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A Paper on:

“Allow Rupee to Appreciate”

Date: 9th September, 2011.

Indian markets have been opened up to

Competition

From within as well as outside India.

Necessary adjustments have taken place in the economy.

Economy has grown.

All other regulators have withdrawn.

Transition from a controlled economy to an open economy is good.

However, RBI has still not given up fully.

It attempts to protect the export sector

By keeping Rupee low.

In the process Indian economy is hurt.

Rupee should be allowed

To gain its right value in the international markets.

“Allow Rupee to Appreciate”

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Short Forms

FERA	-	Foreign Exchange Regulation Act
FEMA	-	Foreign Exchange Management Act
FX	-	Foreign Exchange
GOI	-	Government of India
RBI	-	Reserve Bank of India
\$	-	US \$

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Website: www.rashminsanghvi.com • E-mail: rashmin@rashminsanghvi.com**Allow Rupee to Appreciate****1. Preface:**

We are presenting herewith a paper on the subject: **“Why Indian Rupee should be allowed to appreciate!”** We are fully aware of the fact that: RBI and Finance Ministry are far more knowledgeable than us. Still we are venturing to present our humble views on a subject where we have a difference of opinion. (More clarifications are submitted in Annexure II.)

Our submission is: No deliberate action should be taken by the RBI & GOI to prevent appreciation of rupee and cause depreciation of rupee. **Present policy is:** If rupee appreciates by market forces; then RBI steps in and does not allow any steep appreciation. If rupee depreciates by market forces, RBI generally does not intervene. This policy should be stopped. Let the RBI manage only spikes. Left to itself, Rupee may appreciate. Let it appreciate.

Consequences of our submission are discussed in detail in this paper. It involves various concepts & hypotheses. Some of these require elaboration. Such elaborations are given in **Annexures**.

2. Controlled Economy:

We submit that Government of India (GOI) had controlled Indian economy with Three Strategies from 1947 to 1991. These are listed below as a summary.

Strategy One -	Indian bureaucrats were convinced that they knew what is best for India. Ignorant Indians needed to be controlled.
Strategy Two-	Depreciate the Rupee and get bonanza in terms of higher customs revenue, reduction in imports, boost to exports and protection to domestic production.
Strategy Three-	High direct & indirect taxes mean redistribution of income & wealth in favour of poor. Making the economy socialistic; and earning high tax revenue.
Consequences of Three Strategies	India was on the brinks of insolvency in the year 1991.

In this paper we give more importance to Strategy Two: "Depreciation of Indian Rupee." Other Strategies & their consequences are given briefly in **Annexure I**.

3. Economics is not just mathematics:

Economics is **not just a mathematical Strategy**. Several forces work simultaneously in Economics.

Economic results are sum total of several economic and even personal actions taken by individuals, institutions and Governments. Individuals are many times driven by **sentiments and feelings**. Sentiments and feelings can be irrational and unpredictable. Surprisingly when a sum of the society's actions is taken, there appears a method in the unpredictable sentimental actions of individuals.

The importance of this fact is that: to get desired results in Economics, one has to consider the sentiment of the people. This is seen in real life. When a company wants to make a public issue, it first assesses the market sentiment. Refer To Dr. D. Subbarao's speech on 29th July, 2011 at Indian Economic Services (IES) -where he emphasises that "Economics is a People Matter, which is one way of saying that economics is not physics. Economics deals with real world of people."

A study and practice of Economics should be a study and practice of mathematics, **psychology, politics, pure economics and philosophy**. (There can be objections against inclusion of philosophy. However we leave the controversial issue aside.)

Illustration: Long Term Capital Market (**LTCM**) was incorporated and managed by two individuals who got Nobel prize in mathematics. These geniuses developed special software to predict movement of foreign exchange rates. They betted in Foreign Exchange (Fx) speculation based on their own predictions and made a lot of money. In 1998 they collapsed and endangered the solvency of several banks and institutions. This is a long story. The moral is if some one relies purely on mathematics, there is good chance that sooner than later he will fail.

4. Strategy Two (Rupee Depreciation) in brief:

(i) Conservation of Fx: Discussed in paragraph 4 below in brief.

(ii) Encouraging Export Sector:

(a) Depreciation of Indian rupee & its consequences discussed in Paragraph 5 below.

(b) Other encouragements to Export sector listed in paragraph 6 below.

For many decades, GOI & RBI worked on Strategy Two: "India had scarce foreign exchange (Fx). It needed to be conserved. Left to itself, the market forces will not make a fair use of Fx. Market had to be controlled with an iron hand." Several laws, mechanisms and departments were together used for achieving this purpose.

4.1 Import Licensing was a physical and strong way to reduce imports and hence to reduce the demand for foreign exchange.

4.2 Heavy Customs Duties were levied to increase the cost of imported products. This reduced demand for import & hence demand for Fx. It gave substantial revenue to the Government of India. For many years, customs duty gave more revenue than income-tax. It protected local goods from foreign competition.

We had inelastic demand for imports for certain goods. GOI was happy. Every increase in Customs duty meant higher revenue.

4.3 Whatever demand for FX was not covered by import licensing and customs – was severely controlled by **FERA**.

4.4 Rupee was continuously depreciated. It was and even now is believed that a depreciated rupee (i) discourages imports (imports become costlier), (ii) encourages exports (exports become cheaper for the foreign buyer) and (iii) protects local industry & (iv) increases Customs Revenue. **A win-win-win-win Strategy.**

Looked like a perfect mechanism. Only on paper.

4.5 Consequences of the Strategy in brief:

Ground reality was – **smuggling** became a huge business. From Japanese textile (in the fifties and sixties) to electronics and cosmetics to gold were brought into the country by smuggling.

Simultaneously a huge **hawala** system emerged. Smuggling and hawala became **complementary** to each other. Together they became so profitable & hence powerful that it became impossible to tame these two (smuggling and hawala). Ultimate failure of GOI is evident in so many ways. We discuss the details below in paragraph 5.

5. Depreciation of Rupee & its consequences:

5.1 GOI & RBI had followed a **consistent policy of depreciating the rupee**. Result of this policy is that **now rupee is less than 1% of its value** in the international markets. (See statistics in Annexure III.) (We are not considering in this paper the internal value. It is affected by many factors – including inflation and external value of rupee. Internal value of rupee is a disaster story. External value disaster is sub-part of total value disaster. Let us focus on the sub part for this paper.)

5.2 RBI policy has evolved over past decades. Earlier, RBI used to straight devalue the Rupee. After liberalisation in 1991 **market forces** were allowed **some part**.

If by market forces Rupee appreciated, RBI intervened in the market. Bought dollars and supplied Indian Rupee. This depreciated the Rupee. If by market forces Rupee depreciated, it was allowed to depreciate.

There have been several policies. And RBI officially does not declare its policy. (This practice is followed by all Central Banks.) In absence of policy declaration, we have to rely on observation of the market movements.

5.3 Another policy adopted by RBI was to keep an **informal peg in real terms with U.S. \$**. If U.S. had 2% inflation and India had 10% inflation, nominally Rupee should depreciate by about 8% compared to \$.

5.4 It appears, at present, the policy is that RBI does **not allow Rupee to appreciate against \$ in nominal terms**. This paper proposes that the Rupee should be allowed to appreciate against \$. First few paragraphs (No. 5.5 to 5.14) discuss the cost of depreciating Rupee. Paragraph 5.15 discusses the cost of informal peg with U.S. \$.

5.5 When rupee value falls, all **imports become costly**. Major portion of our **petroleum** needs is imported. Cost of petrol and diesel go up. **Transport** becomes costlier. **Domestic production** becomes costlier. **Exports** become less competitive. Value added exports suffer. Pseudo exports prosper.

5.6 For many decades we have relied on imported machinery & imported technology for building our factories. With every devaluation/ depreciation of rupee, our **capital costs have increased**, making domestic production costly and hence value added exports more difficult.

5.7 Stiff customs duty and import licensing created huge **barriers between international prices and domestic prices**. Importing and selling goods in India was a hugely profitable business. All big industrial/business houses were more interested in imports than in domestic manufacture. Import licenses commanded great value.

Such high price differences attracted **smuggling** business. It grew very fast. A large black money business in import licenses and smuggling thrived under the eyes of DGFT, Customs and ED.

5.8 For businessmen, bureaucrats and politicians everywhere, **fighting** black money, smuggling and hawala was **impossible**. Joining them and sharing a cut was easier.

It is no use blaming the corrupt individuals. The system was and is bad. The system has to be changed to make honesty reasonably profitable and dishonesty costly + dangerous.

5.9 Domestic Production

By depreciating rupee we have constantly **subsidised exports at the cost of imports & domestic production**. It has been repeatedly proved in India that subsidies beyond a limited period turn counter productive. National Textile Mills is an illustration.

Costly domestic production has ensured that we **are not into 'high value addition' items of exports**. We export agricultural produce, garments and ores. Our software exports and BPO services are largely arbitrage of the difference between PPP value of rupee and external value of rupee. This is not to belittle our software companies. However consider the query: "If there were no Fx rate arbitrage; if rupee were valued at its PPP value of Rs. 15 equal to a US \$; how much of the software export and BPO industry would have survived!" (Please see paragraph 5.11.)

Another angle: domestic industry did suffer competition from smuggled goods. Protection planned was not fully effective.

5.10 Black Money:

Imagine a rich man had Rs. 8 crores of cash in the year 1971. It was worth US \$ 1 crore (₹ 8 = 1\$) and worth 4,000 kg. of Gold (₹ 200 per 10 Gm.) in the year 1971. Today (7th September, 2011) it would be worth \$ 18 lakhs (₹ 45 = 1\$) and worth 28 kg. (₹ 28,000 per 10 Gm.) of gold. If he had held his wealth in rupee terms, he would have suffered massive loss. This

is just the loss caused by depreciation in rupee value against \$ & gold. (Further details given below in Annexure III.)

In the years 1971 to 1975 we had a tax system of 97.75% of income-tax, 8% wealth tax and 85% estate duty. The tax system guaranteed that no honest rich man will remain honest and rich for long. He will be either honest or rich. GOI forced people to resort to black money. (Discussed in further details in Annexure I below.)

Depreciating rupee and high tax system together guaranteed that any smart rich man would transfer his riches to Switzerland and other tax havens. GOI + RBI forced Indians to send their wealth abroad! And then punished them for sending the wealth abroad!!

By transferring his wealth abroad, at one stroke, the wealthy person saved Income-tax, Wealth-tax, Estate Duty and Depreciation of Rupee. Since FERA prohibited remittance abroad, a massive and efficient system of Hawala developed in India. This system became so beneficial that even politicians started using the same. When the politicians, the bureaucrats and the businessmen join hands, even Supreme Court of India fails in getting the desired results. Honourable Supreme Court's failures in convicting the accused in **Jain Hawala Case** & in **Bofors Case** are some illustrations. Present frustration of Honourable Supreme Court in **Hasan Ali Khan's** case is also worth a study by scholars in Jurisprudence.

GOI & RBI created several vicious cycles and cycles within cycles which constantly worked against the interests of India.

Billions of Indian rupees were constantly going abroad to the western banks. These banks were financing western economies which were paying taxes to the western governments. And Indian finance ministers were begging before "Aid India Consortium" for aids.

All this humiliation in the name of subsidising exports. At the root of this massive failure lies continuous depreciation of rupee. The **damage** caused to the Indian economy because of flight of capital from India to Switzerland and other tax havens is far **more than benefits**, that the export industry has given to us.

5.11 Cost of Export Subsidy:

Let us now focus on the **cost of subsidy given by way of depreciating Rupee.** As per World Bank's Development Report for the year 2010, the purchasing power parity (PPP) value of Rupee is 3 times more than its market value. In other words, instead of ₹ 45 to \$, the PPP value should be ₹ 15 to \$.

The exchange rate of ₹ 15 to a dollar is not unimaginable. In the year 1991 when India started liberalisation, the value was ₹ 18 equal to a \$. And in the year 1981, it was ₹ 8 to \$.

We accept that real export and import business is not transacted at PPP values. However, this is an indication.

Compared to PPP value if the market value of Rupee is one third, it means that the export industry gets a 200% subsidy. In other words, when an Indian exporter exports goods worth \$ 1,000; he gets ₹ 45,000 instead of getting ₹ 15,000. Subsidy is 200% of turnover. Or ₹ 30 per dollar of export. In the year 2010-11 our exports were \$ 246 Bn. Hence subsidy was ₹ 7.38 trillions. This is a huge subsidy unparalleled by any other subsidy.

5.12 Cost of Imports:

A large part of the cost of this subsidy was and is **borne by import sector**. Of course the entire increase in the cost is transferred to the whole economy. A part of which is also suffered by the export sector.

Total imports of goods by India in the year 2010-11 were \$ 351 Bn. India paid ₹ 15.8 Trillion @ ₹ 45/\$. Assuming the rupee rate were ₹ 15/\$; we would have paid ₹ 5.3 Trillions. The import sector has suffered a cost of ₹ 10.5 trillions because we have depreciated the rupee.

5.13 Notes:

1. Please also see Annexure II Clarifications, paragraphs 7 & 8 for a clarification on **nominal exchange rates & real exchange rates**.
2. As discussed earlier, mathematics is inadequate. In real life the exporter does not get 200% subsidy. The foreign buyer examines detailed cost sheet of the Indian exporter. Each and every benefit that the exporter gets out of all the subsidies is known to the foreign buyer. They squeeze the Indian exporter and all the benefits are enjoyed by the buyer. Indian exporter gets only his normal profits. This means that **for getting Fx through exports, Indian economy paid a 200% subsidy to the foreign buyer**. India has exported iron ore, cotton yarn & software at one third the price. And at the same time imported chemicals, machinery, crude oil & weapons etc. at three times higher cost.
3. **One can dispute these figures**. There is no absolute. All values keep changing. Today Rupee is equal to ₹ 45=1\$. If theoretically it is changed to ₹ 15 = 1\$, what will happen? Exports may reduce or collapse. We may not save ₹ 7 trillions. There may simply be no export at all. Or

exporters may learn to compete. If Rupee appreciates slowly enough, all sections of the economy may adjust themselves. **Our submission is:** Amount of ₹ 7 trillion (cost of subsidy) is a strong indication. Nation is suffering too high a cost for earning \$ 246 Billion in FX.

4: Arithmetical figures give us an impression of certainty, exactness and absolutes. **Economics is more like life** – vague, approximate, arbitrary, probable & constantly changing.

5: People are greedy. Being within the establishment makes greed satisfaction easier, faster & less risky. If the system encourages greedy people at the cost of honest people, the greedy will own and control the establishment – making RBI & SC ineffective against the criminals.

Luckily, Government has now done away with most of the direct tax exemptions. Other reliefs have been drastically reduced. (Though SEZ scandal remains.) Hence the scale of Hawalas & frauds has drastically come down.

5.14 In **1991** India came to the brinks of **insolvency**. Our Fx reserves were \$ 600 millions – not enough for even one month's imports. The Writing has been on the Wall for many decades that Strategy Two has caused tremendous damage to the Indian economy. It has corrupted the society & spoiled politics.

When the fight against Smuggling & Hawala became impossible; came around the partnership of Late PM Mr. Narsimha Rao and the then FM Dr. Manmohan Singh. They boldly **scrapped laws** including Gold Control Act, **liberalised FERA**, drastically reduced customs duties and scrapped (almost) import licensing. **Everything contrary to the calculations in the Three Strategies.** If the bureaucrats' calculations and theories were right, Indian economy should have collapsed after 1992.

Actually the collapse (in the year 1991) was brought about by the three Strategies. By liberalising, Indian economy was saved. When the private sector was given more freedom, GDP jumped from \$ 267 billions (Bn.) in 1991-92 to \$ 1,316 Bn. in 2010-11. FX reserves jumped from \$ 0.6 Bn. in 1991 to \$ 318 Bn. in Sept. 2011.

This is a proof that when GOI controls business, the economy suffers. Eventually, country suffers. When the businessman is given freedom, when bureaucrats' powers are drastically cut down, honest businessman succeeds.

Developments in last 20 years (1991 to 2011) have proved all three Strategies to be wrong.

5.15 Cost of the Peg:

5.15.1 RBI denies it. But there is an informal peg between Rupee & \$. Rupee is not allowed to appreciate against \$. (See exchange rate table in Annexure II.7.)

U.S. economy is going down hill. U.S. Government and Federal Reserve are deliberately depreciating the \$ by Quantitative Easing etc. (See our paper on "Currency War" on www.rashminsanghvi.com) U.S. has started a Currency War. It would like to export its own inflation to other countries. And it has succeeded.

5.15.2 When \$ goes down, Rupee has to appreciate. To prevent the appreciation of Rupee, RBI buys \$ & releases Rupee in the Indian market. Increased money supply within India causes inflation. This is the reason why:

(i) GOI & RBI together could control inflation until the year 2007. Thereafter the inflation has been rising & GOI & RBI are helpless. Agriculture Minister & Finance Minister have been blamed by different people. But there is no solution.

(ii) Our Fx reserves are increasing. Excess Fx reserves also has a cost.

5.15.3 As long as RBI will keep Rupee pegged to U.S. \$; and \$ keeps depreciating; India will keep suffering inflation. This will wipe out the advantage to the Export Sector. This (inflation) is a huge cost that India is suffering.

5.15.4 If RBI relaxes the peg with \$; its need to buy \$ in the market will be reduced. To that extent inflation will be less. There can be objections against this policy proposal.

(i) It can hurt Indian exports. We may consider the fact that Indian exports to USA are less than 20% of our total exports.

(ii) \$ is the Global Currency. Our exports to other countries are also transacted in \$. Consider the fact that: US has reaped undue benefits because of this fact. Benefit to US has been at the cost of China, India and other countries. It is high time that India refuses to suffer this cost.

Relax the peg. Let Rupee appreciate. Increased investment flows will offset the loss on exports. In a short period Indian exporters will adjust and exports will regain original position. (This is a very significant

statement. If this statement is weak, the proposal that exports will not be affected, and hence Fx needs will not be affected adversely will be weak.)

6. Exports Subsidy:

6.1 Government of India has given massive subsidies to the export sector. Concessional import licensing, complete exemptions from all direct & indirect taxes, concessional interest on export loans, cash subsidy and continuous depreciation of Rupee are some significant concessions given to the export sector. Result of all these concessions was: Some trades have entirely thrived on Hawala & Manipulations. We are not naming here, but specific businesses had more of Hawala exports than genuine exports. Several frauds have happened. Responsibility lies with the strategy of giving too many subsidies to the Export Sector.

6.2 How it was that the **foreign buyer had more bargaining strength as compared to the Indian exporter?** All benefits purported to be given to Indian exporter were actually enjoyed by the foreign buyer.

The reason is simple. Indian export sector has relied on lower prices rather than better quality and innovation for getting the market. Hence Indian exports have been largely in commodities and low value addition items. Even our software and BPO sectors rely largely on exchange rate arbitrage. Our software giants have not developed significant software products with brand names owned by Indian companies. They continue to service Microsoft & other international giants.

6.3 In **our submission** the exchange rate depreciation subsidy and all other subsidies to the export sector must go. Of course, in the usual slow & steady manner. When the exporters realise that they have to compete in the world markets, the competent exporters will win the markets. The incompetent will perish. They should. Indian industrialists have proved between 1991 & 2011 that when they are forced to compete, they can come out winners. Heartening illustrations are when Indian collaborators have bought over their foreign collaborators.

If the export sector is forced to compete, and if all subsidies are wiped out, the export sector will spread all over the world, find markets other than US & Europe and thrive.

7. Proposal:

Accept that Strategy Two is damaging Indian economy. Discard the policy of preventing appreciation of Rupee. We all understand the significance of stability in exchange rate movements. Spikes, if any,

should be regulated. However Rupee should not be prevented from appreciation.

Allow the Rupee to appreciate in real terms by upto 5% every year – if market forces cause an appreciation. Let it be known that GOI & RBI will not interfere if by market forces rupee appreciates.

8. Possible Consequences of Reversal of policy:

8.1 Imagine a situation where RBI makes it clear in its own way that it is not going to force depreciation of Rupee. In our view, and in the view of many senior economists and businessmen, left to itself, the Rupee will appreciate. Now the tax rates in India are more reasonable than in most industrialised countries. Hence the **arithmetic equation** of the **loosing proposition**, will convert itself into **winning proposition**. If Rupee keeps appreciating, it will be extremely beneficial for people to park their money within India rather than outside India. In fact even foreigners and non-residents would love to park their wealth in India. There will be no need for a public outcry asking the Government to force Indian in bringing their wealth back to India.

The **massive inflow of money** which can result by a positive policy can finance our plan requirements and all the needs for **infrastructure development**.

8.2 Redundancy of FEMA:

Inflow of funds will also make redundant a large part of FEMA which still exists for conservation of Fx. Today, the exporters have to realise their export proceeds within stipulated time. In proving that they do, they suffer huge amount of paper work. When India will have more than enough Fx reserves, sections 7,8 & 9 of FEMA and Notification 9 will become redundant. These provisions require every Indian Resident to realise & bring back all foreign exchange assets into India.

Even Sections 3 & 4 (and all relevant notifications) which try to regulate each & every Fx transaction will be redundant. Deleting these sections will be a great relief to India.

8.3 Western Financial Crisis:

A serious issue may be raised as under: US & Europe are facing serious financial crisis. This is threatening a full blown economic crisis. This western crisis can impact global economy. In such dangerous environment, can India take the risk of further liberalising? The **South East Asian Economic Crisis of the year 1997** has been a stark illustration of the benefit of exchange controls.

The answer to this query is given in 3 parts.

8.3.1 India has always followed **slow and steady approach**. We support & recommend the same. We are not saying that Rupee should appreciate to ₹ 35 per \$ in a year's time. We are only saying that stop deliberate depreciation of Rupee. Allow the Rupee to appreciate at a rate of not more than 5% per year if the market forces cause the appreciation.

8.3.2 Between 1947 & 1991 GOI & RBI ruled Indian economy. Result was: India came to the brinks of insolvency. When the liberalisation started, a part of the control of the economy shifted to the businessmen. They have largely caused the increase in the FX reserves to \$ 318 billions. In the year 2011 we are far **more capable of withstanding any crisis** as compared to our capability in the year 1991.

The picture is obvious. When the businessman is free, he makes genuine profits. As a sum total, Indian economy grows. When the businessman is controlled, he indulges in Hawala and Black money. Indian economy suffers.

Exactly for the purpose of making Indian economy capable of meeting the impending global crisis, subsidy to export sector must be reduced. Rupee should start appreciating by between 3% to 5% per year. Indian resident as well as NRIs & foreign investors will have better confidence in Indian economy. **Confidence (sentiment) is most important in times of crisis.**

It is true that in the year 1997, India & China were saved from a crisis because of exchange controls. Apart from the five South East Asian countries, Russia, Mexico, Argentina & many other countries not having adequate controls on Fx suffered badly. It is also true that US, UK, France, Germany and several developed countries did not have Fx controls. They took steps & were saved from the crisis. If Rupee is properly valued & supported by adequate reserves, in a free economy, RBI will be more capable of meeting such crises in future.

8.3.3 Indian economy is suffering a **cost of subsidy** given to the export sector. (Please see paragraph 5.11.) An annual reduction in this subsidy will help Indian economy.

8.4 Currency War:

The western financial crisis has diverted funds from USA to developing countries. **Brazil & China** are complaining about Currency War. Switzerland is trying to block inflow of funds. US Government's deliberate attempt to depreciate the \$ is putting tremendous pressure on

developing world. (See paragraph 5.15.) In such a situation would it be appropriate to allow Rupee to appreciate and invite further foreign funds to India?

This query itself is logically defective. Because India & China are **buying up \$**, there is increased foreign exchange reserve and increased money supply within the country. If People's Bank of China and RBI were to stop buying \$, there will be lower money supply within the economy. Hence there will be less reason for inflation.

If the appreciation of local currency invites foreign investment funds, these would be replacing the money supply not caused by the Central Banks. As long as our foreign investment policy prevents hot money flows, appreciation of rupee should be good for the Indian economy.

9. **Functions of Money:**

Money has three functions: (i) Medium of exchange, (ii) store of value and (iii) unit of account.

When a person accepts currency notes against goods and services of value, he is accepting a piece of paper which has no intrinsic value. That paper acquires value if the issuer of currency promises that the authority will do its best to ensure that all the three functions are performed.

What is the performance by GOI & RBI?

Under FERA they prohibited using Indian Rupee in international exchange. (Medium of Exchange function of money disregarded.) And then for six decades went on reducing the value of the notes that they issue. (Store of Value function disregarded.) By passing laws, an unethical strategy can become legal. But who will respect that law!

GOI & RBI have made tremendous progress in liberalising the economy & exposing it to competition. Now if they take further effective steps to restore confidence in Indian Rupee, respect for law will increase. A virtuous cycle will start benefiting Indian Economy. It will also cleanse (to an extent) Indian politics & make judiciary more effective. Frustration in failure to control black money & hawala will be reduced.

Paper Completed

Thanks.

Rashmin Sanghvi Naresh Ajwani Rutvik Sanghvi

Annexure 1 Three Strategies adopted by GOI & RBI.

Summary

- Strategy One -** Indian bureaucrats were convinced that they knew what is best for India. Ignorant Indians needed to be controlled.
- Strategy Two-** Depreciate the Rupee and get bonanza in terms of higher customs revenue, reduction in imports and a boost to exports. This has been discussed in paragraph 5 of the paper.
- Strategy Three-** High direct & indirect taxes mean socialising the economy; and high tax revenue.

Sum Total of Consequences of Three Strategies- } India on the brinks of insolvency in the year 1991.

In this Annexure, we will discuss Strategies One & Three.

Strategy One: Controls:

In the year 1947 India inherited a **bureaucracy** from the **British**. The British bureaucrats were convinced that they were the rulers and that the people in India should do what the bureaucrats prescribed. Even after independence, same bureaucrats continued in Government service. They continued to believe that: "Indian public does not know what is good for India. Left to themselves they will resort to profiteering at the cost of national interest. To prevent any damage to Indian economy, they must be regulated and controlled severely."

In the year 1991 Dr. Manmohan Singh as the then Finance Minister started breaking down this bureaucratic hypothesis. Some laws like the "Gold Control Act" were straight away abolished. Other regulations like Industrial Licensing, Import Licensing etc. were drastically liberalised. Of course Government of India & RBI followed the conservative path of slow and steady progress. The whole country has tremendously benefited by significant liberalisation.

FERA was a draconian law imposed on business community. One can understand strict laws like Criminal Procedure Code meant for the criminals. However FERA acted strictly with the businessmen. (Well, it was meant to be strict with smugglers & hawala racketeers. As seen earlier, RBI & ED totally failed in curbing both - smuggling & hawala. So the only use of FERA was against the ordinary businessman.)

After Liberalisation the bureaucrats have accepted their fate when all kinds of licensing and other regulations have been drastically removed. However RBI managers continue to believe that left to themselves Indian businessmen will harm national interest. **RBI continues** to follow the policy of **micromanagement and prevention of Rupee appreciation**.

Strategy Three: High Tax Rates:

The socialistic beliefs of late Pandit Jawaharlal Nehru and late Mrs. Indira Gandhi had huge impact on our tax system. Late PM Morarjee Desai helped them by Gold Control Act & heavy taxes.

In the year 1975-76 direct tax rates were as under: Income-tax - 97.75% at an income slab of above ₹ 2,00,000. Wealth-tax - 8%. & Estate Duty - 85%. Real impact of these tax rates may be understood by the following illustrations. We assume Mr. I, an Indian wealthy person had income, wealth & estate at the maximum marginal rates. Of this we consider ₹ 1,00,000 wealth & income earned from this wealth. We further assume that this wealth earns income @ 12% per year. Hence Mr. I gets an income of ₹ 12,000.

Particulars	Income & Taxes
Annual income	₹ 12,000
Income-tax @ 97.75%*	₹ 11,730
Balance after tax	₹ 270
Wealth-tax @ 8% on ₹ 1,00,000	₹ 8,000
Balance after both taxes	(₹ 7,730)

Note: For Financial year 1974-75, tax rate was 85% for income in excess of ₹ 2,00,000. Add a surcharge of 15% on tax. Total individual's tax: 97.75%.

This table shows that if an honest man paid all his taxes, every year he would have to sell a part of his wealth. How will he finance his home expenses remained a mystery. No wonder, there was massive black money in India. (Result would be similar even if we assumed a rate of return @ 25% instead of 12%.)

As if income-tax & Wealth-tax damage was not enough, Government imposed 85% estate duty. Only a poet can imagine that an honest man would be left with some estate to pay estate duty. However, the Finance Ministry continued to believe in simple mathematics: Higher the tax rates, higher the tax revenue.

Dr. Man Mohan Singh broke down this hypothesis by drastically reducing tax rates. Government revenue increased beyond Government's expectations turning the mathematical Strategy upside down. (Actually,

tax rate reduction had already started before Dr. Manmohan Singh became Finance Minister. But Dr. Singh made significant moves on several fronts simultaneously.)

While all three Strategies as a whole are the primary cause for under development of Indian economy till 1991; Strategy One & Three have been discarded. Strategy Two continues even now. Its damage to the economy continues.

Further information: If some one did business in **partnership**, he suffered even more. Firm & partners - both were taxed. Resulting into a tax rate of 98.37%.

Income tax computation for Partnership Firm for A.Y. 1975-76

Sr. No.	Particulars	Amount ₹
1.	Firm Taxation	
	Assume Firm Income of ₹.	100.00
2.	Tax on above income	
2.1	Tax @ 20% of ₹ 100	20.00
2.2	Add: Surcharge @ 20% of above tax	4.00
2.3	Total	24.00
2.4	Add: Special Surcharge @ 15% of above	3.60
2.5	Total tax paid by the firm	27.60
3	Individual taxation	
	Partners were taxed separately on their share of profit ₹ 72.4.	72.40
4	Tax on above net income:	
4.1	Tax @ 85%	61.54
4.2	Add: Surcharge @ 15%	9.23
4.3	Total tax payable by Individual	70.77
5	Therefore total tax paid on income of ₹ 100	
5.1	Paid by firm	27.60
5.2	Paid by Individual	70.77
5.3	Total tax paid on income of ₹ 100	98.37
6	Balance amount remaining out of income of ₹ 100 is.....	1.63
	(i.e., ₹ 100 - ₹ 98.37)	

Note: High tax rates were based on the belief that mathematically, higher the rate, higher the revenue. Illustration of **daily confusion between mathematics & sentiments:** Husband talks in terms of mathematics. Wife is sentimental. Both do not understand each other. There is constant friction. GOI (even with a lady as Prime Minister) works with mathematics. People at large act with sentiment. And there is constant friction. Any home or establishment that understands sentiments may be more successful.

Next page Annexure II.

Annexure II Clarifications:

1. We are told that 135 factors affect rains in India. In the same way, in economics there are **several forces and counter forces** working simultaneously. These forces themselves keep changing in intensity, direction and speed.

Hence it is **difficult to project future**. Even analysis of the past is many times a convenient interpretation of events rather than interpretation of driving forces.

In the year 1947 or 1974 etc. people then in charge acted in the **circumstances then prevailing**. Today we are analysing the past with the benefit of hind sight and with the disadvantage that we do not have real and full picture of circumstances that were considered then. Hence our analysis cannot be fair.

For any thing that happens to Indian economy, all are responsible: Government, RBI & the businessmen of India. Government as the leader is more responsible. But businessmen are also responsible.

It is **improper to blame any one individual, institution** or section of the society. Except where there is clear and apparent violation of sound principles of economics. Emphasis here is on analysing past policies. Are they still good for future! If not, change the policies.

2. When the forces act and counter-act, there is a **cause-effect-cause relationship**. There are self-feeding cycles. One may not be able to say - which factor is pure cause and which factor is pure effect.
3. There are **no absolutes in economics**. There are several different sources of data. Each source has its own reasons for incorrectness. Any statistical outline is just an approximate estimate.
4. When we analyse the fact that people do remit funds abroad & evade taxes, we are simply analysing a fact, a trend. There is no judgement, no support for the trend. This is **greed working**. Government & RBI have to recognise the greed as a natural phenomena.
5. **We are not asking for Laissez Faire**. We are not saying: "Abolish all Controls". We are only asking for reversal of the policy of depreciating the Rupee.

Foreign Exchange controls can be divided into a few parts:

(i) Derivatives, hedging, speculation & gambling in FX and Flight of capital.

These are billion dollar games and strategies played by Western banks and financial institutions. They have ruined several economies. Last one being U.S. economy. These big players need to be controlled and regulated. Some spokesmen for these players have demanded removal of all controls on these players. This is a dangerous game.

(ii) Realisation and inward remittance of export proceeds.

(iii) FDI, FII and Portfolio investments.

(iv) Small FX transactions, family loans and technical procedural compliance.

Our Submissions:

(i) FX speculation must be severely controlled and monitored on daily basis. RBI, SEBI, ED & other regulatory agencies must daily monitor large banks and FIIs.

(ii) If RBI does not deliberately depreciate Rupee; by market forces it may appreciate. Even if all controls are scrapped, it will be in the commercial interest of exporters to bring back export proceeds at the earliest practical time.

(iii) FDI may be encouraged.

For FII & Portfolio all tax and other concessions should be scrapped.

(iv) All small FX transactions etc. should be exempted from FEMA regulations. RBI's micro management must stop.

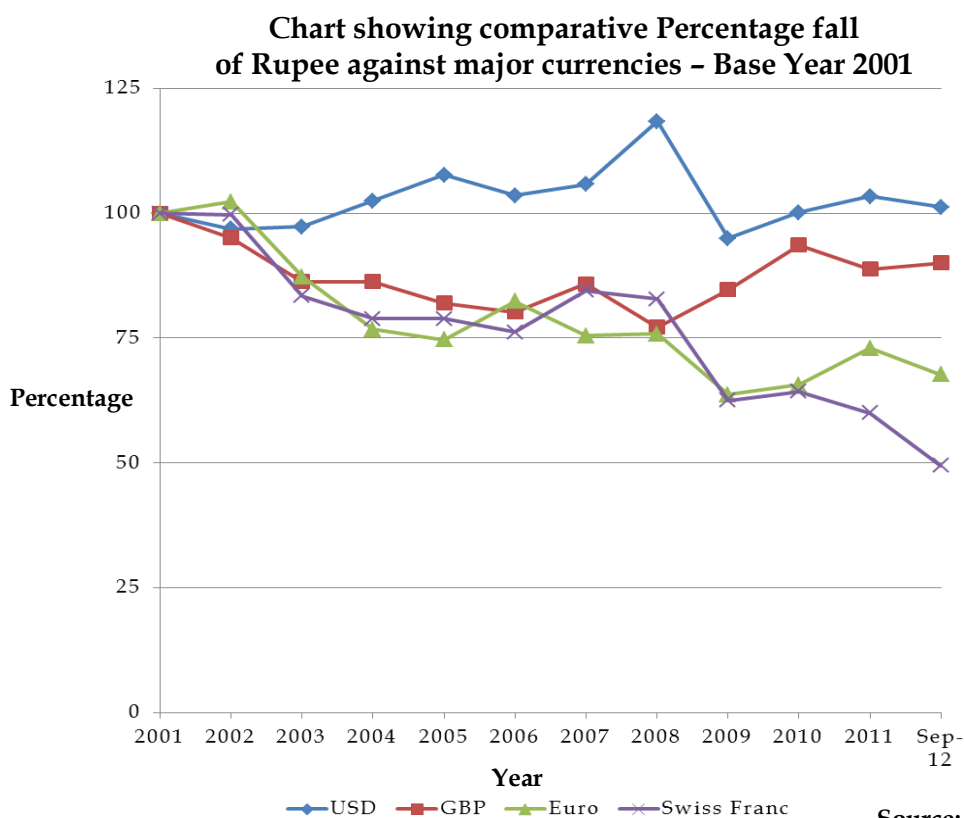
6. Has Rupee actually depreciated!

In the year 2001, rate was ₹ 46 /1\$. In the year 2011 also the rate is almost the same. So why allege that Rupee has depreciated!

Next table shows rates of rupee in different currencies. It is clear that Rupee has depreciated against all currencies except \$. Rupee has not depreciated against \$ because \$ itself has depreciated.

Currency Exchange Nominal Rates for the period 2001 to 2011 vis a vis INR
One unit of foreign currency is equal to ...INR.

Sr. No.	Date of FX Rate	USD	GBP	Euro	Swiss Franc
1	1.1.01	46.67	66.66	43.94	28.96
2	1.1.02	48.17	70.08	42.93	29.04
3	1.1.03.	47.95	77.23	50.33	34.69
4	1.1.04	45.54	81.31	57.27	36.71
5	1.1.05	43.32	83.10	58.80	38.00
6	1.1.06	45.05	77.63	53.33	34.27
7	1.1.07	44.11	86.37	58.19	36.16
8	1.1.08	39.41	78.68	57.93	34.97
9	1.1.09	49.13	71.21	68.98	46.29
10	1.1.10	46.57	75.09	66.90	45.04
11	1.1.11	45.13	69.94	60.19	48.22
12	7.9.11	46.10	73.99	64.86	58.53

Source: www.oanda.com

7 Real Rate of Rupee.

Above table gives nominal rates of Rupee. If we consider real rate of Rupee, it has appreciated. Between the years 2001 & 2011, India had more inflation than USA. And yet, in Nominal terms, the exchange rate has remained same. This means, Rupee has appreciated in real terms. So why allege depreciation!

RBI Annual Report - 2010-11. Appendix table 14 - Real Effective Exchange Rate:

Year / Month	36 Currency Trade Based Weights	6 - Currency Trade Based - Weights.
2004 - 05	100	100
June 2011	101.51	117.35

Observations: When 36 currencies are compared, Rupee has not changed over last six years. When only 6 currencies are taken, in terms of real exchange rate, Rupee has appreciated.

Whether the Rupee has appreciated or not depends upon reference points that we take. Between the years 2001 & 2011, in real terms, Rupee has appreciated. However, even now the PPP value is three times more than the market value. In the past, it used to be four times more. There are two observations:

- (i) It is true that Indian Rupee has started reducing the difference between the PPP rate & market rate. If this is the deliberate trend, it is a matter of great joy.
- (ii) The difference even now is too high. All the losses in exports & imports calculated in paragraphs 5.11 & 5.12 above are calculated at current differences. They are still too large losses. In the past, the losses as proportion would be even larger. It is necessary to reduce these losses & the rate difference.

We would submit that the Rupee should so appreciate that the gap between the PPP rate & market rate is reduced by about 5% points every year.

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Annexure III Statistics

1. From 1947 to 1991 we had severely controlled economy. From 1991, liberalisation started. It took ten years to have effective impact. Real benefits of liberalisation started in 2000. However, almost throughout, Rupee has continued to depreciate.

Year	Rs./\$	Month/Year	Rs./Per 10 grammes of Gold
1971		Jan., 1971	200
1981	8	Jan. 1981	457
1991	18	Jan. 1991	1,506
2011	46	Sept.2011	28,000

Observations:

1. As compared to \$, Rupee has depreciated from 1981 to about 18% of its value in the year 2011. \$ itself has depreciated to 22% of its value. From \$400/ ounce to \$1800/ ounce. Thus rupee has depreciated from 1981 to less than 4% of its value in the year 2011.
2. Compare the gold price prevalent in India in rupee terms. As compared to Jan-1971, Rupee has depreciated in September, 2011 to 0.71% of its value. Compared to Jan-1981, Rupee has depreciated to 5.51% of its value.

Note: All statistics in economics have the use in indicating trends. Beyond indications, they do not have absolute value.

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Annexure IV

Concepts of Government Administration (Raj Dharma):

- I.1 A policy (like FX depreciation) or a law (like FERA etc.) may work in a set of circumstances. The same policy may be a failure or even cause damage in changed circumstances.
 2. And circumstances always keep changing.
 3. Yet, people within establishment generally do not see the need for change. It is human nature to cling to the past.
 4. Every law, every policy needs to be independently reviewed every ten years.
- II. In a population of 121 crores, not more than one crore people may have FX transactions. And yet FEMA seeks to control 121 crore people.

When section 3 says: "No person shall" it regulates a beggar getting \$ 5 as alms from a foreign tourist. It also regulates family transactions where there may be no commercial intention at all. Our submission is, all transactions below a limit should be exempted from FEMA discipline. For example, no FEMA restrictions per person per year for transactions upto \$ 10,000. We have already submitted our representation in this matter to RBI.

- III. Anyone can go wrong. Governments go wrong many times. RBI also goes wrong. After all, every one is human. Institutions are also nothing but collection of individuals.

High tax rates - Strategy Three was absurdity by GOI. Today we accept that it was clearly a wrong policy. But it continued for many years.

Similarly, Strategy Two is equally wrong. The earlier we realise, the better.

IV. Confucius on 'Rajdharma'.

King asked Confucius: "For Nation's stability and success, what is most important - strong army, huge wealth or something else!"

Confucius: "People's confidence in the King."

King: "If the enemy is attacking the Kingdom, army is more important or 'confidence'?"

Confucius: “Confidence of the people in the King.”

King: In times of severe, prolonged drought, godowns full of food grains are more important, or ‘confidence’?

Confucius: “Confidence”.

In modern times, ‘King’ is not one individual. There is a large, complex Government organisation and several different agencies performing King’s functions. Are GOI & RBI performing their functions in a way that inspires confidence in Indian Rupee! Do they draft the laws considering the ground realities?

Conclusion: An important **function of money** is Stability (store) of Value. Duty of GOI & RBI is to establish confidence of the people in Indian Rupee. We hope, now GOI & RBI will take necessary steps to increase the confidence in Indian Rupee. Allow it to appreciate at a steady rate if market forces cause the appreciation.

Annexures Completed

Thanks.

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