# ISAS Brief

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Institute of South Asian Studies
Hon Sui Sen Memorial Library Building
1 Hon Sui Sen Drive (117588)
Tel: 68746179 Fax: 67767505
Email: isaspt@nus.edu.sg
Wesbite: www.isas.nus.edu.sg

## Capital Account Convertibility for India – Current Concerns


S. Narayan[1]


The Indian Prime Minister announced at a major event at the Reserve Bank of India (RBI) in Mumbai some three weeks ago that India needed a road map for full Capital Account Convertibility (CAC) for the Indian Rupee. Soon thereafter, the Indian government set up a committee under the chairmanship of Dr Tarapore, former Deputy Governor of the Reserve Bank of India. Interestingly, Dr Tarapore had headed a similar committee that submitted its recommendations in 1997, though the committee had been set up while Dr Manmohan Singh was the finance minister.

There is no formal definition of CAC. It is normally understood as the freedom to convert local financial assets into foreign financial assets and vice versa at market determined rates of exchange. CAC is widely regarded as one of the hallmarks of a developed economy. It is a major comfort factor for overseas investors, who feel confident that at any time, they will be able to repatriate the proceeds and gains from business and commerce. It is considered to be a signal of the openness of the economy and aimed at encouraging global capital flows into the country. CAC can coexist with restrictions other than on external payments. For example, it does not preclude the imposition of policy restrictions on foreign holding in any one sector. The United States does not allow foreign participation in its domestic airlines industry. The recent case of Dubai Port Authority seeking to gain control of some United States ports is yet another example, where the proposals were rejected by the United States government.

Economists understand that capital mobility, fixed exchange rates and interest rates autonomy cannot exist together in any economy. The effects of monetary and fiscal policy in an open economy depend on capital mobility. Under floating exchange rates, monetary policy is a powerful tool for policy. Developing countries that seek to manage all three of the ingredients through policy often attempt (like India) to adopt a 'moving peg' system that corrects exchange rates through a series of time lagged steps. The problem in this approach is that the central bank (the RBI, for example) has to intervene periodically in the market to buy or sell dollars to prop up the current exchange rate.

On the other hand, CAC allows free flows for all purposes other than capital purposes such as making investments and loans. In India, CAC was established with the acceptance of certain

[1] Dr S Narayan is Head of Research and a Visiting Senior Research Fellow at the Institute of South Asian Studies, an autonomous research institute within the National University of Singapore. He is the former economic adviser to the Prime Minister of India. He can be reached at isassn@nus.edu.sg.

obligations with the Internal Monetary Fund (IMF) in 1994. Progressively, there has been increasing liberalization on this account. For example, resident Indians are allowed to invest abroad without any limits. Non Resident Indians (NRI) [now a very wide term] are allowed to repatriate proceeds of their assets sold in India. Permitted allowances for business travel, education, health, etc., are extremely generous. The ceilings on corporate investments abroad or in joint ventures are very liberal, as also for securing external debt. In 2005-2006, repatriation from India in the form of interest and dividend payments as well as profits of corporates was in excess of US$10 billion, the highest figure ever in the last five decades. Thus, in most respects, there is almost total current account flexibility. It is, however, true that the Indian rupee is still not an 'international' currency, that is, it cannot be bought and sold in the exchange market.

Up to 1991, when India faced a major foreign exchange crisis, there had been very rigid controls on both the external capital as well as the current account. The liberalization process that started after 1991 and the terms of the IMF conditionality helped to relieve the current account transactions and the resulting growth and investments in the economy augmented the forex reserves of the country. The improvements encouraged the government to set up a committee in 1997 to spell out a road map for the full convertibility of the rupee.

This committee, in its report, suggested several preconditions for introducing CAC. The first was that gross fiscal deficit as a percentage of GDP should go down from 4.5% budgeted for 1997-98 to 3.5% by 2000.The gross fiscal deficit, on the other hand, increased to 5.9% in 2002-2003. It only came down to 4.1% in 2005-06. It is targeted to come down to 3.8% in 2006-07, but still not close to the 3 % that is required by the Fiscal Responsibility Budget Management Act. There is also the concern about stated fiscal deficits that had reached high levels, and have only recently started coming down.

Another precondition was that the annual rate of inflation should be in the 3% to 5% range. This has been maintained in India for over a decade and is close to 5% now. However, higher energy and commodity prices are likely to be a cause for concern on this front.

The third precondition was that the foreign exchange reserves of the country should be sufficient for six months' imports. Phenomenal increases in foreign exchange reserves were seen after 1999-2000. In 2002-2003 alone, the reserves grew by US$21.3 billion. At present, foreign exchange reserves are equal to two years import cover.

The final condition was that non-performing assets of banks should not be more than five percent of the deposits. This is close to being reached.

Soon after the submission of the report in 1997, the East Asian crisis broke and there was rethinking on the issues of full convertibility. In fact, economists all over, including the IMF, started advocating a more gradual approach. The policy developments of the subsequent years focused on gradual relaxations of the exchange rate regime, more oriented towards greater flexibility for trade and investment than for macroeconomic management of monetary or fiscal policy. The relaxations have progressively extended to most sectors of the economy, and for quite some time now, there have been suggestions for clarity of policy in respect of CAC.

The need for a clear road map at this stage arises from several considerations.

Firstly, the floating peg regime that the RBI is implementing is becoming untenable. As long as the RBI had significant quantities of government bonds to unload, it could sterilize the liquidity caused by the buying of dollars by the release of these bonds into the market. As the stocks of these bonds ran out, a new mechanism of market sterilization bonds was thought up in 2004, by which the RBI continues the sterilization process through the issue of these instruments. As these are off the Consolidated Fund of India and do not enter into the revenue streams of the government, they do not add to the fiscal deficit, though the interest on these is to be paid for by the budget and has, to that extent, a fiscal implication. It is an ad-hoc measure intended to have a control over liquidity and hence over interest rates and inflation, but not a measure that would be able to be used long term. It has succeeded moderately in the last year due to lower needs of sterilization as current account flows turned negative last year.

Secondly, there is increasing exposure of firms to external currency borrowing and this requires a stable currency regime to be in place urgently. When the central bank intervenes in the currency market, it creates an illusion that the currency is not volatile, and this encourages firms, banks and governments to be reckless in dollar borrowing. Borrowers tend not to hedge currency risks. When the central bank is no longer able to sustain this illusion, there are sharp currency movements that inevitably hurt the borrowers. Sound policies require that the government should not have dollar liabilities. In India, de facto dollar borrowing is taking place through devices such as bond issues by the Securities and Exchange Board of India (SEBI) or NRI deposits of banks. Since banks are not allowed to bust, these are actually sovereign liabilities.

It should make sense to allow Foreign Institutional Investors (FIIs) to access rupee borrowings and to discourage firms from external borrowings until the currency regime and the currency derivatives are in good shape. But, at the moment, the reverse is the case. The problem is exacerbated by the fact that the rupee is pegged to the United States dollar. Borrowers are encouraged by the belief that the dollar is a safe currency. As the rupee/dollar exchanges lurch into periods of volatility, it would hurt the borrowers and the institutions significantly.

Thirdly, progressive relaxations of controls have led to anomalies in terms of opportunities for investments and repatriation. The slew of regulations on FDI, on investment in external primary markets, on internal fund flows etc require a complex regulatory policing that the banks, the RBI and SEBI are finding difficult to handle. Several of these regulations have loopholes that are being exploited. An important example is the use of Participatory Notes in the financial markets. These are funds at the hands of FIIs that have been subscribed to by unknown institutions and individuals, and are in the nature of 'hot' money. Attempts to regulate them have not succeeded significantly; the RBI is worried about likelihood of sudden outflows and of destabilizing effects.

Managing the rupee's float within a system of limited convertibility and full interest rate autonomy has become a nightmare. The RBI has had a difficult time balancing capital inflows against the nation's policy on money supply, interest rates, inflation, price stability and growth. CAC has therefore become a necessity. The timing is to India's advantage with growing trade, expanding and transparent financial markets, and increasing integration with global markets. Full convertibility freely floating exchange rates would restore India's autonomy over money supply, interest rates and growth.
The step is not, however, without concerns.

First, the Tarapore committee report did not take adequate account of current account deficits. With increasing trade imbalance and larger energy imports, current account flows are likely to be significantly negative in the next few years. The foreign exchange reserves have also not been rising significantly in the last year.

Second, apart from the structural correctives that CAC would bring, there is little other advantage. It is unlikely that there would be great global demand for Indian Rupees. On the contrary, Indians may want to convert their holdings into international currencies as a measure of security. This could result in the depreciation of the value of the rupee. Further, how will India integrate itself into global currency markets? A mechanism and a road map would have to be worked out.

Even empirical experience does not provide enough evidence to show that capital account openness results in large increases in capital inflows. Thus in terms of FDI, whether step alone will lead to greater inflows, are quite debatable. Already there are sufficient relaxations for the corporates on the issue of equity and debt abroad. All that full convertibility will mean is that they will not have to get even those permissions that they need to get now.

There is also the question of whether we are talking about full currency convertibility or fully open capital account or both? Currency convertibility refers to the absence of any restriction on the holding of foreign currencies by residents and of national currencies by foreigners, and on free conversion between the two. An open capital account, on the other hand, is the absence of restrictions on non currency-asset holdings. Open capital account augments investible capital in the country through greater access to international capital, and enhances choices of domestic savers to a wider portfolio choice.

There have already been sufficient relaxations, and there now need to be guidelines on the kind of controls that have to be put in place. There needs to be greater emphasis on monitoring and supervision. The RBI is likely to be concerned about this. In the past, the world has lauded the exchange rate management policies of India, but the present situation requires a paradigm shift.

The committee, therefore, is likely to look carefully at the pros and cons. While CAC is likely to be put in place, it is expected that the report of the committee will spell out safeguards in regard to investments and supervision, as well as to delineate areas and activities where such controls would continue.

The report of the committee is to be ready by 31 July 2006. It is likely that there would be phased movement towards convertibility, and the phasing would be decided in consultation with the RBI. The current expectations are that convertibility would be I place between one to two years from now. On its part, the RBI would have to take into account expectations about oil prices in the medium term as well as sustainability of investment flows into the country. It is also likely that there would still be restrictions in some sectors. Initially, there would be a flow of rupees from the country, as private individuals seek to convert into other currencies. The resulting depreciation is not likely to be significant (<5%), and the currency is likely to stabilize. Greater flows of NRI funds, particularly into the financial markets and in real estate, are to be expected. Trade in services is likely to increase significantly. On the manufacturing side, it is unlikely that this would make a major difference. There are other constraints like infrastructure, labour regulations and regulatory hassles that are holding up investment flows, and the investors would be equally anxious for a resolution of these. The

financial markets would integrate better with global markets. In short, considerable advantages are seen, perhaps at a lower value of the rupee. It is, however important that the RBI put in place mechanisms to monitor and supervise flows to avoid sudden volatility and 1997 type problems.

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