Capital Account Convertibility: Issues and implications

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ABSTRACT:
Hon'ble Prime Minister Manmohan Singh, a great economist, when called for a renowned push towards making the rupee convertible on capital account, there were wide spread protests. Capital Account Convertibility (CAC) has not been on the political agenda since 1997, when a committee headed by former Deputy Governor S.S. Tarapore set out a road map towards full CAC by 2000. The East Asian crisis intervened, and the plan was shelved for the time being. Tarapore heads a new committee to look into another CAC roadmap in the month of March of this year. The committee report was made public by the Reserve Bank of India on September 1, 2006. However, since the last one, India has opened up its capital substantially. Through this research paper, we are trying to analyse the various issues towards CAC and its effect in the Indian economy with fair suggestions.

A. INTRODUCTION

The convertibility of a currency implies that a currency can be transferred into another currency without any limitation or any control. A currency is said to be fully convertible if it can be converted into some other currency, at the market price of that currency. Current account convertibility refers to currency convertibility required in case of transactions relating to exchange of goods and services, money transfers and for those transactions that are classified in the current account of country's balance of payment. On the other hand, Capital Account Convertibility (CAC) required in the transactions of capital flows that are classified under the capital account of the balance of payments. In the country's balance of payment, the capital account transactions are those, which lead to changes in the overseas financial assets and liabilities of the country. These include investments abroad and inward capital flows. Capital account convertibility refers the freedom to convert domestic financial assets into overseas financial assets at market-determined rates as well as conversion of overseas financial assets into domestic financial assets. Broadly, it could mean freedom for firms and residents to freely buy into overseas assets such as equity, bonds, property and acquire ownership of overseas firms besides free repatriation of proceeds by foreign investors.

B. ISSUES AND PRE-CONDITIONS

In 1994, transactions on the current account were made fully convertible and foreign exchange was made freely available for such transactions. However, capital account transactions are still not fully convertible. The rational behind this is clear. India wants to conserve precious foreign exchange and protect the rupee from volatile fluctuations. In the early 1990's India's foreign exchange reserve had dipped to such abysmally low levels that there was just enough forex to pay for few weeks of imports. To overcome the crises, the then government had to pledge a part of its gold reserve to the Bank of England to obtain foreign exchange. The situation improved in mid 1990's. The convertibility of rupee also helped in improving the foreign exchange reserve of the country. The foreign exchange reserve of the country increased to $ 141.5 billion by 2005 as compared to $2.5 billion in 1991 . The road to convertibility, in India is a calculated gradual transaction path starting in the early 1990, when the high level committee on balance of payment, chaired by C. Rangarajan recommended the introduction of a market determined exchange

rate regime. The liberalized exchange rate management system was instituted in March 1992 as a transitional phase before the convergence of the dual rates on March 1st 1993. The current account full convertibility was achieved in August 1994 by accepting article VIII of the articles of agreement of the International Monetary Fund. A committee headed by Dr S.S. Tarapore, the then Deputy Governor of RBI, was appointed to look into the issue of capital account convertibility. The Committee had indicated the pre-conditions for capital account convertibility. The three crucial pre-conditions were fiscal consolidation, a mandated inflation target and strengthening of the financial system. The Tarapore committee on capital account convertibility in 1997 defined the framework for the third and final stage of forex liberalization. The committee in May 1997 had chalked out three stages to be completed by 1999-2000. The three major recommendations of the committee were:

B1. A reduction in gross fiscal deficit from 4.5 percent to 3.5 percent of GDP in 1999-2000.

B2. A mandated rate of inflation for the period 1997-98 to 1999-2000 at 3 to 5 percent.

B3. A reduction in non-performing assets (NPA) in the banking system to 5 percent of total loans in the final phase of liberalization.

C. PHASED LIBERALIZATION OF CAPITAL CONTROLS IN INDIA

Influenced by the recommendations of the Tarapore committee, the Indian government encouraged automaticity in the area of foreign direct and portfolio investment and foreign borrowings and allowed the authorized dealers in the foreign exchange, mainly banks to account flow of funds in certain cases freely without any approval of the RBI. In October 1997, the government decided to allow free import of gold by eight banks and three canalizing agencies. As per the monetary policy pronouncement, the exporter were allowed to retain one half of the foreign exchange earnings in EEFC Account which was only one quarter earlier. Foreign banks too could hedge their repatriable profits. Earlier they use to get such permission on a case-by-case basis. Banks could extend credit/non-credit facilities to Indian ventures operating abroad up to 5 percent of their unimpaired tier one capital and could undertake forfeiting of medium term export receivable, which was earlier the domain of the EXIM bank. Again, the SEBI registered Indian fund managers including mutual funds were allowed to invest in overseas market with in specific limits.

In the first week of November 1997, the RBI identified three broad areas for taking steps towards capital account convertibility. First, in money market, the RBI proposed to reduce the minimum period of termed projects to reduce the lock-in period of mutual funds, to enlarge the participation in repo markets. Second, the RBI planned to increase the number of primary dealers and enhance their underwriting power, to allow the FII's to invest in treasury bills and to introduce interest rate futures in treasury bills and dated government securities. Third, the RBI proposed to permit the assurance of foreign currency denominated bonds to the residents to allow the FII's, the hedge, the equity exposure in forward market, to allow financial institutions to act as the authorized dealers in foreign exchange market and to introduce derivatives. However, soon there after with the deepening of the impact of South East Asian crisis on India's external sector, the Indian government adopted a go-slow policy.

The RBI announced a package of reforms in the banking sector in conformity with the recommendations of the Narasimham committee report that could pave the way for CAC. In 1999-2000, ADs were allowed to provide foreign exchange cover to FII's up to 15 percent of their outstanding equity investment. The Indian

companies could use commercial papers for borrowing from the overseas corporate bodies on non-repatriable basis. The shares of the Indian companies could be sold/purchased among the non-resident Indians and overseas corporate bodies. In 2000-2001, the Indian companies were permitted to acquire foreign companies. The country's investments abroad under automatic route were further liberalized. The ban on overseas investment by registered partnership firms were lifted. The limit for FII's investment in India was raised from 24 percent to 40 percent of the paid capital of the company. In 2001-02, settlement of claims in foreign currency in respect of general insurance policy was allowed. The limit for the issue of foreign currency convertible bonds by approved corporate bodies was further raised to US$ 50 million. In 2002-03, the Indian banks were permitted to open short-term deposit accounts of the non-residents. An automatic route for prepayment of external commercial borrowings was introduced. The Indian banks were allowed to invest in overseas money market instruments/debt instruments. The resident individuals/mutual funds/listed Indian companies were permitted to invest abroad up to 25 percent of their net worth in listed companies. The automatic route for overseas direct investment was further liberalized to 100 percent of the net worth.

While the inflation target was achieved early, India came close to achieving NPA target in 2004-2005 (it was 5.2 percent at the end of that year). A fiscal deficit target of 3.8 percent of GDP is likely to be achieved in 2006-2007, according to budget projections. Despite this delay in achieving the preconditions, which the committee had said was of "critical importance"; many important reforms were carried out.

D. IMPLICATIONS OF CAC ON INDIA'S ECONOMY

The rational behind the full capital account convertibility is efficient allocation of global capital, which not only equalizes the rate of return of capital across the countries but also increase the level of output and equitable distribution of level of income. The whole cost of capital account transaction has been liberalized or deregulated in the recent past. It has been argued that for most business and personal transactions, the rupee is practically fully convertible, further in cases where specific permission is required for transactions above a monetary ceiling, it is generally received easily. The authorities have also declared that they will continue to pursue this deregulation policy further. Such liberalization would cause extreme domestic financial vulnerability as the Asian crisis taught us, it should be realized that free mobility of capital has effected many countries including Mexico, East Asia, Russia and so on. However strong the economic fundamentals of developing countries, free flow of global capital inevitably sows the seeds of financial crises. Excessive inflows of capital results in exchange rate appreciation and thereby affect the competitiveness of the host country in the international goods market, on the other hand, and widens the trade deficit by increasing imports. The central banks intervention to avoid these affects causes problems and effects the independent monetary policy operation.

Full capital account convertibility may encourage arbitrage operation in forex market. It is so because banks, non banking financial institutions and individual borrowers will prefer to borrow cheap global capital which would not only increase the external debt burden of the country but also encourage the functioning of the "black economy" and financial instability. Full capital account convertibility often provides wrong signals to the international investors about the host countries economic fundamentals. Since the international investors are concerned about their profit maximization rather than productive investment, they mobilize their funds for higher returns, which may result in moral hazard and

adverse selection problems and thereby destabilize the financial system and cause great loss to the host country.

India adopted a gradualist approach while initiating a process of gradual capital account liberalization in early 1990s. In 2003, the RBI governor outlined issues related to capital account convertibility in India. In the RBI's latest credit and monetary policy, RBI governor Dr. Bimal Jalan had asserted that the Central Bank would continue its approach of "watchfulness, caution and flexibility" in the management of foreign exchange. "India's exchange rate policy of focusing on managing volatility (that includes preventing the flight of capital on the capital account) with no fixed rate target while underline demand and supply conditions to determine the exchange rate in an orderly way has stood the test of time" Dr. Jalan had noted. Hon'ble Prime Minister Manmohan Singh on 18th March 2006 said "there was merit in India moving towards fuller capital account convertibility. He asked Finance Minister and the RBI to revisit the subject and come out with a road map on capital account convertibility based on current realties. In response to Prime Ministers statement, RBI on 20th March 2006, announced committee to set out roadmap towards fuller capital account convertibility. Even as the new committee is all set to begin discussions on how to take CAC forward, a number of economists have signed a petition against further liberalization. The RBI too seems wary of it. The term of reference for the committee clearly states that its job is to chart a path towards 'fuller' not 'full'.

The committee has submitted the report to the Reserve Bank of India and was made public by RBI on September 1, 2006. The committee had recommended that the scheme for fuller CAC should be implemented in a five year period in three phases and at the end of five year period in 2010-2011, "There would be a comprehensive review to chalk out the future plan of action.

Major recommendations are as follows:

D1. The Annual limit of remittance by individuals to open foreign currency accounts overseas be raised to $ 50,000 in phase one from the current level of $ 25,000 and further raised to $ 1 Lac in phase two and $ 2 Lac in phase three.

D2. All individual non-residents should be allowed to invest in the Indian stock market through SEBI registered entities including mutual funds and portfolio management schemes which will be responsible for meeting Know-Your-Customers (KYC) norms and money should come through bank accounts in India.

D3. Non-residents corporates also to invest in Indian stock markets in the same manner as the RBI allowed non-resident individuals.

D4. Review of double taxatation treaties which favor some countries as source of investment.

D5. FII's should be prohibited from investing fresh money raised through Participatory notes and the existing PN holders may be provided an exit route and phased out completely within one year.

D6. The limit for corporate investments abroad should be raised in phases from 200 percent of networth to 400 percent. The overall ECB ceiling as also the ceiling for automatic approval should be gradually raised.

D7. The limits for mutual funds to invest overseas should be increased from the present level of $ 2 billion to $ 3 billion in phase one, to $ 4 billion in phase two and to $ 5 billion in phase three and these facilities should be available to SEBI registered portfolio schemes apart from mutual funds.

E. SUGGESTIONS

Globalization issues concerning financial sector merit far more serious attention than what the present literature would seem to indicate. The key topic today ought to be risk management. That will include a substantial amount of technological support. That will be the greatest challenge for all banks management as and when full convertibility arrives. However, as of today the subject of risk management in all banks in India (bearing perhaps foreign banks) remains only on paper. The convertibility factor should affect not only on the business-NRI deposits for instance but much more so on the profitability of banking operation. Obviously, risk factor ought to figure prominently in the scheme of preventive measures. An interesting scenario in which banks can accept deposits in India in any currency from anywhere in the world is possible under full convertibility regime. The crucial determinant will be the usual "swap cost" that is the cost of converting a currency into another currency depending on the current exchange rate at the material time. The other important thing could be the comparative interest rate in India as well in other deposit exporting countries. In the words of Jagdish Bhagwati " we have to be very cautious. What is required is a ten year profile of high growth, good financial discipline, a truly transformed economy and a very sound democracy."

In conclusion, given the strong macro economic environment, it is the right time to embark on the current exercise. It will also be appropriate to compare India with China and some of its other regional peers. China is fast integrating into the global economy without introducing full CAC. The experience of certain South East Asian Nations, which went in for full convertibility, also needs to be kept in mind. Foreign speculators bet huge amounts in these currencies, indulged in price speculation, and withdraw money after booking huge profits, and in the process left the economies of these countries in a shambles. Clearly, it needs to be understood that CAC is a process and not a one off-event where the country needs to proceed slowly but surely, after due care and thought.

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