India And Capital Account Convertibility :
A Journey of Progress and Menace

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ABSTRACT

India has vigilantly opened up its capital Account since the early 1990's as policymakers realised that domestic savings and taxes are inadequate to cater country's huge investment needs. Therefore indigenous savings should be supplemented with overseas funds for the future growth of the nation. Hence, India sustained with the policy of 'moving slowly' rather than taking a single leap in accomplishing full convertibility, for the consequences would be disastrous if anything goes off beam. It has been so observed that India has adopted a discriminatory approach depending upon the sensitivity and economic importance of the various forms of capital flows. Over the time, India has been able to draw reasonable sum of foreign investment and there has been a tremendous growth in the transactions allied to foreign exchange market. Indian companies and retail investors too have made investment abroad. India has received foreign money in the form of FDI, ADRs, GDRs, ECB, Bonds, and FII etc. The set of laws related to various components of capital accounts have been revised from time to time based on the economic conditions, global events and needs of the nation. Foreign capital flows have benefitted the country in multiple ways. Forex reserves, Balance of Payment surplus, bullish stock market or growth of MNC's and market all are the upshots of international finance. In recent times, there has been an ongoing turmoil in the developed countries of the world. India too is experiencing the heat of global contagion. This paper explores the impact of measures taken towards the liberalisation of capital account in the milieu of unfavourable events globally and attempts to reach at suitable conclusions and solutions.

INTRODUCTION

Economic growth and development of a nation is almost always coupled with the progress of its tradable sector. In times of today all economies are finding themselves integrated to each other in some or other way through forces of liberalisation and globalisation. In context of these sweeping advancements capital account convertibility has been widely persuaded by developed and developing countries around the world. India too is persistently poignant on the path of liberalisation, by opening up its markets and loosening its controls over economic and financial matters.

Capital account convertibility (CAC) refers to the freedom of converting local financial assets into foreign financial assets and vice versa at market determined rates of exchange. It refers to the elimination of restraints on international flows on a country's capital account, facilitating full currency convertibility and opening of the financial system.

An array of transactions is within the ambit of capital account, the policies regarding these transactions are modified in the shift towards capital account convertibility. A country can achieve scores of benefits in its move towards capital account liberalisation but it has associated costs which can be disruptive. The process of capital account liberalisation is therefore, managed with farthest prudence given the latent for sudden reversals.

Practically, there is a mix and match of experiences with the countries those who have liberalised their capital account. All developed countries have adopted full convertibility, but the 2008 crises of USA and current turmoil of European Union has raised several questions while China has written its success story without full capital account convertibility. It may be noted that full capital account convertibility doesn't inevitably lead to a financial catastrophe, but it makes the country further vulnerable to such crises. India has found itself fairly successful in the matter with its gradualist approach. India's conduct and experiences with the liberalisation of capital account are the subject matter of elaboration in this paper.

CAPITAL ACCOUNT CONVERTIBILITY: JOURNEY SO FAR

The national freedom of India was lost to the foreign traders who were licensed to trade by the rulers of that era, so general opinion about the foreign trading interests or foreign capital has been very guarded and suspicious since independence. It was also felt that the domestic economy is endowed with a reasonable base of human skills, institutional, social and physical infrastructure and diversified industrial base that the country could productively commence on the path of self reliance with relatively low level of economic reliance on rest of the world.

Therefore, for the first four decades after sovereignty in 1947, all economic policies were centred on regulation and capital controls. Although there were intervallic reforms in areas of foreign procurement, technology, travel, education, exchange rate depreciation and easing of restrictions on inflows. As these measures were narrow in scope so they had little impact on inflows and outflows of foreign exchange.

Real liberalization was initiated in 1991 aftermath balance of payment crises. On the basis of recommendations made by Rangrajan Committee the reforms in the external sector were initiated. Recommendations included dismantling of trade restrictions, transition to market determined exchange rates and gradual opening of capital account.

In 1997 a committee under stewardship of S.S.Tarapore submitted its report on 'Capital Account Convertibility' which provided the initial roadmap for the liberalisation of capital account transactions. Taking the lessons from international experience, committee recommended a set of preconditions to be achieved prior to liberalisation of capital account. It was the time when banking sector reforms were also instigated on the proposition of Narasimhan committee.

Finally in year 2000 Foreign Exchange Regulation Act (FERA) was scrapped and a new act Foreign Exchange Management Act (FEMA) came into existence. Till now, all the rules pertaining to foreign exchange are governed by FEMA. All the current account transactions are permitted under FEMA and no prior permission of RBI is required for any such transactions, while there remain restrictions on capital account. Under FEMA some capital account transactions are completely permitted, some are totally prohibited while some are allowed within a fixed ceiling. Sectoral rules have also been shaped and enforced with FEMA rules.

On the success of the measures adopted, the issue of capital account liberalisation was re-examined by Tarapore committee II. Setup in year 2006 it was an extension of the previous committee. It also did not recommended unlimited openings of capital account but preferred a phased liberalisation of controls on outflows and inflows with a comprehensive review of the actions taken.

PRESENT STATUS OF CAPITAL ACCOUNT LIBERALISATION

Government of India (GoI) has revised rules pertaining to FEMA and capital account transactions during different periods of time. In context of large capital flows and the upshots of previous modifications during the last few years, GoI and RBI have recently done some additional amendments. The revisions related to capital account are listed below.

Component of Capital Account	**Present Regulation**
Authorised Dealers (AD)	RBI has provided license to the entities for dealing in foreign exchange. They have 3 categories: **a)** Authorised Dealers Category-I (Public, Private and Foreign Banks). **b)** Authorised Dealers Category-II (Authorised on the city basis. They include cooperative banks, private forex dealers and travel agents etc.). **c)** Authorised Dealers Category-III (Non Banking Finance Corporations) The authority vested in the hands of AD-I is largest (ranging from stock market transactions to NRI accounts, ECBs, ADRs etc.) while other categories of ADs have a limited role to play.

Foreign Direct Investment (FDI)	FDI is restricted in the following sectors: **a)** Multi brand retailing. **b)** Lottery (public, private, online), gambling, betting and casino. **c)** Chit funds and Nidhi Company. **d)** Trading in Transferable Development Rights in real estate business or construction of farm houses. **e)** Manufacturing of Cigars, cheroots, cigarillos and cigarettes, of tobacco or of tobacco substitutes **f)** Atomic energy and Railway transport In rest other sectors such as agriculture, mining, manufacturing, broadcasting, print media, aviation, courier services, construction, telecom, banking, insurance etc; the limits of FDI range from 26% to 100%. All the foreign operators have to abide by the sectoral restrictions of the statutory regulators in addition to FDI rules.
ADRs/ GDRs by Indian companies	Indian companies can raise additional finances abroad through the issue of ADRs/ GDRs, in accordance with guidelines issued by the Government of India. Unlisted companies, which have not so far accessed the ADR/GDR route for raising funds in the global market, would require prior listing in the domestic market. Unlisted companies, which have already issued ADRs/GDRs in the international market, have to list in the domestic market on making profit or within three years of such issue of ADRs/GDRs, whichever is earlier. A Limited two way fungibility scheme is also operationalised through the custodians of securities and stock brokers under SEBI.
External Commercial Borrowings (ECBs)/ Foreign Currency Convertible Bonds (FCCBs)	The ECB limit under the automatic route is enhanced to USD 750 million (Circular No. 27 dated September 23, 2011). The maturity guidelines have also been revised (Circular No.64 January 05, 2012). **a)** ECBs up to $20 million in a financial year should have a minimum average maturity of three years. **b)** ECBs of more than $20 million and up to $750 million or equivalent should have a minimum average maturity of 5 years. **c)** Eligible borrowers under the automatic route can raise Foreign Currency Convertible Bonds (FCCBs) up to USD 750 million or equivalent per financial year for permissible end-uses. **d)** Corporates in services like hotel, hospital and software, can raise FCCBs up to USD 200 million or equivalent for permissible end-uses during a financial but the proceeds of the ECB should not be used for acquisition of land. **e)** ECB / FCCB availed of for the purpose of refinancing the existing outstanding FCCB should be viewed as part of the limit of USD 750 million available under the automatic route.
Government Securities	NRIs and SEBI registered FIIs are permitted to purchase Government Securities/ Treasury bills and Corporate debt. The details are as under: **1.** On repatriation basis a Non-resident Indian can purchase without limit, **a)** Dated Government securities (other than bearer securities) or treasury bills or units of domestic mutual funds. **b)** Bonds issued by a public sector undertaking (PSU) in India.

	c) Shares in Public Sector Enterprises being disinvested by GoI. **2.** On non-repatriation basis **a)** Dated Government securities (other than bearer securities) or treasury bills or units of domestic mutual funds. **b)** Units of Money Market Mutual Funds in India. **c)** National Plan/Savings Certificates. A SEBI registered FII may purchase, on repatriation basis, dated Government securities/ treasury bills, listed non-convertible debentures/ bonds issued by an Indian company and units of domestic mutual funds either directly from the issuer of such securities or through a registered stock broker on a recognised stock exchange in India. The FII investment in Government securities and Corporate debt is subject to the Investment limit. For the FIIs in Government securities currently is USD 10 billion and limit in Corporate debt is USD 20 billion.
Rupee And Foreign Currency Denominated Bonds	Rupee and Foreign currency denominated bonds issued by the Infrastructure Debt Funds (IDFs) set up as an Indian company and registered as Non-Banking Financial Companies (NBFCs) with the Reserve Bank of India have been allowed (circular number 49, dated 22.11.2011) **Eligible non- resident investors:** Sovereign Wealth Funds, Multilateral Agencies, Pension Funds, Insurance Funds, Endowment Funds, FII, NRI, HNIs registered with SEBI are allowed to invest in these bonds. **Maturity and lock-in period :** The maturity period for these bonds is five years. They are subject to a lock in period of three years. However, all non-resident investors can trade amongst themselves within this lock in period of three years. **Quantitative limits :** All non-resident investment in IDFs would be within an overall cap of USD 10 billion. This limit would be within the overall cap of USD 25 billion for FII investment in bonds / non convertible debentures issued by Indian companies in the infrastructure sector.
Joint Venture/Wholly owned subsidiary	Overseas Investment can be made under two routes (i) Automatic Route and (ii) Approval Route **Under Automatic Route,** an Indian party has been permitted to make investment in overseas Joint Ventures (JV) / Wholly Owned Subsidiaries (WOS), not exceeding 400% of the net worth as on the date of last audited balance sheet. Investment in an overseas JV / WOS may be funded out of one or more of the following sources: **a)** Drawal of foreign exchange from an AD bank in India **b)** Capitalisation of exports **c)** Swap of shares **d)** Proceeds of ECBs / FCCBs **e)** Balances held in EEFC account of the Indian party **f)** Proceeds of foreign currency funds raised through ADR / GDR issues. In respect of (e) and (f) above, the ceiling of 400% of the net worth will not apply. **Approval of the Reserve Bank:** Sectors have been currently reserved for RBI approval. Investments in energy and natural resources sector, overseas investments by Proprietorship concerns and Registered Trust / Society require

	prior approval of the Reserve Bank for direct investment abroad.
Disinvestment from Joint Venture/ Wholly owned subsidiary abroad	An Indian Party is allowed to disinvest, subject to the satisfaction of conditions, without prior approval of the RBI in the following cases : **a)** The JV / WOS are listed in the overseas stock exchange. **b)** The Indian party is listed on a stock exchange in India and is having a net worth of INR 1000 million and investment in JV/WOS outside India is not exceeding USD 10 million. **c)** The Indian Party is an unlisted company and its investment in JV/WOS outside India does not exceed USD 10 million. **d)** The Indian party does not have any outstanding dues by way of dividend, technical know-how fees, royalty, consultancy, commission or other entitlements, and/or export proceeds from JV/WOS **e)** JV/WOS has been in operation for at least one full year and the Annual Performance Report together with the audited accounts for that year has been submitted to RBI **f)** The Indian party is not under investigation by Central Bureau of Investigation (CBI)/Directorate of Enforcement (DoE) /Securities and Exchange Board of India (SEBI) /Insurance Regulatory and Development Authority (IRDA) or any other regulatory authority in India An Indian Party, which does not satisfy the conditions stated above for undertaking any disinvestment in its JV/WOS abroad, shall have to apply to the RBI for permission.
Foreign Venture Capital Investment (FVCI)	FVCIs can purchase equity / equity linked instruments / debt / debt instruments, debentures of an Indian Venture Capital Fund through initial public offer or private placement. All their investment would be subject to the SEBI regulation and sector specific caps of FDI.
Foreign Institutional Investment (FII)	Non Resident Indians (NRI)/Persons of Indian Origin (PIO) are allowed to make direct investment in Indian companies under the automatic route. FII/ NRI/ PIO/HNIs are allowed to invest in the following: **a)** Securities in the primary and secondary markets including shares, debentures, and warrants of companies, unlisted, listed, or to be listed on a recognized stock exchange in India **b)** Units of schemes ?oated by domestic mutual funds including the Unit Trust of India, whether listed or not listed on a recognized stock exchange **c)** Government securities **d)** Derivatives **e)** Commercial paper **f)** Security receipts **g)** Indian Depository Receipts Investments in shares or convertible debentures of an Indian company engaged in the following type of activities are not permitted: **a)** Chit fund or Nidhi company; **b)** Agricultural or plantation activities **c)** Real estate business; **d)** Construction of farm houses; or

	e) Dealing in Transfer of Development Rights (TDRs). SEBI registered FIIs and its sub accounts cannot exceed 10% of the paid up capital of the Indian company. For High Net worth Individuals (HNIs), NRIs and PIOs this limit is 5%. **Facilitators:** Purchase is made through a stock exchange or through the designated branch of an authorized dealer.
Commodity Hedging	**Users:** (i) Delegated Route: Companies in India listed on a recognized stock exchange engaged in import and export of commodities are permitted to hedge the price risk of permitted commodities in the international commodity exchanges/ markets. (ii) Approval Route: Applications of companies/ firms which are not listed on recognized stock exchanges, engaged in import and export of commodities may be forwarded to the Reserve Bank for consideration. (iii) Entities in Special Economic Zones: AD-I may allow entities in SEZ to undertake hedging transactions in the overseas commodity exchanges/ markets, subject to the condition that such contract is entered into on a stand-alone basis. **Facilitators:** Authorized Dealer category-I provide facilities for remitting foreign currency amounts towards margin requirements and may issue guarantees/ standby letters of credit to cover specific payment obligations related to commodity derivatives **Products:** Standard exchange traded futures and options (purchases only) in international commodity exchanges. **Operational Guidelines:** AD Category I banks satisfying certain minimum norms, and authorized by the Reserve Bank may grant permission to companies listed on a recognized stock exchange to hedge price risk on import/ export in respect of any commodity(except gold, silver, platinum) in the international commodity exchanges/ markets.
Derivatives Trading	**Products:** Various instruments available under this facility are- **Foreign Currency-INR Swaps** Facilitators: AD Category I banks Users: Residents and companies having a foreign currency liability and undertaking a foreign currency-INR swap to move from a foreign currency liability to a Rupee liability and vice versa ,subject to certain minimum prudential requirements or a minimum net worth of Rs 200 crore. Statutory limits: No limits are placed on the AD Category I banks for undertaking swaps to facilitate customers to hedge their foreign exchange exposures, a limit of USD 100 million is placed for net supply of foreign exchange in the market on account of swaps which facilitate customers to assume foreign currency liability **Cross currency option and foreign currency –INR option** Facilitators: AD Category I banks Users: Listed companies and their subsidiaries/joint ventures/associates having common treasury and consolidated balance sheet or unlisted companies with a minimum net worth of Rs. 200 crore **Interest rate swap, Cross currency swap, Coupon swap,** **Forward rate agreement**

	Facilitators: AD Category I, Overseas branch of Indian bank authorized to deal in foreign exchange in India and Offshore banking unit in a SEZ in India. Users: Persons resident in India who have borrowed foreign exchange in accordance with the provisions of FEMA. **Forward foreign exchange contracts** Facilitators: AD Category I banks Users: Importers and exporters of goods and services, Small and Medium Enterprises and Resident Individuals **Currency Futures:** Currency futures contracts have been permitted to be traded in stock exchanges recognised by SEBI in the country. Regulations: **a)** Currency futures are permitted in US Dollar (USD)-(INR), Euro (EUR)-INR, Japanese Yen (JPY)-INR and Pound Sterling (GBP)-INR. **b)** Only 'persons resident in India' may purchase or sell currency futures contracts to hedge an exposure to foreign exchange rate risk. **c)** The size of each contract shall be USD 1000 for USD-INR contracts, Euro 1000 for Euro-INR contracts, GBP 1000 for GBP-INR contracts and JPY 100,000 for JPY-INR contracts. **d)** The contracts shall be quoted and settled in Indian Rupees with a maturity period of 12 months. **e)** AD Category-I are permitted to become trading and clearing members of the currency futures market. **Currency Options:** These are allowed to be traded in stock exchanges approved by SEBI. Regulations: **a)** The underlying for the currency option shall be US Dollar – Indian Rupee (USD-INR) spot rate. **b)** Only 'persons resident in India' may purchase or sell exchange traded currency options contracts to hedge an exposure to foreign exchange rate risk. **c)** The maturity of the contracts shall not exceed twelve months. **d)** The size of each contract shall be USD 1000. **e)** AD Category - I are permitted to become trading and clearing members.
Overseas Investment by Indian Mutual Funds	Mutual Funds can now invest up to $7 billion overseas. The investment would be subject to the terms and conditions and operational guidelines as issued by SEBI. Besides investment can also be made in- **a)** Overseas mutual funds that make nominal investments (to the extent of 10% of net asset value) in unlisted overseas securities **b)** Overseas exchange traded funds that invest in securities **c)** ADRs/GDRs of foreign companies
Borrowing in Foreign Exchange by Residents	There is general permission to borrow up to US$ 250,000 or its equivalent in foreign exchange on a repatriable basis by an individual Resident from his close relatives resident outside India subject to: **a)** The loan is free of interest **b)** The minimum maturity period of the loan is 1 year **c)** The amount of loan is received by inward remittance in free foreign exchange through normal banking channels or by debit to the NRE/ FCNR account of the non-resident lender.

	A resident, not being a company incorporated in India, may borrow in rupees on non repatriation basis from an NRI or PIO subject to: **a)** The term of the loan shall not exceed 3 years **b)** The loan has to be utilised for meeting the borrower's personal requirement or for his business purposes and under no circumstances be used for relending or for investment in shares, securities or immovable property **c)** The rate of interest shall not exceed 2% over the bank rate prevailing on the date of availing of loan
Exchange Earners' Foreign Currency Account (EEFC)	All categories of foreign exchange earners, such as individuals, companies, etc. who are resident in India, may open EEFC accounts. An EEFC account can be held only in the form of a current account. No interest is payable on EEFC accounts. EEFC Account holders were permitted to retain 100% of their Forex earnings in EEFC Account with any Authorised Dealers in India. This scheme has been reviewed now (RBI circular no. 124 dated 10.05.2012)and it has been revised as follows: **a)** 50% of the balances lying in the EEFC Account should be transferred to Indian Rupee accounts of the account holders within 15 days from the date of Circular (10/05/2012) **b)** For future earnings, only 50% shall be retained in Foreign Currency and the balance 50% shall be converted and transferred to Indian Rupee account **c)** EEFC account holders henceforth will be permitted to access the forex market for purchasing foreign exchange only after utilising fully the available balances in the EEFC accounts.
Rupee loans to NRIs	Authorised Dealers (ADs) may grant loan in rupees to NRIs against the security of shares or immovable property in India for personal or business purposes and housing loans against the security of houses/flats to be acquired for residential accommodation in India. Restriction has been removed on the use of loan and allows it to be applied for any purpose other than the basic embargoes on chit funds, Nidhi companies, agricultural and or plantation activities, etc. It cannot also be applied for trading in Transferable Development Rights (TDRs) or investment in capital market including margin trading and derivatives. The loan is non-repatriable. Hence the loan amount cannot be credited to the NRIs NRE/FCNR accounts. The repayment of the loans should be by direct remittance from abroad or by way of debit to the NRE / FCNR account or by way of sale of shares and immovable property.
Branch/ Project/ Liaison Office of a foreign company in India	Foreign companies keen of setting up of Liaison Office / Branch Office (LO/BO) are required to submit their application to RBI through an Authorised Dealer bank. The applications from such entities in Form FNC will be considered by the Reserve Bank under two routes: **Reserve Bank Route** - Where principal business of the foreign entity falls under sectors where 100 % Foreign Direct Investment (FDI) is permissible under the automatic route. **Government Route** - Where principal business of the foreign entity falls under the sectors where 100% FDI is not permissible under the automatic route.

	Applications from entities falling under this category and those from Non - Government Organisations / Non - Profit Organisations / Government Bodies / Departments are considered by the Reserve Bank in consultation with the Ministry of Finance, Government of India.
Facilities for Non-Resident Indians / Persons of Indian Origin	Remittance outside India of current income like rent, dividend, pension, interest, etc. in India of the account holder is a permissible debit to the NRO account NRI or PIO may remit an amount up to USD one million, per financial year, from the balances held in its NRO account from the sale proceeds of assets and immovable property without any lock-in-period. Repatriation of sale proceeds of residential property purchased by NRI / PIO is permitted to the extent of the amount paid for acquisition of immovable property in foreign exchange received through banking channels. The facility is restricted for two such properties. The balance amount can be credited to the NRO account and can be remitted under USD 1 million scheme. Authorised Dealer banks have been permitted to issue International Credit Cards to NRIs/PIO, without prior approval of the Reserve Bank

Source: RBI Revisions up to 15th June 2012.

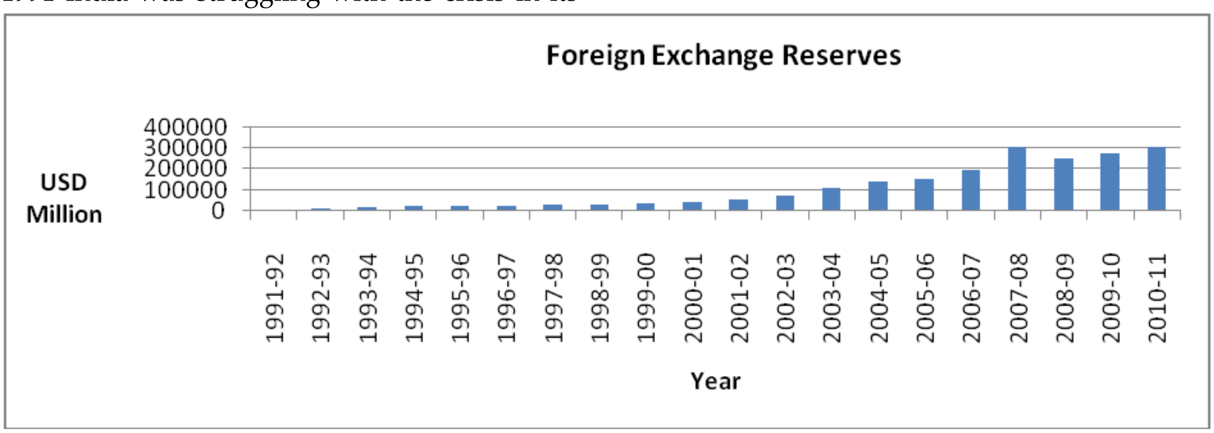
PROGRESS THROUGH CAPITAL ACCOUNT CONVERTIBILITY

A hybrid between control and liberalisation of the capital account, has served country well for nearly a decade. India has witnessed a significant surge in cross border capital flows through CAC. The strong capital movements to India in the recent period reflect the momentum in following:

PROGRESS AT COUNTRY LEVEL

(1) End of Balance of Payment (BoP) crisis: In 1991 India was struggling with the crisis in its balance of payments. Importing was essential for the country while the government's conservative approach towards exports pushed country into severe balance of payment deficit.

Capital account liberalisation has been the strongest medium in curbing such crisis. Depicted in the graph there is an ongoing trade deficit from the year 1990-91, but a positive capital account has provided cushion against all odds and overall balance of payments are in surplus. BoP status is shown in the graph below:



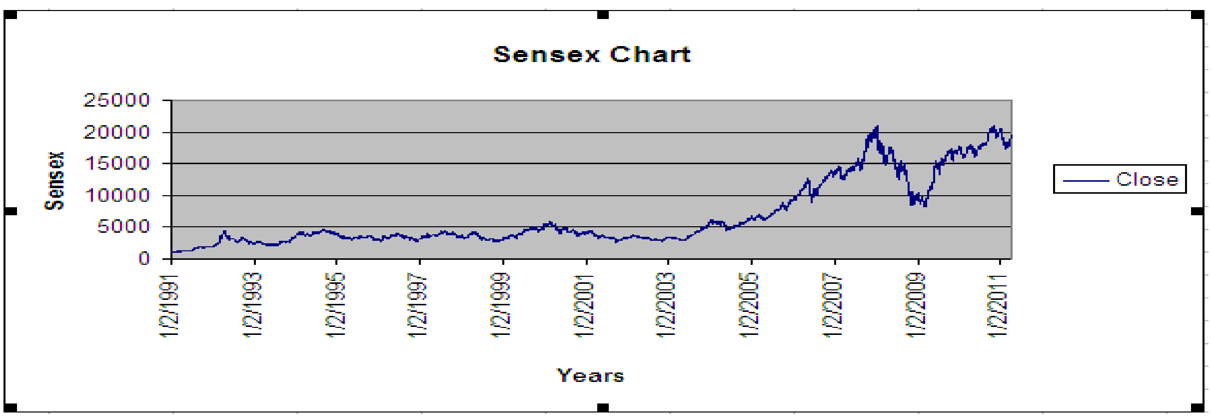
Source: RBI

(2) Plenty of Foreign Currency Reserves: India has envisaged a plentiful surge in its reserves. The liberalisation of capital account has helped country in recovering from reserve shortage. The doting supply of dollars to Reserve Bank exchequer is a healthy sign for economy, as reserves can be utilised during the times of adversity. The reserve position is shown in the graph:

Source: RBI

(3) Efficiency in Financial System: Capital Account Convertibility is incomplete without fiscal consolidation, sound policies and financial prudence. RBI and Government of India have been very conservative and watchful during whole process of liberalisation. This has improved total financial performance of economy. Banks today have greater access to additional capital (foreign borrowing), autonomy in operations (easening of control by RBI) and intensive competition (opening of private and foreign banks and Non Banking Finance Corporations). There is larger room for financial efficacy, specialisation and innovation in financial system.

(4) Development of Securities Market: Gush of Foreign Institutional Investment (FII) has helped in multifold enlargement of security market. The market capitalisation of BSE and NSE has significantly risen. Derivates, bonds, commodities now constitute the major trading instruments besides equity shares. Sensex (above 20,000) and Nifty (above 6,000) touched new heights due to huge investment in the listed stocks. The position of BSE Sensex is shown in the graph:



Source: bse2nse.com

(5) Worldwide Presence and Friendly Relations with Trading Counterparts: Flow of investment is a distinctive medium of developing global relationships. Indian MNCs and service organisations are conducting business operations in almost 140 countries across the globe. India is 19^{th} largest exporting country in the world according to 2011 estimates. Indian IT services, handicrafts, cuisine and jewellery are world famous and contribute to major chunk of revenue from international operations. It all has become reality with the financial liberalisation.

India is the founder member of WTO, IMF and World Bank. It is a member of BRICS and G-20 at WTO trade negotiations. Government has entered into multilateral trade agreements and tax avoidance treaties with the trading counterparts. Immigration norms have also been untangled. All this has given a global presence to the country and friendly relations too are in progress.

PROGRESS AT CORPORATE LEVEL

1) Indian corporate sector is inundated with broader access to low cost capital through External Commercial Borrowings. In addition, companies have the prospect of expanding their

capital base through issue of American Depository Receipts, Global Depository Receipts and corporate bonds.

2) Diversification of risk and economies of scale through business performance in different realms.

3) Increase in profit after tax through intercontinental operations (manufacturing, sales, services and Intellectual Property Rights).

4) Gains in technology through joint ventures, international license and import of technology from the specialised manufacturer.

5) Access to worldwide pool of intellectuals, managers, technical personnel etc and their specialised knowledge and skills.

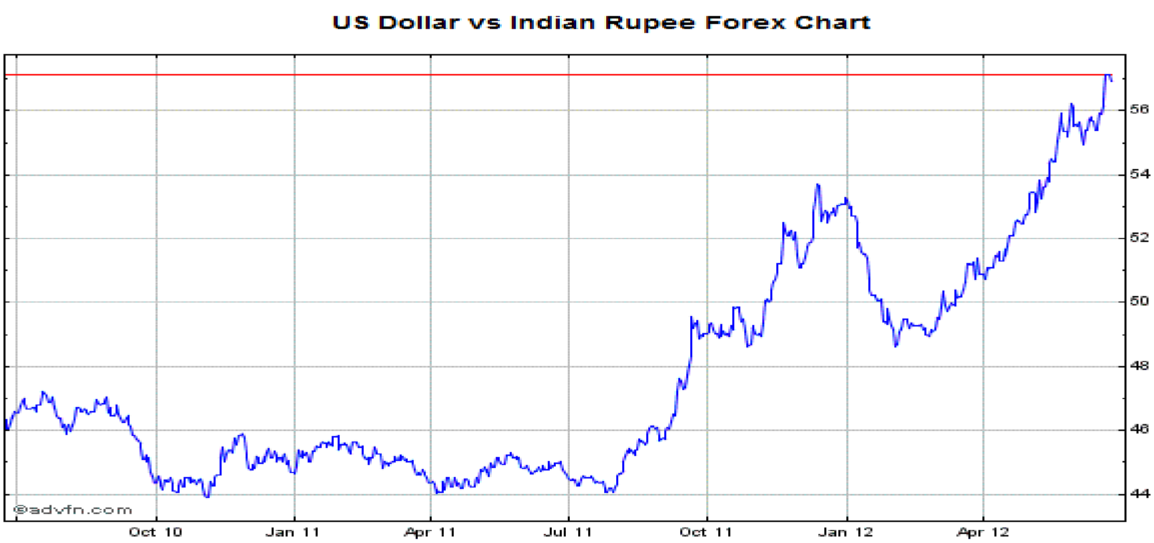
PROGRESS AT CUSTOMER LEVEL

Indian customers have gained in plenteous ways, and are getting superior quality, competitive prices and added features in the goods available in the market. They have a bundle of offerings in every sector from fast moving consumer goods (FMCGs) to automobiles, furniture to food, health clubs to telecommunication, clothes to electronics and so on. This has amplified the price wars and there has been an eminent improvement in customer services and customer information through 24×7 help lines and World Wide Web technology.

Capital Account Convertibility and Menace

It is a discernible fact that a number of empirical studies do not find evidence that greater openness of capital account and higher flows of capital lead to advanced growth (Prasad et al 2000). Some economists believe that the opening up of capital account is the last mile connectivity to the globalised world; to others it symbolise a shortcut to economic ruination. India's most recent negative experiences with the capital account liberalisation are as follows:

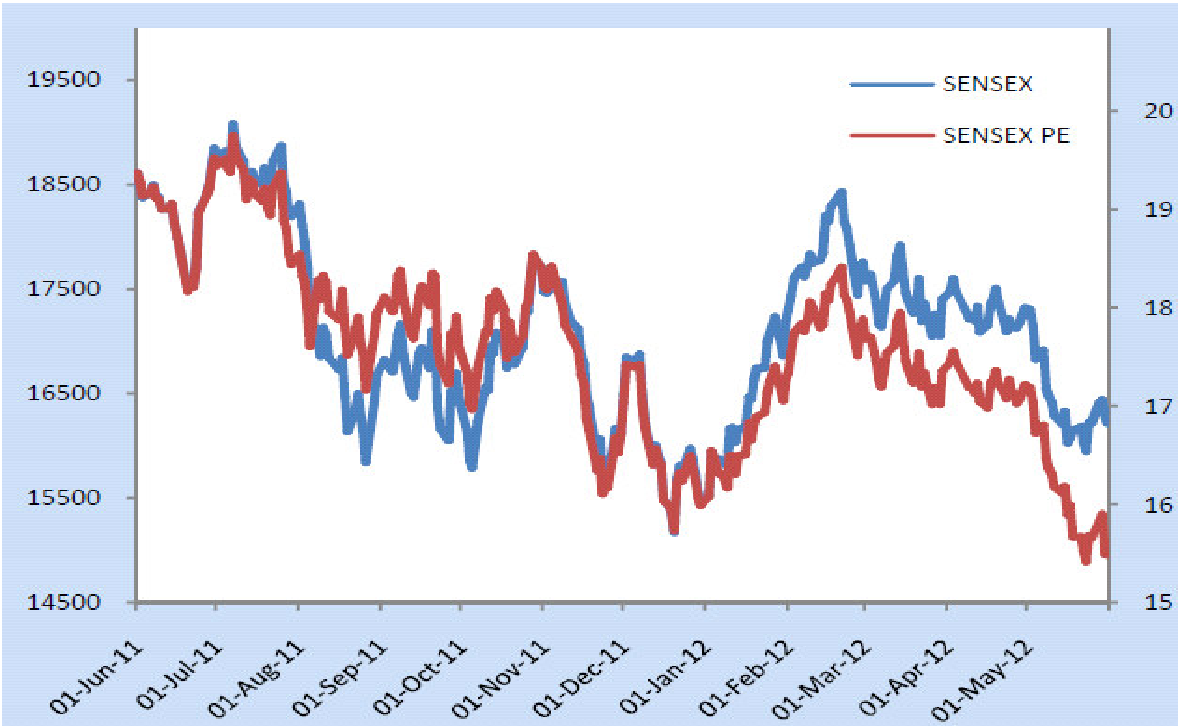
(1) Depreciating Rupee: With the liberalisation of capital account large amount of money is flowing in and out of the economy. Subsequently rupee has become highly volatile and slipped to its all time low (1$=57.33). India's imports are greater than its exports and former has further declined due to financial crisis in Euro zone. Reserve Bank is not able to peg rupee at harmless levels, consequently imports have become too expensive and the risk of widening trade deficit is obvious. Reserve Bank has to buy or sell dollars in substantial amount to maintain the value of rupee at reasonable levels. Weakening rupee has also created problems in setting appropriate interest rates. Graph shows the value of Indian rupee pegged to US dollar.



Source: advfn.com

It is clear from the graph that in August 2011, value of 1 USD was INR 44 and by June 2012 this value has become 57 rupee, the lowest value ever.

(2) Volatility in Stock Markets: International financing and investment shifts from country to country in search of higher speculative returns. Stock markets have undergone this phenomenon rapidly. In good times of the economy (good rating, healthy IIP, high GDP, political stability) foreign institutional investors are on buying spree, but in bad times FII quickly lose their confidence in market and there is an abnormal selling. Investors experience huge losses some become bankrupt too. Given in the graph drastic ups and downs in stock market indicators-

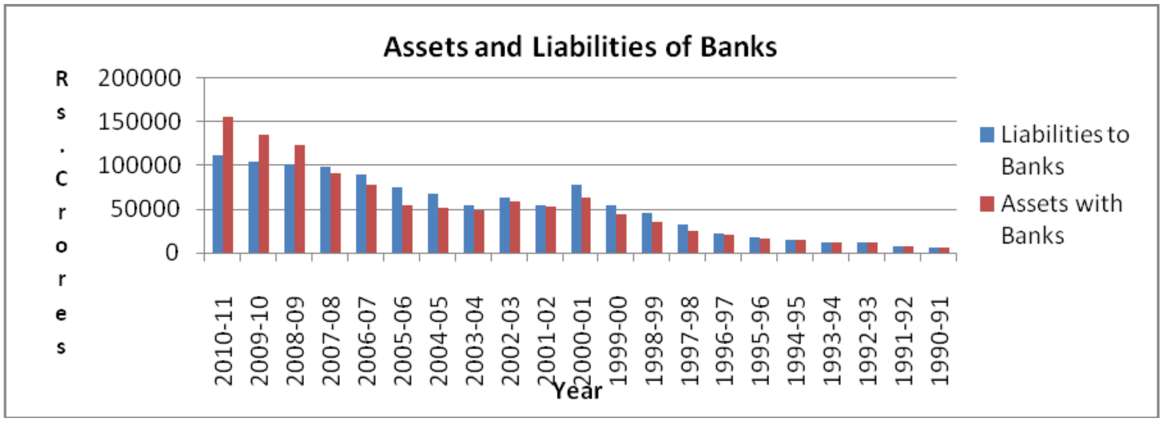


Source: BSE

According to Birla Sun Life Investment Report- 'Indian equities went through another consolidation phase in April 2012, with the index ending marginally lower by 0.5%. Lingering uncertainties on the GAAR front, a renewed weakness in US data, the resurfacing of European problems and associated weakness in INR weighed on market sentiments. Consequently, Indian equities posted their second consecutive month of decline as foreign investors stayed away. Perhaps one of most worrying factors was the steep decline in market volumes - cash volumes averaged $2.4bn in Apr v/s an average of $3.3bn from Jan-Mar 2012.'

(3) Debilitating Impact on Inflation: Capital convertibility has lead to exchange rate volatility of the Rupee resulting in macroeconomic instability caused through the risk of rapid and large capital outflows as well as inflows. When capital flows are large money supply increases and RBI comes up with tightening of monetary policy. Also, India imports approximately 75% of its crude requirements. Given the fact that the oil prices have been well above the USD 90 per barrel and extremely volatile, this has further widened the trade deficit of India and has resulted in soaring energy prices. This has upset the economy and has a debilitating impact on inflation within India. Such speculative capital flows have made domestic monetary policy virtually ineffective.

(4) Asset Liability Mismatch of Banks: In global experience with convertibility, banking envisages to be another weaker link. Banks are facing an inequality between their assets and liabilities. Banks generally refuse to lend a company which has a debt equity ratio of more than 2. Indian banks presently have high debt because of cheap borrowing through ECBs. Moreover high interest rate in market on borrowings has led to slump in demand of loans and advances. Decline in loans and advances on the asset side of balance sheet has increased the pressure to sustain the same maturity period for deposits and the asset liability management has come under strain.



Source: RBI

RBI has eased guidelines for External Commercial borrowings to resolve Asset liability mismatch of banks. The External Commercial borrowings up to $20 million in a financial year should have a minimum average maturity of three years and the ECBs up to $750 million or equivalent should have a minimum average maturity of five years.

(5) Flow of Black Money through Participatory Notes (P-Notes): SEBI allowed issue of P-Notes to FII in 2006. Concerns have been raised on the secrecy afforded to investors through P-Notes. Different types of foreign entities are eligible for the issue of P-Notes but the identity of the actual investor may be mysterious to the regulatory bodies. Therefore some of the money invested in the market through P-Notes may be unaccounted wealth of affluent Indians hidden beneath the pretext of FII investment. Such funds could be tainted and linked with unlawful activities like corruption and smuggling. Hedge funds too may use P-Notes and sub accounts of FII to operate in stock market. Reserve Bank stance is towards prohibition of P-Notes.

(6) Does not serve the Purpose of Real Sectors: Capital Account Convertibility (CAC) primarily benefit industrialists and financial capitalists who invest in stock market for speculative gains. It is mainly pursued to please international organisations (IMF, WB, and WTO) and foreign investors. It hasn't addressed the real problems of the country like poverty, unemployment, income inequalities, infrastructure bottlenecks and many more.

The irony is that burden is borne by the common man under a crisis, which has become an actuality these days. This comes up in the form of sharper reduction in subsidies, less budgetary allocations for social welfare programmes, high taxes and high inflation. The foreign speculators and domestic players walk out of the market by converting their assets into cash and insulate themselves from losses in such during economic problems.

CHALLENGES OF CAPITAL ACCOUNT CONVERTIBILITY AND THEIR MANAGEMENT

In the process of capital account liberalisation, Indian economy has been able to attract reasonable foreign investment without any major shocks. The benefits that have been derived with an open capital account have induced the growth and development of India's financial markets and external sector. Due to some or other reasons from inside and outside macroeconomic instability has lingered in the economy and things are not going well.

Inflation rate is high from the year 2009onwards. The average yearly inflation was 10.9% in 2009 and 11.7% in 2010. In 2011 the rate of inflation stood at 9.6%. Between the periods it rose to double digits too. RBI has revised monetary policy during the different time periods. Cash Reserve Ratio (CRR) was revised 13 times in the time frame of 2 years which is a benchmark in itself. Despite continuous efforts RBI is not able to tame inflation and it is still modest at the level of 8% according to latest estimates. The depreciation in the value of rupee to the level of 1 USD=57.33 INR has also raised serious questions and concern on the conduct and policies of Reserve Bank and Government of India. Global rating agencies Standard & Poor (s & P) and Fitch have revised India's rating from 'Stable' to 'Negative'. S&P has released a report strongly criticising the Government's inability to move ahead with economic reforms and referred to cracks in ruling coalition that they were holding up progress. Fitch has censured and added the general elections due in early 2014 could see politically driven pressure to loosen fiscal policy, which could further weaken India's public finance related to peers. The ratings and statement of S&P

and Fitch raise the risk of Indian bonds slipping into junk category, hurting the country's image as an investment destination. The cost of overseas borrowing for Indian companies could also go up.

The story is not yet over. Equity market is plummeting week after week because FII are on selling fling. Sensex is currently trading lower than 17,000 and Nifty near 5,000. Investor sentiments are down. Individual portfolios are making losses. Volatility and panic are the latest buzz words for the 'Dalal Street'.

Food inflation is constantly maintaining its double digit levels causing a decline in domestic savings with banks. IIP has fallen to the level of 3.5% from 8.1% of the previous year. GDP growth in 2012-13 is estimated at the aching level of 6.5% while fiscal deficit is at 5.9%. Reserve Bank's Governor D.Subbarao said 'fiscal deficit in 1991 was 7% and it is ruling at 5.9% in 2012.' Is it an alarming signal? Because, India was going through its meagre times in 1991 and latest GDP estimates too are worrisome. There are additional doubts about Government's ability to trim subsidy level to cut fiscal deficit, which could further increase the prices of essential commodities. A new retro tax GAAR (General Anti Avoidance Rule) is also proposed to be enacted in budget for fiscal 2013. GAAR aims to target tax evaders, partly by stopping Indian companies and investors from routing investments through Mauritius or other tax havens for the sole purpose of avoiding taxes. It has sparked an outcry among foreign investors.

Thus the recent global turmoil, volatile capital flows and economic instability have considerably heightened the uncertainty surrounding the outlook for India, complicating the conduct of monetary policy and external management. The intensified pressures have necessitated stepped up operations in terms of capital account management and more active liquidity management with all instruments at command of Reserve Bank. Therefore in this scenario, it is suggested that India should adopt a go slow approach in moves to liberalise capital account. Instead, it is important for the country to be ready to deal with potentially large and volatile outflows along with spillovers. In this context, there is a need of manoeuvre for Reserve Bank to deal with present serious matters by deployment of monetary policy instruments, buying and selling operations of forex, complemented by prudential restrictions and measures for capital account management.

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