Convertibility of Rupee on Capital Account

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"Free Enterprise was born with man and shall survive as long as man survives".

-A.D. Shroff
1899-1965
Founder-President
Forum of Free Enterprise

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Dr. S.R.K. Rao*

What is Capital Account Convertibility? Currency of a country is deemed to be convertible on capital account when the local financial assets can be converted into foreign financial assets and vice versa, at market determined exchange rates without government controls, regulations etc. It also implies that there would be no controls on the two-way movement of international capital and on their end-use except in cases of transactions of undesirable nature. Capital account convertibility facilitates changes of ownership in foreign and domestic financial assets and liabilities. It enables the creation and liquidation of claims on/by other countries of the world. If foreign exchange transactions are of undesirable nature, capital account convertibility does not preclude imposition of appropriate monetary and fiscal measures.

Advantages of Capital Account Convertibility: It enables the country to integrate its economy with the global economy. It facilitates greater access to international financial markets and to obtain larger stock of foreign capital at relatively low costs, to supplement domestic capital resources. This would enable the economy to achieve a higher growth rate. It allows residents to invest in foreign markets. By diversifying their investment portfolio they can reduce the "risk factor". Further, it facilitates specialisation in financial services and thereby increases allocative efficiency and productivity of capital. When currency becomes convertible on capital account, financial prices, both domestic and international, tend to level

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*The author is an eminent economist and was formerly Principal Adviser to the Reserve Bank of India. The text is based on a talk delivered in Mumbai on 30th September 1997 under the auspices of Forum of Free Enterprise.

off since capital can move both ways without hindrance. This would make domestic tax regime to fall in line with tax regimes in the developed countries. This would deter capital flight. Lastly, capital account convertibility gives impetus to the development of a wide range of derivatives and risk management products, thereby widening and deepening the financial markets.

Economic environment congenial to Capital Account Convertibility : For capital account convertibility to be successful certain congenial conditions should exist in the economy. Fiscal consolidation is imperative and the government should slash subsidies and dismantle administered prices mechanism, accelerate the process of disinvestment of PSUs on a large scale and cut-down to the minimum its non-development expenditure.

Larger the fiscal deficits greater will be the dependence of the government on market borrowings from within and outside the country resulting in higher interest rates, inflation, crowding out the private sector etc. One of the main objectives of capital account covertibility is to bring down domestic interest rates on a par with the international levels. If inflation rate is not kept under control this objective gets frustrated. Therefore inflation rate should be kept at a manageable level, among others, in relation to GDP. Thirdly, capital account convertibility and domestic economic reforms are intertwined and inseparable. When large capital resources flow into the economy consequent on capital account convertibility, their impact on the economic growth depends on how productively they are employed in different sectors.

Prioritisation of investment will minimise, if not eliminate wastage of scarce capital resources. For instance, if foreign capital supplemented by domestic resources is employed in infrastructure sector, it would map-out the future growth rate in the economy. Fourthly, balance of payments position should be strengthened and current account deficit should be kept under control. Further, it is essential that sufficient foreign exchange reserves are built-up when a currency is made convertible on capital account. Lastly, the process of financial sector liberalisation and economic reforms should be accelerated to cope-up with the likely large inflows of foreign capital into the economy. So far as the financial sector is concerned, existence of an efficient regulatory and supervisory machinery is essential to detect and prevent foreign exchange transactions of only desirable nature. Supervisory role of the central bank needs to be strengthened and capital base of banks broadened.

Capital account convertibility operates successfully in an environment where interest rates are fully deregulated and cash reserve ratio of banks is kept at the minimum. Banks' non-performing assets (NPAs) should be reduced to the minimum and banks should be fully equipped with the latest technology and monitoring mechanism when large inflows and outflows take place through their channels. Reforms also cover stock exchanges, which are apt to attract large inflows of capital into primary and secondary markets. Their efficiency and machinery to handle the increased volume of dealings should conform to the standards of their counterparts abroad. A well developed foreign exchange market would greatly help in ironing out volatalities in exchange rates since it offers such facilities as hedging, forward cover etc.

India and Capital Account Covertibility: There is no uniformity or conventionality in the experiences of countries which in recent years embark on capital account convertibility. Report of the Committee on Capital Account Convertibility (CAC) has given the experiences of ten countries in this regard which varies from one another. In the case of India the process of capital account convertibility was set in motion, though in a small measure, in 1991 (July). Stabilisation and structural reforms were undertaken in right earnest to prepare the ground for it. Devaluation of the rupee by 18 per cent in two stages, (in July 1991), liberalisation of trade, industrial and foreign investments, policies, among others, were initiated by the government.

The journey towards capital account convertibility started in the mid-nineties. Automatic approvals for upto 74 per cent equity participation in certain infrastructure areas and upto 51 per cent equity participation in 45 "priority" industries were allowed by the government. Investment limits on investments in other industries were to be decided on a case-by-case basis by the Foreign Investment Promotion Board (FIPB). Proposals for higher foreign equity participation was also considered subject to the approval of the Secretariat of Industrial Approvals (SIA) and (FIPB); the latter specially set-up to invite, negotiate and facilitate substantial investment by non-resident corporates involving high technology transfer. Free repatriation of disinvestment proceeds, profits and dividends is allowed and the rate of withholding tax is aligned with international levels. Restrictions imposed on the operations of companies with significant foreign equity holdings were removed through amendments to FERA, thereby placing them on a par with Indian companies. A major step was taken in August 1994 when Current Account Covertibility for both inflows and outflows of residents and non-residents was established in accordance with Article VIII of the IMF's Articles of Agreement.

Controls however continue to operate on resident individuals and corporates sending capital abroad and also on inflows and outflows of capital associated with banks and non-banking financial companies. The early "Basket" arrangement and "dual rate system" of March 1992 were given way to a unified marked-based exchange rate regime in March 1993. There had been a progressive liberalisation of trade and payments regime. Convertibility facilities given to FD investors were extended to portfolio investments of FIIs in the Indian stock exchanges. Further, Indian corporates were allowed access to foreign financial markets through Global Depository Receipts (GDRs) and Foreign Currency Convertible Bonds (FCCBs). New deposit schemes were launched for NRIs, viz., Foreign Currency Non-Resident (Banks) (FCNR(B)) and Non-Resident Non-Repatriable Rupee Deposits (NRNRRD); Schemes guaranteeing exchange rates were phased out. Access to External Commercial Borrowings (ECBs) was made more flexible. Though there is an overall cap of US 8 billion dollars per annum on loans below ten years raised recently to US$8.5 billion; this ceiling is removed recently for loans above ten years of maturity. Further, FIls are allowed, after November 1991, to invest in the primary and in the corporate and government debt markets. In 1996 government allowed them to launch 100 per cent dedicated debt funds. Since liberalisation in 1991, Global Depository Receipts (GDRs) and Foreign Currency Convertible Bonds (FCCBs), - which are Euro-issues - are allowed though the proceeds are not allowed to be invested in the stocks and in the real estate markets. In the case of outward investments, investments beyond US four million dollars and not qualified for fast track clearance approved by Special Committee, are permitted.

Against this background two issues call for examination: first, whether at all India should move towards full convertibility of rupee on capital account at this juncture? Secondly, should it traverse through the "Road Map" chalked out by the Committee on Capital Account Convertibility or, adopt "an eclectic approach" to liberalise the capital account transactions even as the process of achieving some of the pre-conditions laid down by the Committee is in progress? The first issue appears to be academic in view of IMF considering a proposal to amend the article VIII of Fund's Articles of Agreement to incorporate capital account convertibility as one of the obligations of the Fund's membership. The Governor of RBI at the Fund meeting held on April 28, 1997 said, "We welcome the move towards capital account convertibility", though Article VI of the Fund's Articles of Agreement allows at present the right to maintain capital control. This could be the background to Union Finance Minister's announcement in his Budget speech for 1997-98 that he had appointed a Committee " to lay out the road map towards capital account convertibility". It may be noted that capital account convertibility is already in operation at present for foreign direct investors under the extant FDI policy, for portfolio investment by FIIs, for NRIs and for investment in non-resident repatriable deposit schemes with banks in India. The issue involved relates to feasibility of allowing capital outflows by residents.

The Committee on Capital Account Convertibility (The Committee) recommended, among others, (a) capital account convertibility is possible only after the pre-conditions/sign-posts laid down by it are met with, and (b) it should be sequenced over a period of three years beginning with 1997-98. Among the pre-conditions/sign posts, it laid emphasis on fiscal consolidation (from the budgeted 4.5 per cent this year to 3.5 per cent by 2000 A.D.) a mandated inflation target (on average 3-5 per cent), strengthening the financial sector (complete deregulation of interest rates, weak banks to be converted into "narrow banks" with limited functional activities; NPAs of banks to be brought down from the present 13.7 per cent to 5 per cent by 2000 A.D., average effective CRR to be reduced to 3 per cent by 2000 A.D., RBI to have a Monitoring Exchange Rate Band of + or - 5 per cent around the neutral Real Effective Exchange Rate (REER) outside of which it should intervene, strengthening of B.O.P. position by raising the ratio of current receipts to GDP from the present 15 per cent, to reduce debt service ratio to 20 per cent by 2000 A.D., and build-up forex reserves of not less than six months imports. For evaluating the adequacy of reserves the Committee spelt-out a number of guidelines.

The Committee also made very useful suggestions to strengthen the financial system. RBI seems to differ from the Committee's views. In its Annual Report for the fiscal year 1996-97 it observed : "It is not essential that any liberalisation of capital account transactions should wait until all the pre-conditions are fully met. In some cases, liberalisation of capital account transactions can itself facilitate achieving of some of the pre-conditions. Therefore an eclectic approach should be to liberalise the capital account transactions even as the process of achieving some of the pre-conditions is in progress". However, RBI and government should take immediate steps to strengthen the financial system, including the banking system, financial institutions and stock exchanges, as recommended by the Committee. The government also on its part should make every effort to drastically reduce its non-development expenditure and raise resources from hitherto non-taxed sources.

Impact of Capital Account Covertibility On the Economy: There is likelihood of interest rates falling largely due to two-way movement of capital and increased flow of foreign capital into the economy either as FDI and/or portfolio investment by FIIs. This should boost the investment and GDP growth rate. For banks there would be an increase in the volume of business but the "spreads" will be squeezed. Domestic banks will have to face stiff competition and this would call for restructuring of banks through mergers and consolidation. It is doubtful that the small and regional banks would be able to withstand the competition; either they have to get merged with big banks or have to limit their functions like nidhis! If SLR is not reduced and "priority sector lending" as at present, banks' `profits would get squeezed further.

Banks which borrow from overseas will face problems if rupee slides down substantially and RBI does not intervene and they have not taken proper precautions to meet with such contingencies. Benefits of capital account convertibility cannot be minimised. Banks will have access to foreign sources from where they can obtain funds at relatively low costs. They can also take foreign currency loans, and banks' stocks will attract premium in the capital market. If the Committee recommendations are implemented, banks get more autonomy in their functioning and "a level playing field" between them and financial institutions.

The crux of the problem for the banks would be the reduction of NPAs from the present 13.7 per cent to 5 per cent by 2000 A.D. They will have to increase their efficiency, reduce operating costs, develop risk management skills, modernise management, press into service high-tech to raise productivity etc. Since foreign funds are likely to be augmented banks have to take proper cover for exchange risks.

Financial institutions may not find themselves in the same advantageous position, if they are kept on a par with banks, as recommended by the Committee; they may be subjected to SLR requirements which would put pressure on their "spreads". If like banks they are to make 40 per cent of their credit ratio to "priority sector", their profitability is likely to be affected. Financial institutions at present do not deduct tax at source on interest paid on foreign currency loans. This benefit may be withdrawn resulting in cost increases for them.

Impact of Capital Account Covertibility on Stock Exchanges: Availability of foreign funds at relatively low costs should not tempt the investors to over-invest in the bourses. This may result in setting-up of low hurdles and in a fall in the return on equity. As a result of capital account convertibility inflows would increase in the stock markets and investment will get a boost if these are channelled into infrastructure industries such as cement, steel, road and bridge construction, capital goods, telecom etc. Liquidity in the markets is likely to increase and offer a wide range of choice to the investor. As the country moves towards capital account convertibility stock premiums in the GDR markets may get reduced over a period of time.

Stock exchanges have to gear-up to meet the challenges posed by capital account convertibility. First, market efficiency should be improved, especially in regard to valuation techniques and sophisticated information technology. Further, they have to conform to international reporting norms and updating information which can be made available at call. Secondly, accounting and disclosure norms should be of international standards. Thirdly, existence of an efficient Depository is essential to handle large inflows of funds into stock markets. Fourthly, to reduce volatality and improve liquidity, it is necessary that wide range of derivatives such as futures, options etc. are introduced. Lastly, the present settlement and clearing systems should be overhauled completely. Even after BSE and NSE have adopted screen-based trading system and brought down the trading cycle to a seven day cycle, there is need to reduce it further to atleast a three-day cycle. There is need to move towards international norm of T $\pm$ or T $\pm$ 3 for investors to receive their certificates/ cash as against the present 10-25 days. Transparency of transactions is the hallmark of efficient stock exchanges.

Capital Account Convertibility and its impact on Exchange Rate: Indian forex market is narrow and ill-equipped. The forward market in particular is thinner than the spot markets. There is shortage of long term covers which can be attributed to the absence of long-term players. The position can improve if well established agencies are allowed to provide hedging mechanism in the long-term market. When the economy is opened to large inflows of funds under capital account convertibility the currency is apt to become vulnerable to volatility in its exchange rate. If the rate of inflows exceeds that of out-flows exchange rate is likely to appreciate to the detriment of export growth. Consequently RBI intervenes in the market to buy the US dollars by pumping rupee resources. Conversely if rupee slides significantly, RBI sells the US dollars at the interventionist rate to push-up the exchange rate. CAC recommended that RBI should intervene only when the fluctuations are within the band of ±5 per cent. It is for the importers and exporters to anticipate and act seeking forward cover, hedging etc. RBI should not act as an Intensive Care Unit (ICU) to supply oxygen to the unstable rupee. In the ultimate analysis the strength of the external value of the rupee depends, among others, on the strength of the fundamentals of the economy. There is a perception that when rupee is made convertible on capital account, capital flight would take place on a large scale from India to outside world.

One cannot turn Nelson's Eye to the fact that already there exists a large "Hawala" market outside India and thanks to controls, restrictions etc. all these years, capital flight has been taking place over the years. However, consequent on launching of reforms in 1991 (July), adoption of current account convertibility of the rupee, and liberalisation of trade, among others, "Hawalaisation" has been reduced to an extent. Dr. Y.V. Reddy, Deputy Governor of RBI, in his address at Centre for Economic and Social Studies, Hyderabad (June 21, 1997) observed : "there is at present no evidence of larger capital flight out of the country through legal or illegal channels after the reforms process has been initiated as compared to the pre-reform period. On the contrary, there is a possibility of net reverse capital flight".

CONCLUSION: As observed earlier, whether India should move towards capital account convertibility by now is an academic question. As observed by S. Venkitaramanan, former Governor of RBI "we are already three-fourths of the way to capital being convertible" (Economic Times, June 26, '97). Further the Board of Directors of IMF are seriously considering to amend Article VIII of Articles of Agreement to make it mandatory for membership of the Fund. Lastly, RBI's commitment to it can be discerned from its assertion in its Annual Report for 1996-97 that the process of liberalisation of capital account transactions need not wait for the fulfilment of pre-conditions laid down by the Committee on Capital

Account Convertibility. The Committee sequenced its recommendations over a period of three years in three phases. If these are scrutinised one finds that of the forty recommendations itemised under different classifications, twenty five can be initiated straight away in 1997-98 as there is no change in the recommended conditions under Phase II and Phase III as compared with Phase I. In the case of nine recommendations, they differ marginally and not materially and hence can also be taken up in 1997-98. Only in case of six recommendations, sequencing calls for in-depth examination as to when they should be implemented. Instead of fulfilment of pre-conditions ushering-in capital account convertibility, moving towards capital account convertibility in 1997-98 should compel RBI and the government to meet the pre-conditions expeditiously. Even after capital account transactions are liberalised, there is need for an institutional framework for management of foreign exchange. Replacement of FERA by FEMA (Foreign Exchange Management Act) as proposed by the government, is a welcome step in this regard. We have examples of countries with free floating currencies such as Japan, U.S.A., South Korea, to name a few, which have legislation to manage foreign exchange. In U.S.A., individuals and corporates are required to intimate the central bank the outflow of foreign exchange beyond a limit.

In Japan also all inflows and outflows, beyond a point, have to be intimated to the central bank. Such legislation while facilitating maintenance of inflows and outflows statistics upto date, keeps the central banks vigilant about fluctuations in the exchange rate of the currencies. In some countries such as Chile, Philippines, Malaysia, Indonesia, though their currencies are fully convertible on capital account, intervention by central banks takes place when exchange rate fluctuation goes beyond a band/range set by them.

While India adopts eclistic approach to capital account convertibility, it cannot afford to ignore the recent experience of countries like Malaysia, Thailand etc. Malaysia's Ringgit and Thai Baht collapsed causing economic crisis in those countries. Malaysia's Prime Minister Dr. Mahathir Mohammad blamed foreign fund managers like Dr. George Sores for hostile financial speculation and manipulation of economic crisis. He said currency trading beyond that needed for financing trade is "unnecessary, unproductive and immoral" and called for stringent restrictions on currency trading. Mr. Sores' reply was typical of foreign fund managers. He said the Malaysian crisis was due to "institutional inadequacies" in that country. Unrestricted liberalisation is apt to spawn a complex variety of financial instruments and encourages reckless lending and investment. Because of weak banking sector and other institutional incapacities existing in the country these cannot be properly monitored and the inflowing and outflowing funds cannot be properly managed. It should be remembered that all foreign inflows do not contribute to growth. As a recent UNCTAD Report pointed out, these foreign inflows acquired a life of their own. A large proportion of these are driven into short-term speculative gains, and rendering them highly volatile. This affects adversely on economic decision making and business confidence. A few suggestions to check this have not been taken into consideration by IMF even at the Hongkong meet:

(i) Imposition of TOBIN TAX on these flows, which would ensure transparency in their volumes and end-use.

(ii) Setting-up of "Global Watch dogs" to minimise excessive financial flows through checks and controls; and

(iii) A Frame-Work of rules and principles on ethical and professional standards and stronger disclosure requirements for Global Fund Managers.

The views expressed in this booklet are not necessarily those of the Forum of Free Enterprise

"People must come to accept private enterprise not as a necessary evil, but as an affirmative good".

-Eugene Black

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FORUM OF FREE ENTERPRISE

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