs duty rates in the range of 5% to 20%, while developed countries have even lower rates. Only S. Asian duty rates have been much higher. Pakistan has, however, recently brought down its peak rate to 35%, the level that already prevailed in Bangladesh. Sri Lanka has also recently brought down its peak rate from 35% to 30% and intends to reduce it further in the next few years. Reduction of our peak rate by 5% points a year would bring the overwhelming majority of basic customs duty rates to between 10% & 20% by 2003.[3]

10. Given the limited administrative capacity of less developed countries and their need for revenues, somewhat higher rates of customs duties have historically been justified in low-income countries. The most efficient revenue maximising tariff is a uniform customs duty. This is a useful ideal against which the protective elements of duty can be judged. A uniform import duty on all manufactured goods (including processed mineral & agricultural items) is a practical goal, as it would greatly simplify the whole process of import and export. Primary (unprocessed agricultural & mineral) products (including mineral oils) could have somewhat lower (uniform) rate. We can target a 10% duty on all manufactured goods and 5% on all primary

[3] The customs duty on soft (hard) liquor can be set equal to twice (thrice) the peak rate.

products by 2005. Given a flexible exchange rate, macro-economic adjustments will ensure that the actual import increase is much less than the threat of imports and any increase in imports is accompanied by higher growth of exports and GDP.

III. UNFINISHED REFORM AGENDA

A. EXTERNAL TRADE

1 Canalised Imports

11. Canalisation has been used either as a means of subsidising the canalising agencies or as means of implicit taxation (petroleum). These hidden subsidies must be brought out into the open by complete de-canalisation of imports and exports. An export duty can be imposed if justified.

2 Agricultural goods

12. A major reason for the high and volatile price inflation in Primary goods is that imports are still restricted and several exports are subject to quantitative restrictions (QRs). Such a system is not in the interests of farmers and often not even the consumers, as the government's information systems and speed of reaction is inferior to that of private trade and industry. The lagged government response often tends to aggravate volatility rather than dampening it. Both imports and exports of all agricultural items should be de-licensed. The best way to dampen excessive volatility is by allowing derivatives in all these products, and imposing import tariffs and export duties on selected sensitive products (e.g. common wheat, rice). The latter creates a price band around the international price, so that fluctuations in world prices within this band do not affect domestic prices, while domestic price volatility is also restrained beyond this band. This will be in the interests of both farmers and consumers, as a stable environment is more likely to encourage investment and productivity growth.

3 Consumer goods

13. Most manufactured consumer goods could be put on OGL without affecting production significantly because the existing customs duties provide sufficient protection. Even the most important consumer durable, the personal automobile (car) can easily meet the competition from new car imports at current rates. It is nevertheless extremely important to complete the process expeditiously, as the threat of competition is a potent force for efficiency and productivity.

4 Export control

14. Export controls should be eliminated. In a few cases such as inferior food grains an export duty can be imposed to ensure that domestic prices remain below world prices.

B. TECHNOLOGY IMPORT

15. Controls on technology import are even more difficult to justify than investment controls. Transfer of technology from the developed countries is the easiest way to close the huge technology gap and technological change is an important source of economic growth. Licensing only serves to slow technology transfer and consequently it slows growth. Technology import should be completely free. Any fears regarding transfer pricing (payments to foreign promoter companies) should be addressed through disclosure rules and transparency norms under company law.

C. CURRENT ACCOUNT CONVERTIBILITY

16. Given the Passage of FEMA and the continuing liberalisation of trade, current account payments must continue to be liberalised. Despite India having moved formally to complete current account convertibility five years ago, many still do not appreciate that foreign exchange is just another form of money. As it is a different type of money it has a market price in terms of rupees called the exchange rate. All citizens now have a right to buy foreign exchange at the market price for use in any current account transaction. Our attitude and approach to the foreign exchange market and to exchange rates must change drastically if we are to go confidently forward to meet the challenges of the world economy.

17. Formally we became convertible on the current account in 1994. There is a need to eliminate the gap between the theoretical position and the reality. It is almost certain that all import controls (QRs) imposed on protection grounds will be eliminated by April 1st 2001 (perhaps by December 2000). The lifting/easing of exchange controls should precede this deadline. Rules and procedures for exporters of both goods and services and for knowledge-based industries like Information Technology and Pharmaceuticals must change urgently. The policy focus must be on making the average Indian feel that complete current account convertibility truly exists in India. Greater and clearer delegation of powers to Authorised Dealers would remove persistent complaints, even regarding routine transactions. Dishonest individuals or illegal activities can be dealt with through better flow of information to and co-operation with appropriate authorities such as Enforcement Directorate & Central Board of Direct Taxes.

18. Use/purchase of foreign exchange by individuals to import goods and services into India should therefore be virtually free by December 2000.

This can be effectively achieved by allowing individuals to use international credit cards or bank cheques (FE denominated accounts) for purchasing goods & services up to a value of $100,000 per annum. This limit could be phased in over the next 12-15 months, in two steps, starting with the announcement of a $50,000 per annum (per resident) limit in the budget for 2000-2001. The credit card records would be available to RBI (as well as to the Income Tax department) and any violation of the provision would attract penalties under the new FEMA. The limit could be raised to $100,000 in the October 2000 credit policy or the budget for 2001-2002.

19. EEFC account holders can be allowed 100% retention of foreign exchange for current account use and permitted capital account transactions.

IV. SECOND PHASE OF REFORM

20. There are number of reforms, which have been mentioned and talked about but have not yet been undertaken seriously, and others which have elements similar to those in the earlier phase, but nevertheless represent a significant departure or advance over earlier reforms.

A. FOREIGN DIRECT INVESTMENT

21. Foreign direct investment is the best means of transferring business knowledge from the developed countries. This consists not only of technology defined in the conventional sense of production processes for existing and new products, but also organisational, managerial, marketing, distribution, procurement and logistics knowledge & systems. Skills and technology diffuse from such foreign companies into the rest of the economy through movement of skilled personnel, through demands on input suppliers, through supplies of superior output to users and by imitation.

1 Airlines

22. The brief spell of competition ushered in by allowing a few domestic airlines produced a dramatic change in the attitude of the staff of national airlines. This was short lived. Though natural barriers to entry and exit into this industry are quite low, the capital and organisational requirements are quite high. True competition therefore requires the entry of experienced players such as foreign airlines. Up to 49% foreign equity must be allowed to all foreign entities in domestic airlines. A start could be made by immediate lifting of restrictions on foreign airlines within the current 40% foreign equity cap.

2 Airports

23. The terrible delays at airports during the past winter combined with the air traffic controllers strikes have been a deathblow to the tourism industry.

The quality of our airports compares very unfavourably with those in S. E. Asia. Private entry and foreign participation can change this situation dramatically in a couple of years. Up to 100% foreign entry can be allowed in the international and major airports.

3 Urban Infrastructure

24. Real estate development and housing are an area requiring comprehensive reforms to unleash a boom in employment and investment. The real estate sector is also a sector that attracts FDI from non-resident nationals (or former nationals) & small companies relatively easily and therefore helps build momentum for an overall increase in FDI.
25. Automatic 100% foreign equity approval should be given for, (a) Urban infrastructure, (b) The development of integrated township projects including urban infrastructure, and (c) Manufacture of building materials/components and construction of building with newer technology. Automatic 51% foreign equity approval should be given for Housing, Commercial and Industrial (Real Estate) complexes. Case by case approval could be given up to 49% foreign equity for stand-alone housing and commercial projects.

4 Printing & Publishing

26. Provision of programming and software services is a harbinger of changes across a wide range of services. As has already been realised, we can duplicate our success in Software exports in the IT industry as a whole, by creating the right climate for exporting a wide range of data and information processing activities. What has not been fully realised, however, is that there are many other services where we have a comparative advantage or could create one, to become a significant exporter and player on the world stage. India is well placed to be a major exporter of publishing and printing services. It could replicate the success of Hong Kong by allowing free entry of foreign printing and publishing services into the country.
27. We desperately need to raise the educational and intellectual quality of our entire population and labour force. Foreign competition will reduce prices or increase quality (or both) and help extend the reach of publications to the entire educated population. Automatic 100% foreign approval should be given in areas, which are potentially of the highest benefit to the society and economy. Lower automatic limits could be set in areas in which the benefits are less clear-cut.
28. We should allow automatic 100% foreign equity holding in presses and other printing facilities as well as associated services like layout design.
29. Automatic 100% equity should also be allowed in the business of publishing for export on the same basis as the EOU/EPZ policy for industry and the forthcoming Free Trade Zone (FTZ) policy. Material allowed for

domestic sale would (of course) be subject to the press and other laws applicable to domestic media.

30. Automatic 100% foreign equity should also be allowed in publishing of commercial or private material such as stationary, brochures, pamphlets, leaflets, diaries, calendars, house magazines, journals & newsletters and all other published matter which is not explicitly restricted by a lower foreign equity limit.

31. Automatic 100% foreign equity should be allowed in the Publishing of Books and Journals in Science & Technology, Social Sciences, Professional areas (medicine, management, business, accounting, law etc.) and Humanities (Art, literature, geography). This would also apply to "self-help" or "do-it-yourself" books in these areas. It should also cover educational material and topical magazines in the same subjects (but exclude history books directed up to the high school level). Automatic 51% foreign equity can be allowed in areas relating to Culture, society and entertainment subject to certain conditions related to true globalisation.[4] Up to 26% foreign equity could also be allowed on a case-by-case basis for Current Affairs and News (magazines & newspapers).

5 Electronic Media

32. Internet Publishing can be carried out from anywhere in the world and it content sent anywhere instantaneously. Any restrictions on this type of publishing are therefore futile. Automatic 100% foreign equity should therefore be allowed on all and every type of Internet publishing.

33. We should distinguish facility ownership from control of content. That is there would be two types of companies, namely facility companies and broadcasting companies. Foreign investment in facility companies can be very liberal, with 100% foreign equity allowed if there is clear and effective separation from broadcasting content control. Foreign equity in companies that effectively control broadcast content would be less liberal (up to 26% say). An independent regulatory authority, which ensures equal and fair access to use of facilities by other broadcasting companies, must complement the liberal approach to facility ownership.

6 Automatic Route expansion

34. Allow 100% foreign equity in Software & Hardware Technology Parks (STP, HTP), 100% Export Oriented Units and Free ports (free trade zones). Allow automatic 74% foreign equity in all manufactured goods that are on OGL and automatic 51% foreign equity in manufactured goods that are on SIL. Allow automatic 74% foreign equity in all modern, technical, financial, professional, educational services, software, entertainment and construction

[4] Limits to USA, UK coverage, adequate India coverage.

services. This will help improve quality, promote international linkages and lead to a boom in export of services. Move to 100% foreign equity in manufacturing and exportable & importable services by 2003 by which time all QRs related to BOP will be eliminated. Move towards allowing 100% foreign equity in all infrastructure services constituting a 'natural monopoly' segment subject only to the condition that this segment must constitute a separate company that provides universal access at fair and non-discriminatory prices ("common carrier" principle) under a regulatory authority. Government could keep a *golden share* in such 100% foreign owned 'natural monopoly' companies. Allow automatic 51% foreign equity in the production of all other goods and services.

7 Insurance

35. Serious development of the long-term debt market awaits the opening of the insurance sector to private competition and introduction of international best practices. Following the Insurance regulatory authority bill, the IRA must get its systems and procedures in place for quick processing of applications. Quick introduction of Health Insurance and Pension funds must be encouraged.

36. In the not too distant future up to 49% foreign equity investment should be permitted. This could be conditional on the Indian promoters having a larger proportion of shares than the foreign joint venture partner (i.e. Indian management control).

B. EXPORTS

1 Export Production

234. Exports are essential not only for long term sustainability of the current account and the Balance of payments, but also for sustaining high growth rates. Exports played a critical role in the high growth rates seen in Korea, China and other countries in Asia. These countries were successful because they subordinated other objectives to the combined objective of high export & economic growth. These objectives permeated the entire bureaucracy. In our case the indifference of many parts of government is apparent from the frequent and repeated complaints of exporters. A fundamental change in mind set is needed. Labour and SSI policy must be subordinated to export objectives.

2 Free Zone For Export

37. As already declared export processing zones should be converted into Free Trade Zones (FTZ), on par with the best in East and S. E. Asia. Recognised global electronics companies could be allowed to have FTZ status in custom bonded factories. A free foreign investment regime would be applicable to

the Free Trade Zones, with free inflow and outflow of all capital except short-term debt (less than one year). The only condition on debt would be that it is related to production activity within the zone, and is not used as a channel for flows into the domestic tariff area. Any remaining controls licenses and reservations (e.g. SSI) should not apply inside the zone. Labour laws inside the zone and their procedural applicability would be put on par with those of successful exporting countries (e.g. China) and regions (S. E. Asia). Private enterprise would be free to supply any and all types of infrastructure services within the zone without any price or investment control. Radio frequency spectrum would be auctioned only if there is excess demand, other wise it would be free.

3 Free Ports

235. The conversion of Export Processing Zones into Free Trade Zones must be a genuine one, which converts them into real free ports. Customs must treat them as virtual foreign enclaves where free import export is permitted without any duty. India despite being a low income, labour surplus country has a pathetic record in the export of labour intensive products. This has deprived many poor relatively unskilled people of jobs. The two main reasons are the highly inflexible labour laws, rules and procedures, and SSI reservation. We must introduce a highly flexible labour regime in the Export Processing Zones and de-reserve all industries within the zones.

4 Service Export Zone

236. Though ‘brain drain’ is better than “brain down the drain’ it would be even better if the brains could be re-cycled back to the country after gaining global experience. The only way in which can be done is by creating a Service Export Zone which is a replica of the living and working conditions available to these brains in the developed countries. Such zones could be a tremendous source of comparative advantage in the modern service sector, including professional services. Service exports are the new frontier for developed countries, and the creation of service export zones with conditions matching theirs could put us on the frontier. This would, however, require the creation of a free market area with complete de-control & de-licensing and 100% freedom to private (including foreign) investment, including that in infrastructure and social sectors.

C. CAPITAL ACCOUNT

1 Towards Convertibility

38. Debates about capital account convertibility often seem to treat it as an indivisible monument that you can either afford to have or not. In reality it is a continuum with infinite degree of possibility. Our experience of the BOP crisis of 1990-91 is sufficient for handling the phasing and sequencing of capital account convertibility. Even before the BOP crises, the eighth plan working groups on BOP had emphasised the need for reducing the country's debt-equity ratio and the short-term debt. Subsequent reforms have also emphasised the importance of exchange rate flexibility based on underlying market fundamentals, and the importance of banking reform, capital market development and modern regulatory systems for the financial sector. All these are lessons that East and S. E. Asians, as well as observers across the world have re-learnt from the Asian crisis. We must therefore move confidently forward toward complete capital account convertibility, without taking undue risk, but with all deliberate speed. A possible target date for capital account convertibility defined as 99% (say) of USA or EU level, could be 2010, by which time our financial system and fiscal management must meet international standards.

39. Given sound macro-economic policies and a reasonably well-developed and regulated financial system, the main area of risk is short-term capital movement. Though short term is generally defined as one year, this should be viewed as an upper limit. The focus of restraint has to be on agents and instruments through which large amounts of funds could be moved legally over a short time period. In other words these are agents who have large amount of liquidity, leveraging capability or access to credit.[5]

40. It follows from the above analysis that both long-term capital inflows and outflows can be quickly freed up. Purchase of derivatives and guarantees by residents from non-residents against known exposure, must be freed urgently as this has the additional benefit of reducing 'country risk.' All restrictions on hedging of risk by all those with foreign exchange exposure should be lifted.

2 Transition: Capital Flow Tax

41. To aid the transition to full capital account convertibility a dual exchange rate mechanism or a tax on capital flow could be used as a phase-in device. Lifting of controls on capital flows can in principle be combined with a dual market for such flows, which is completely free with no RBI intervention to control volatility. Alternatively a tax could be imposed on all purchase of

[5] It is often overlooked that banks themselves have this capability. Their short-term foreign borrowing should be subject to strict prudential regulations.

foreign exchange (spot or forward), with an exemption for import of goods & services into India. The money collected would be used to create a country risk insurance fund separate from the foreign exchange reserves. This fund would have a specific constitution, an independent management board and rules for use in a potential crisis. The tax can be complimented by the imposition of CRR on foreign deposits and debt with banks & financial institutions, which is greater than the CRR on domestic deposits.

42. Some of the policy measures which need to be set on a clear and unambiguous reform path for creation of competitive advantage are:

3 Indian FDI & Portfolio Outflow

43. Foreign direct investment abroad by Indian companies and foreign portfolio investment by individuals can also be freed, starting with manufacturing and export or import related services. Indian individuals should be freed to carry portfolio investment abroad from their (declared) personal wealth or income. A start can be made by channelling this investment through SEBI registered financial intermediaries, who could be required to report large investments to RBI. A system of registration could remain for the time being, with suitable communication to CBDT and other authorities to aid in detecting undeclared income & wealth. Similarly, investment in listed or unlisted Indian companies and in unincorporated firms can be allowed for nationals of developed countries that are a potential source of knowledge.

44. We should in the next budget de-control the flow of Indian Direct Investment Abroad by Indian Companies up to a limit of $50 million per annum. Remove the conditions on repatriation of earning by way of dividends etc.

45. A significant step towards capital account convertibility could be made, by simultaneously allowing individuals, businesses and Corporations to make capital transfers abroad, including for opening current accounts. This would be up to a limit of US $100,000 per annum per resident, to be phased in the same manner as the limit for purchases. The resident entity would however be required to keep a record of all such transactions and the assets so purchased, for showing to RBI or other designated authority when required to do so. In fact there could be a single overall limit of $100,000 (from March 1, 2001) that includes both current and capital account transfers.

4 GDR & ADR

46. Issue of Global Depository Receipts or American Depository Receipts is the least risky form of equity issue from the issuing country's perspective. It is dollar denominated and trading occurs between non-residents. There is therefore no *direct* effect on the country's foreign exchange or equity market at the time of a crisis. It should therefore be completely de-controlled.

5 ECB & FCCB

47. Now that Indian banks and companies have learnt from the experience of other countries, long term debt (over 3 years) can also be freed for all domestic banks and corporations, followed by medium term borrowing (1 to 3 years). This would be subject only to the condition (auditors certification) that they have the capability to assess the real risk adjusted cost of such borrowing and adequate systems for exchange risk assessment and management.
48. We should plan for complete de-control of ECB and FCCB of maturity greater than one year by 2002-3. These should be phased in starting with immediate de-control of ECB of average maturity greater than 7 years and above, followed in the next budget by, De-control of External Commercial Borrowing (and Foreign Currency Convertible Bonds) of average maturity of five years or more by resident companies.

6 Derivatives: Futures & Options

49. With the reduction in controls and increase in competition the sources of risk have also increased. Economic agents must have access to hedging instruments if they are to manage this risk in effective and efficient manner. With the Securities Contract Act now amended to allow derivatives, financial derivatives can now be introduced expeditiously. Among these are Exchange rate and commodity (e.g. oil & gold) futures. A screen-based, electronic market in non-deliverable forwards and futures should be set up as a precursor to a free foreign exchange market. Strict prudential requirements could be imposed on leveraged purchase of foreign exchange in the future/forward market and on credit given for this purpose.
50. Derivatives markets are as much about information as hedging and risk taking. Savvy traders and large industrialist with their host of employees always have more information than the farmer or tiny industrialist. Derivative markets are a small step in correcting this imbalance in information. In well functioning screen based derivatives market new information about production, stocks and demand available to any of the savvy economic agents, is instantaneously reflected in the price of contracts. Even the small importer or exporter thus gets this information indirectly. He can then have an idea of the likely future price of items he may be planning to import or export accordingly. He could also hedge some of his risk by forward or future sale.
51. There is a need to introduce forward, futures & options in all internationally traded commodities, particularly agricultural crops as they are subject to the hazards of weather & pests. The ideal system would be a single Regulatory Authority for all commodity derivatives and a single unified electronic exchange with trading terminals all over the country. This derivative

exchange could be linked to a similarly unified screen based commodity exchange under a single regulatory authority. The regulatory authority could have subsidiary regulatory bodies and regional commodity exchanges so as to incorporate the existing commodity exchanges. As derivatives are essentially financial instruments consideration could be given to making SEBI the regulatory authority for all derivatives and allowing NSE to trade in commodity derivatives.

52. Short sale of foreign exchange must also be de-controlled, subject to a well-regulated system, which allows security lending and borrowing. A 'when issued' market must also be permitted on electronic exchanges with screen based trading. All this could be carried out easily in a well managed & regulated electronic exchange such as the NSE

D. STRATEGIC & DUAL-USE ITEMS

53. Defence electronics and aerospace is currently reserved for the public sector. The assumption that only the public sector can be trusted, on which this reservation is based is no longer valid. Export of such products to unfriendly countries can be controlled under the EXIM policy or the National security act. As the sole buyer of lethal weapons, government already has a domestic monopsony. Competition in the production of dual use defence, nuclear and aerospace items would benefit the nation in terms of better quality, reliability, speed of delivery, and cost reduction.

54. A new dimension has been added to this issue by the introduction of technology denial regimes, purportedly on defence, nuclear, missile and dual-use goods and technology. These constitute what be may be called 'strategic technology,' the flow of which is determined by geo-politics, as distinct from normal commercial technology which is available on world markets. Our national R&D effort has to focus on development of 'strategic technology.' It is in the interest of national security that such strategic items be produced in India. Paradoxically, it is also in our national interest to open all such areas to 100% foreign investment, and even provide special incentives for transfer of this technology to India.

E. FINANCIAL SYSTEM

55. The financial system plays a vital role in the economy by channelling funds from savers (saving) to investors (investment). The financial market is the pivotal market for economic growth and cyclical fluctuations. The health and efficiency of the financial system and of financial markets can therefore play an important role in improving the efficiency and sustainable growth prospects of the economy. Given that finance professionals of Indian origin have demonstrated their capability all over the World, financial services are

a potential source of competitive advantage and exports in the 21st century. This, however, requires a sharp improvement in the average level of skills, an environment with international regulatory standards and free competition unhindered by outdated controls. A few specific aspects of direct concern to international trade & capital flows are;

1 Venture Capital

56. There is a tendency in India to confuse start-up capital with venture capital. Start-up or initial risk capital is always provided either by the entrepreneur or his (her) family and friends. This is the essence of entrepreneur-ship, and also has the merit of eliminating harebrained schemes. Venture capital is designed to support new products & services and innovative approaches and ideas, not new persons' producing/supplying the same things in the same way that numerous firms are already doing. Venture capital funding needs to be strongly supported, but this can only be done if it is not confused with the provision of start-up capital. Venture Capital Funds can be key engines for growth in technologically intensive knowledge based industries & services.

57. The two most important reforms needed to promote venture capital are a Limited partnership act and rationalisation & simplification of tax incentives for venture funds. Limited partnership allows for 'pass through' which makes a VCF more attractive to investors. In essence Venture Capital Funds pass through their losses in the initial years of the fund to their investors, so that investors can set-off their share of losses against profits in later years. Provisions of the Indian Trust Act 1988 could be modified to accommodate limited partnership and pass through in line with the Venture capital trust act of the UK. The investment pattern required for getting tax benefits needs to be liberalised. For instance Venture Capital Funds should be allowed to invest in quasi-equity such as partially or fully convertible debentures and convertible preference shares of target companies. Venture capital could be allowed to invest in the modern service sector with export potential such as electronic media, Internet, publishing, health & education related services. SEBI code on Acquisitions and Take-overs may also have to be liberalised for Venture Capital Funds.

2 E-Commerce

58. If we are to be active and prominent participants in the information (IT) revolution we must quickly upgrade our payments system. The information technology society requires an urgent introduction of a nation-wide Electronic Funds Transfer (EFT) system that can transfer funds anywhere in the country within one day if not quicker. This must be followed by introduction of systems and procedures for electronic banking, wider use of debit cards and E-commerce. Appropriate legal, regulatory and system

change will have to be made to insure security and confidentiality of information and funds.

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