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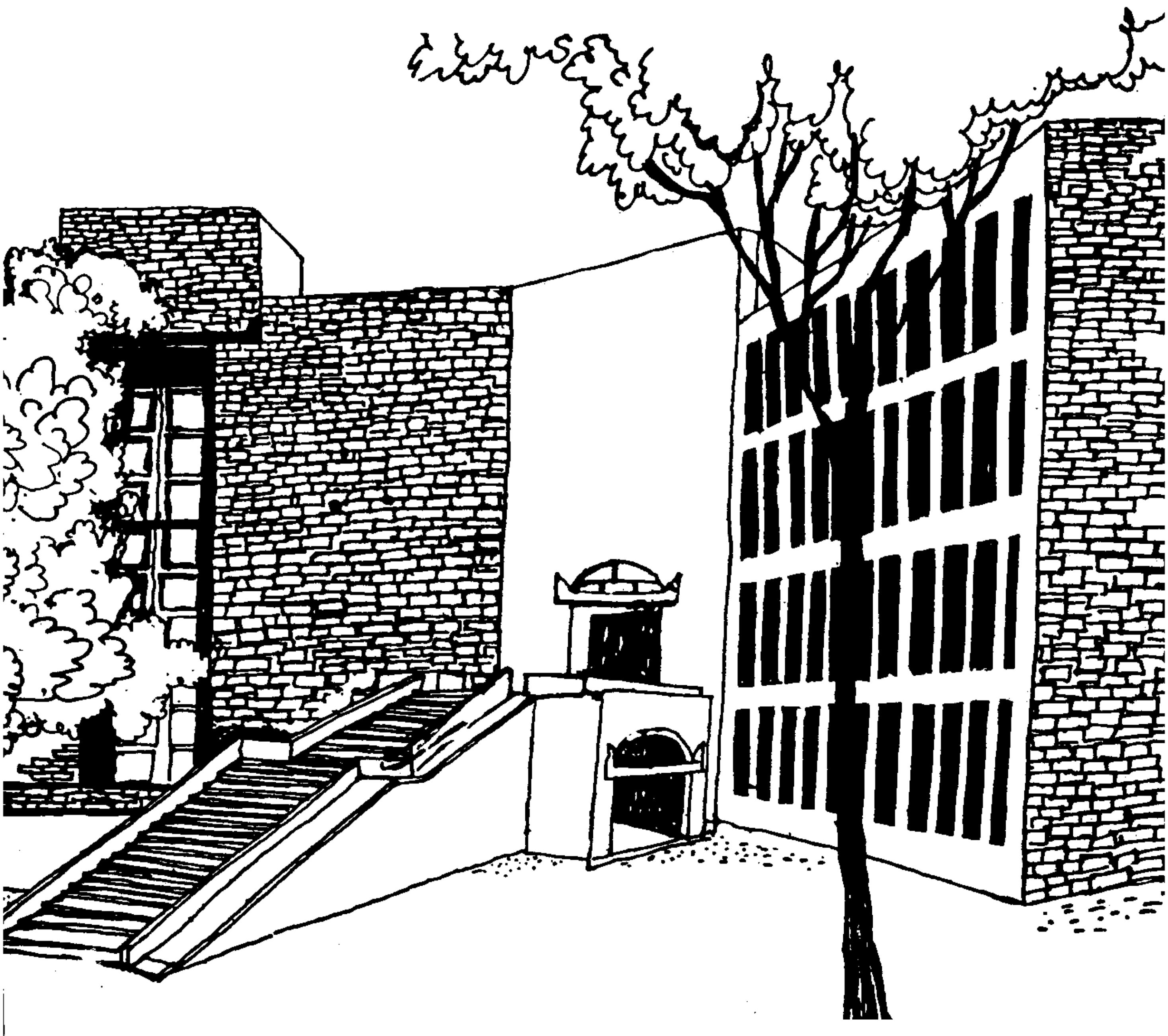

RUPEE CONVERTIBILITY AND EXIT POLICY

By

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ABSTRACT

The success of partial convertibility of rupee and adequate foreign reserves have boosted confidence of the government. It is more than likely that we are going to see a convertible rupee on trade account before the end of this year. In official quarters it is believed that fiscal imbalance is only stumbling block in the path of a fully convertible rupee. Other important issue which is as important as fiscal imbalance is an exit policy. An exit policy for existing enterprises or just only for new enterprises is essential to keep a stable exchange rate. Otherwise, we are going to see a sliding rupee against trade weighted basket of currencies as we had in eighties.

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The success of partial convertibility has influenced the finance minister to change his mind to full convertibility on trade account much earlier than he had indicated earlier. The RBI assurance that the BoP and reserve positions are stable has also played a role in expediting the decision to make the rupee fully convertible on the trade account. The main reason is that the government wants to eliminate grey market (*havala* trade) so that all the remittances come through the official channel which is estimated to be $2 billion per annum. The March figures suggests only half of the remittances through the *havala* trade have been lured to official channels. If all the remittances come to India through the official channel it would give a big boost to India's foreign reserve. The finance ministry has further reduced import duty on gold which is essential to kill the *havala* trade. On the other hand prices of the canalised items like POL, fertilisers etc. would go up about 10%-12% in rupee terms and if this increase in prices is passed on to consumers, it may notch up inflation by another one percentage point.

The premium of 10%-12% on foreign currency in the open market indicate market's confidence in the stability of rupee. The timing for full convertibility of the rupee would depend on this important factor. However, the timing of the full convertibility would depend on the behaviour of the monsoon, on export performance and on the level of foreign reserves in the coming year. The government has liberalised foreign investment by Indian companies selectively and investment by selected financial institutions in the capital market. This way government is able to test the water before taking the final plunge.

The Finance Minister has suggested in March in an interview that as soon as fiscal imbalance is under control, the convertibility of rupee can be achieved. I suppose what he had in mind was not only convertibility of rupee on trade account but also on capital account. But fiscal imbalance is one of the constraints for rupee convertibility; another one - and almost as important as the fiscal imbalance - is a sound exit policy for labour. Until now there had been a convoluted mechanism available for closing down private sector units after referring to the Board for Industrial and Financial Reconstruction (BIFR) and only recently public sector companies can be referred to the BIFR for closure. One of the points not adequately taken on board is the amendment of the Industrial Dispute Act of 1947 as amended in 1976, which inhibits a going concern to change its production process or product mix in line with changing demand. If one looks back at the causes of sickness in sick units one finds that management of such enterprises did not employ new capital equipment which could have raised the productivity. The management knew that labour enhancing and productivity raising capital equipment necessitates retrenchment of some labour which the management was not allowed to do so easily. They chose a softer option of not updating the capital equipment. They continued to use the old equipment which produced at a high cost, ultimately resulting in an unviable unit, which in turn was turned over to the government.

In all the vibrant developing and developed economies, enterprises are allowed to change the pattern of production and be more productive by bringing in new capital equipment and required skilled labour. And this productivity not only keeps the producer competitive in the domestic market and keep foreign competitors at bay but also internationally competitive. The best guide to productivity in different countries is to compare unit wage cost - the total wage bill divided by number of widgets produced. This isolates the domestic costs of production from other costs such as raw materials, which would be set largely in world market as a result of rupee convertibility and would not vary between countries. Therefore, productivity along with low rate of inflation is the bed rock of a stable exchange rate and good export performance. Two examples of these from the developed countries are that of erstwhile West Germany and Japan. In spite of widely believed *nenko* system of employment, popularly known as cradle to grave employment system of

Japan, Japan has a flexible labour market. On average one-third of total labour force in an enterprise is under *nenko* system and the rest two-third of total labour force is under flexible employment system. Furthermore, flexibility in the labour market in Japan is achieved by reducing real wage rather then by retrenching labour as normally practised in other developed countries. On the other hand Germany has liberal compensation law and state funded employment insurance scheme. There an enterprise is allowed to carry on business as competitively as the market forces allow. Other small countries like South Korea, Singapore and Taiwan also achieved high productivity by classical means - namely long hours of work at a very low pay - which is neither desirable nor possible in India in the organised sector. And all these countries have achieved phenomenal growth in exports. So much about the importance of productivity in promoting exports and maintaining a stable exchange rate.

Let me point out the rough weather a convertible rupee may face in the absence of a bold exit policy for labour for an existing enterprise. Even with a fiscally balanced or a fiscally neutral budget, which would remove one of the main sources of inflation, a convertible rupee in the uncharted waters of world financial market sea would face rough weather. It would always be on a downward spiral for the following reasons. First, the productivity of Indian industries will be lower than its international competitors and trade partners as a result of inflexible labour market. This implies loss of competitiveness and hence loss of exports which markets would correct by lowering nominal exchange rate of rupee. This downward spiral can only be arrested by increasing interest rate. This would give a temporary breathing space to rupee value and may attract hot foreign money, but it would have undesirable effect on domestic investment. Anyway, this is a short term measure and this cannot be sustained indefinitely as a depreciating currency would push domestic wages and prices.

Second, the rupee convertibility is supposed to attract foreign direct investment. This would remain a distant hope if labour market - as it is now - remains inflexible. For it is well known that a multinational corporation (MNC) brings in capital to improve its world-wide productivity and thus its corporate profitability. In fact, without a flexible labour market and a convertible rupee, it would be more profitable for an MNC to trade in India and take advantage of India's large domestic market than produce in India and help in India's efforts to increase exports and employment. The whole advantage of a low skilled labour force in India is lost from the view point of an MNC if the labour market is inflexible as it is now.

Labour unions may frown upon the idea of a flexible labour market as they have enjoyed, with political backing, a life time rigid employment system. However, they may oppose a flexible labour market due to fear of high unemployment and indiscriminate hire-and-fire policy by industrialists. Let us analyse the reality of the past. First, in the whole history of industrialisation since nineteenth century gross employment in an economy has always grown and has never shrunk in absolute terms except over short business cycles. Second, it is a fact of life that workers who go home in the evening out of a factory gate are expected to come through the same gate next morning and man the machines and equipments, no matter how flexible labour market is. The cost of hiring, firing and training labour is enormous and no enterprise can survive very long who hires and fires employees indiscriminately.

In fact, it would be in the interests of the workers to have an exit policy with government funding a national renewal fund; rather than the present state of affairs wherein private firms are free to declare lock outs without compensation to workers. Moreover, exit policy is crucial as it concerns future investors, especially foreigners. Since the investment programme for the 1990s depends critically on foreign investment, the government should consider an exit policy which applies only to future jobs, while exempting existing ones as a second best solution. This is not a very good solution as it will create a pool of uncompetitve enterprises. But at least this will make everyone happy in the short run.

At this point, let us evaluate India's record of competitiveness under existing labour laws in the past. In 1975, India switched to a flexible exchange rate system with the peg being a trade weighted basket. Since then, except the July 1991 devaluation, overt devaluations have been avoided and there have been various movements in nominal and real terms. There had been some tendency to rigidity in terms of the dollar from late 1985 to mid 1991 and that is official Reserve Bank of India's policy at present. But, against trade weighted basket rupee has been sliding all through the eighties. That is how the authorities have tried to keep Indian exports competitive in the absence of productivity.

Rupee convertibility without a sound exit policy, for all enterprises or only for new enterprises, is fraught with danger and even with a balanced budget it may not be sustainable as the finance minister seems to suggested in March this year. On the other hand, to keep a stable exchange rate it is not only necessary to follow a non-inflationary fiscal and monetary policy but also to have a labour policy which does not tie the hands of entrepreneurs behind their backs.