
**THEORETICAL ISSUES OF CAPITAL ACCOUNT CONVERTIBILITY –
SOME POLICY PRESCRIPTIONS IN INDIA**

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Abstract

One of the hotly debated issues in the arena of Indian economics in recent years is the full capital account convertibility (CAC) that arises in the context when by the mid-1990s, the Indian economy improved its BoP and forex reserve position. Several countries in Asia and Latin America have adopted full convertibility of their currencies in pursuing the policy of liberalization and reform. Whether a time is right for India to move towards full convertibility is now a moot question, though the IMF and the several committees set up in India is in high favour to ensure a smooth transition towards fuller CAC enamoured with vibrant fiscal consolidation, a strong banking system, sustainable current account deficit and appropriate maintenance of external debt and forex reserves. And India meanwhile has already gone for an adventure in its way towards full CAC. The present paper gives an account of the basic theoretical issues that have arisen in international discussions on CAC and India's standpoint on this issue in particular. An attempt has also been made here to deal with the arguments for and against international capital mobility, with an assessment of how the Indian economy has been moving from exchange control to the gradual, step by step approach towards CAC.

Keywords: Dutch Disease, Contagion, Speculative Attack

Jel Clasification: F2, F21, F32,

I. Introduction

One of the most hotly debated issues that cropped up in the context of the currency and banking crisis experienced by several countries of East Asia, erupted from July 2, 1997, traveling from Thailand to Indonesia, Malaysia and South Korea by December 1997 as well as those seen in India in 1998 (to some extent) , Russia in 1998 and Brazil in 1999 and peripheral Euro-Zone economies in 1999-2000 in the halcyon years, 1997-2000 through their contagion effect is that of capital account convertibility (CAC) of the balance of payments (BoP) of developing countries. Among developed countries, the US was the first one that went in for CAC in 1974. Between 1979 till 1991, most of the European Countries, Japan, Australia and New Zealand also adopted full capital account liberalization although patterns as well as time taken varied between countries. The IMF nowadays proposes that all its member countries should make their currencies freely convertible for all current as well as capital account transactions.

Against this background, the objective of this present paper is to provide a critical analysis of India's approach to capital account liberalization programme through the lens of new literature on financial globalization and to give an account of the basic theoretical issues that have arisen in international discussions on CAC and India's standpoint on this issue in particular.

With the displacement of pegged exchange rates by a regime of floating rates in the 1970s, a new orthodoxy begins to campaign that free capital mobility is of utmost importance for maximizing global benefits from international trade and investments. The floating market-determined exchange rate determined by the forces of demand and supply and the lifting of capital controls were considered essential steps in the establishment of an efficient international financial system. The argument is that full convertibility on capital account will bring about equilibrium in the external sector of developing countries by bringing in capital flow to finance whatever current account gap that may result in if only interest rate is put to a high level. This argument is in line with the Mundell – Fleming Open Economy Model which extends the Keynesian Fix Price Model for well developed domestic financial markets.

The new orthodoxy is also vociferous on capital mobility, but the peculiar thing is that there has not grown any consensus on the exchange rate regime. However, the IMF defines CAC as the 'freedom from exchange controls on capital transactions in the BoP' within either a fixed or a flexible exchange rate regime. India has accepted the goal of capital account convertibility as part of the ongoing liberalization process. In 1996, the Reserve Bank of India appointed a Committee on CAC: to (1) examine and indicate preconditions for full convertibility of the rupee; (2) recommend measures to achieve full convertibility; (3) specify the sequencing and the time frame for such measures; and (4) suggest domestic policy measures and changes in institutional framework if necessary.

The report of the Committee on CAC, submitted at end-May 1997, had a road map for moving towards CAC by 1999-2000. The Tarapore Committee recommended in May 1997 (RBI 1997) that CAC should be conditional on a set of stringent requirements, including fiscal consolidation, low inflation, strict supervision and regulation of financial institutions, and financial restructuring, besides keeping watch on BoP and the quantum of foreign exchange reserves

The Tarapore Committee, appointed by the RBI has looked into the issues and prospects of undertaking CAC in India. The Committee set up in February 1997 has given a pragmatic working definition of CAC as "the freedom to convert local financial assets to foreign financial assets and vice versa at market-determined exchange rate, without needing any permission from the government. It is associated with changes of ownership in foreign/domestic financial assets and liabilities and embodies the creation and liquidation of claims on, or by, the rest of the world. CAC can be, and is, coexistent with restrictions other than on external payments. It also does not preclude the imposition of monetary/ fiscal measures relating to foreign exchange transactions which are of a prudential nature." In other words, CAC implies complete mobility of free and unregulated capital funds across countries with no legal restrictions, that is, the domestic

financial market is integrated with the international market. The absence of a fully open capital account places limits on large-scale capital transfers without short period of time.

But the onset of the Asian currency crisis in 1997 put a brake on the process of CAC in the emerging market economies. India was able to ward off the currency instability and uncertainty, when some stronger emerging markets reeled under the pressure of foreign exchange turmoil, due to its cautious approach and step-by-step liberalization of the BoP under the philosophy of gradualism. To examine the issue of CAC afresh (motivated by the Speech of the Prime Minister, Dr. Manmohan Singh in Mumbai) on March 18, 2006, the RBI on 20 March 2006, issued a Memorandum favouring a move towards fuller CAC and appointed the Second Tarapore Committee (Tarapore II). The Committee submitted its report on July 31, 2006. Tarapore II observed that there was progress towards CAC, '... on an ad hoc basis and the liberalized framework continues to be a prisoner of the erstwhile strict control system.' The Committee recommended measures such as reduction of the gross borrowing requirement of the government, adopting the public sector borrowing requirement (PSBR) as a clear indicator of the public sector deficit, setting up of an Office of Public Debt outside the RBI and a clear setting of monetary policy objectives jointly by the government and RBI, for fuller CAC. The Committee set out the micro- institutional development required in financial markets and recommended a gradual approach towards fuller CAC consisting of three phases, with 2006-07 being the first phase, 2007-09 the second phase, 2010-12 be the third and the final phase. The substantive recommendations of Tarapore II included raising the annual ceiling on external commercial borrowing (ECB), relaxing restrictions on rupee-denominated and on long-maturity external commercial borrowings (ECBs), easing up on FII investment in debt securities, and liberalizing outward investment by both individuals and corporates. On December 20, 2006, RBI completed the first phase of fuller CAC and allowed the Indian residents to remit USD 50,000 for any current and capital account transactions or a combination of both. Indian Investors are now free to buy property or share or any other assets abroad without any prior approval of the regulator, RBI. Now Indians are able to invest in any listed foreign entity. Additionally, this liberalization will offer individual to open, maintain and hold foreign currency accounts with a bank outside India without prior approval of the RBI. In short, most of the recommendations of the Tarapore Committee have been implemented by the Government of India following the liberalization of most capital account transactions. The Persy Mistry (PM) Committee (2007) and the Raghuram Rajan Committee (2008) also have unanimously recommended a move towards faster fuller CAC. The PM Committee has observed that India had a de facto open capital account for the real economy, but not for financial services. Lack of capital account convertibility has reduced competition in the Indian financial sector and denied the country to have competition-induced efficiency gains. In its report, the PM Committee argued for introduction and rapid transition to full CAC, an inflation-targeted monetary policy, a move from the rule-based and fragmented to a principles-based and unified financial sector regularity texture,(without adequately considering the implied loss of autonomy for India's exchange rate and monetary policies). Some experts go even far ahead to say that the benefits from CAC for the financial sector in India will be analogous to the benefits that accrued to the real sector from the policy of opening up in the early 1990s. But the global financial crisis overturned the Second Committee's recommendations for faster liberalization.

In this paper an attempt has also been made in Section III to deal essentially with the arguments for and against international capital mobility, with a brief sketch of the simple macroeconomics of BoP transactions, because an understanding of the link between the current and capital account is crucial in understanding the issues involved in the discussion on CAC. In the section titled 'Rupee Convertibility, Long-Run Exchange Rate Mechanism and BoP in India', stress is given on rupee convertibility that can well explain the behaviour of exchange rate variation and its implications to India's merchandise trade balance and BoP situation as a whole.

II. Conceptual Issues

As we all know that gross national product (GNP) may be considered from either the product side (demand) or the factor payments side (supply). On the product side, we have

$$Y=C+I+G+X-M \dots\dots\dots (i)$$

Where Y is GNP, C is consumption, I is investment, G is government purchases, X is exports, and M is imports.

On the factor payments side, we have

$$Y=C+Sp+T \dots\dots\dots(ii)$$

Where C is again consumption, Sp is private saving, and T is tax revenue.

We may subtract equation (ii) from equation (i) to obtain

$$0= (I-Sp) + [G-T] + [X-M]$$

Rearranging, we may identify the resource gap as:

$$M-X= (I-Sp) + (G-T)$$

Thus, the excess of imports over exports must equal the excess of investment over private saving plus the excess of government purchases over tax revenue. Considering that the government's fiscal balance is tax revenue minus government spending or T-G and that this balance may be thought of as government's saving (Sg), we now rewrite the resource gap as :

$$M-X=I-Sp-(T-G)=I-Sp-Sg=I-(Sp+Sg)=I-S$$

where S is the total of all saving, government plus private. Thus, the need for the external resources, and therefore the trade gap, equals the excess of domestic investment over total domestic savings. Similarly (X-M) is the surplus in the trade account. If we add to it invisible trade and unrequited transfer payments, we have the current account of BoP. If we assume for simplicity, that such receipts are zero, then the current account surplus has be matched by excess of saving over investment and the budget surplus. In this perspective, a deficit in the current account implies insufficient saving relative to investment and government spending.

Since the overall BoP always balances, we now have to look towards the BoP in the capital account. The capital account records all international transactions that involve a resident of a country changing either his or her assets with, or liabilities to, a resident of another country and

consists of short-term and long term private official flows towards, portfolio and direct investment, and changes in official resources. In fact, capital account transactions can involve changes in the composition of the national capital of the country. In what follows, a deficit in the current account will always imply a surplus in the capital account and vice versa that also means inflow of foreign funds has to supplement domestic savings.

And the net inflow of foreign funds though the capital account meet the excess requirements of invertible funds over domestic savings in the economy. In fact, the following relationships hold between the current and the capital accounts, from two sides:

Current account deficit = capital account surplus + drawing down of reserves

Or

Surplus in the current account = $(X-M) = S_p - I + T - G = \text{Change in Net foreign assets.}$

This means that if a country has a deficit on its current account, the country has spent more abroad than it has earned during the specified period. This can be settled by international borrowing, or by seeking capital flows in the form of direct or portfolio investment or by depleting reserve accumulation of foreign currency that have built up over the years. Now any changes in the capital account of BoP, brought about by autonomous capital 'flows' get reflected through changes either in the current account position or the reserve position. The decision to allow the free flow of direct and financial foreign capital across national boundaries can thus have serious implications for the national sovereignty of a country.

A substantial inflow of capital sometimes distort the medium and long-term fundamental of an economy as it happened in case of Mexico in 1995, East Asia in mid 1997, and Euro-Zones during 1999-2000. Even if economic fundamentals remain strong, a country may be highly vulnerable to speculative attacks with high current account deficits.

However, large capital inflows or outflows affect the domestic economy in a variety of ways. For example, within a flexible exchange rate regime, excessive inflows of capital results in an unsustainable appreciation of the domestic currency and thereby affect the competitiveness of the host country in the international goods market, on the one hand, and widens the trade deficits by increasing imports, on the other. This results in the possibility of increasing current account deficits that can become unsustainable. With an unsustainable appreciation of the domestic currency (say, rupee) and when the market assessment is that appreciation is unsustainable, there can be sudden capital outflows and an uncontrollable spiral of depreciation of currency. The central bank's intervention to avoid these effects causes problems and affects the independent monetary operation, while on the other way, capital outflows in a flexible exchange rate regime tend to depreciate the domestic currency and can cause inflationary pressures and can induce capital flight. Moreover, we know that the interests of global investors and domestic policymakers are not the same. But a trinity is always at work. It is not possible to have a fixed (or highly managed) exchange rate, monetary policy autonomy and open capital account liberalization simultaneously.

So the exact choices for the appropriate exchange rate determination along with whether and how to control capital flows have become crucial. Second, the maintenance of high interest rate concerning incoming of foreign portfolio flows can adversely affect productive investment directly and it also makes public debt servicing more expensive. Thus opening up of global portfolio flows may result in stagnation of the country since portfolio investment comes to a country when the BoP position of a country is good. Hence the debate whether a country should liberalize capital account transactions, or not and, if they do so, how this should be done.

III. Over the CAC Debate Hovering around India

The essence of CAC is a liberalization of outflows for residence. CAC for foreign investors and Non-Resident Indians (NRIs) has all along been available for undertaking direct and portfolio investments. In fact, there is full convertibility for portfolio flows through foreign institutional investors (FIIs) as far as equity markets are concerned. Currently, there is virtually full CAC for Indian corporates. However, discussion on liberalization of the capital account on the BoP essentially revolves around whether or not to restrict the free movement of capital across the national boundaries and, if a free flow is deemed a desirable objective, how and why it should be introduced in the context of an overall liberalization program in India.

The basic issue of capital account liberalization has been to integrate the domestic capital market with the free working of the international capital market so that various policy-induced distortions stemming from multitude of controls in the domestic capital market are eliminated and the law of arbitrage (which takes into account of the riskless purchase of a product in one market for immediate resale in a second market in order to profit from price differences between the markets) prevails in the capital account transactions. This again calls for systematic dismantling of controls and elimination of informational asymmetries such that arbitrage conditions prevail and the capital market functions smoothly. But the encouragement of the arbitrage operation for which banks, non-bank financial institutions and individuals would prefer to borrow global capital cheap and resell it in a second market immediately in order to profit, would increase not only the external debt burden of the country but also encourage the functioning of the black economy and financial instability because of the heavy investment in physical and financial assets. Moreover, full CAC often provides wrong signals to the international investors about the host country's economic fundamentals. Since the international investors are mainly concerned about their profit maximisation 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 countries. Above all, CAC puts new pressures on the overall macroeconomic management of the economy in that poor macroeconomic policies will invariably generate large outflows of funds, and price volatility.

One can easily point out that the present Indian situation is not ripen enough to go into for full convertibility on capital accounts on the account that full convertibility involves freeing capital markets. Unless and until the rupee is freely floated, this would complicate the task of the exchange rate management. India does not have a formal exchange rate target. The Indian rupee has been managed to varying degrees at different times. Even though the nominal exchange rate

relative to US dollar has fluctuated over a wide range in the new millennium, the effective exchange rate has been managed within a much narrower range. This has, no doubt, constrained the independence of monetary policy...

The globalization of capital has had its discontents. In the aftermath of Asian crisis, many academics and policy-makers blamed volatile, speculative capital flows for the virulence of this financial crisis and their contagion effects. For example, the introduction of CAC in the case of South Korea was the chief culprit for the virulence of the crisis. The collapse of the currency in that country was the resultant of so many factors like accumulation of short-term foreign loans, the gradual loss of confidence of foreign managers who actually flocked together to East and South Asia on the look out for higher returns and the contagion effect of crises in neighbouring countries. This crisis led to a breakdown of international finance and resulted in costly adjustment for those economies. Besides, hasty capital account liberalization will lead to speculative attack on the exchange rate as it happened in several countries. Thirdly, financial openness index for the Indian economy is still very low in comparison to the other countries. Fourthly, the inadequate liberalization in the domestic financial and banking sector may cause to greater volatility. Fifthly, full capital account convertibility will put a pressure on the trade balance of the economy, as it is told earlier. Another thing may happen, following an increase in the interest rate structure in the developed countries with CAC as a step, like sudden withdrawal of foreign funds invested through the foreign financial institutions. This happens in India and now it is apprehended that the resources mobilized through the Mutual Funds have been channelled into the share market without adequate preparation resulting in an artificial upward trend in the share prices. As a consequence, there has been a crash as well as instability in the share market. This problem may have the implications of distant thunder, and it may cause adverse effect on the unemployment situation. Finally, India has had the past memories of an acute shortage of foreign exchange. Capital outflows by overseas deposits by Indian investors will fetch a lower return as well as a currency risk for the Indian investors. One must draw lessons from the recent history of Latin America where the outflow of capital pushed a number of countries into debt trap and towards "casino capitalism." Nay, a review of the international experience with CAC shows that liberalization of the capital account induces large capital inflows which can cause real appreciation in the exchange rate and erode the effectiveness of the domestic monetary policy. It is often been argued nowadays that the developed countries always give pressure on developing countries to adopt CAC. This argument can be very simply understood in terms of the imperatives of sustaining the US deficit. The leading countries of the world have a large and mounting external deficit which they finance by issuing debt in their own countries, while absorbing savings and capital from the rest of the world. The open financial market of the developing countries has always provided a safety valve for the US dollar by sustaining the growing deficits. Capital flight from these developing countries allows the US to maintain its deficits.

Moreover, an open capital account imposes tremendous pressures on the financial system and brings weaknesses in the financial system into sharper focus. Thus the critics argue that in the absence of complementary macro-economic policies, full scale liberalization of capital account will pose much more danger to the Indian economy as is not comprehended by the Tarapore I

Committee (*Chatterjee*, 1998). Even in the recent past, the Central government's keen attitude to take the economic reforms on the path of fuller CAC as is indicated by the appointment of the Raghuram Rajan Committee has been harshly criticised by Amiya Kumar Bagchi (2009) when he alleges, "the interim report (of the Committee) is one of the most egregious exercises in rich men's ideology that I have come across." Despite the international experience of full convertibility of a developing country currency being regularly attended by a currency crisis and banking crisis and despite the warnings of practically all leading economists of home and abroad about the dangers of the move, the government of India has moved far in that direction, allowing Indian corporate firms to borrow abroad and invest abroad (*Bagchi*, 2009). In the last couple of years, high level of ECBs have invited the problem of foreign capital surge and engendered a temporary Dutch disease problem leading to an excessive exchange rate appreciation, hurting an export-led growth strategy. Hence CAC is not a meaningful term. Williamson (2006) articulates that India has liberalized its capital account too early and that it should slow down the process noting that liberalizing debt flows could be risky and would have few benefits. The experience of Indonesia suggested that debt convertibility is dangerous. He also advocates that CAL was good so long as liberalization was limited to FDI or portfolio flows. It is probably bad especially on debt flows.

160 leading economists had already issued a statement against CAC. Someone did not hesitate to comment that promoting CAC in emerging market economies is really a right-wing conspiratorial one. Someone even has told that non-industrial countries have experienced few benefits through CAC, but on the other, they exposed themselves to considerable risks (*Bhagwati*, 1998; *Rodrick*, 1998).

Implementing CAC will imbalance our forex reserves. Lawrence Summers, Clinton's Treasury Secretary argues, "India's 15 per cent forex reserves are in excess. In such a case if CAC is implemented, it will hike this figure more and the value of our domestic currency will appreciate, in turn, it will badly affect export trade because the depreciated value of the foreign currency will reduce out corporate earnings." If our policy- designers now think that by implementing CAC in India will bring more capital flows, think of China. Even China does not have any modal of CAC; it has restricted capital inflows, guided perhaps by the 'four fears' (*Calvo and Reinhart*, 2000) that lurk beneath the surface: 'fear' of appreciation, 'fear' of hot money, 'fear' of large capital inflows (dislocating the financial system and fuelling inflow-driven asset price bubbles (in narrow domestic markets) and encouraging risk taking and 'fear' of loss of monetary policy autonomy.

Now a pertinent question is whether there are any benefits from CAC. Advocates in its favour articulate that a reasonable policy approach is to accept the rising financial openness as a reality and manage rather than resist the process of fully liberalised capital account transactions, though of course managing is a difficult task. Advocates for faster CAC wanted more market-led innovation, an end to financial repression and distortions, and the change to develop India as a centre for financial services, given its skilled manpower. Their arguments are that there would be some distinct advantages in the following manners:

- With CAC, the Indian resident will be able to use the world capital market for risk diversification and maximize the return on their resources. For example, in a situation for bad year in India, when financial assets generate a poor return, foreign assets owned by Indians would continue to generate good returns.
- By allowing residents to diversify their portfolio into foreign assets, such convertibility can reduce the variability of their income and wealth from domestic shocks and diffuse the risk of asset-price bubble.
- Convertibility would enable aggregate saving and investment to be optimised.
- Rates of return on debt and equity in India are high by world standard. With CAC, foreign money will come into India to reduce these rates of return. That is to say, the cost of capital faced by the companies of India in equity and debt financing would come down as there will be large inflow of capital in the country. At a lower cost of capital, more investment projects would be viable, which will generate a faster pace of investment and growth in the economy.
- CAC will foster financial globalization — a term that encompasses cross-border flows of financial capital in various forms. The phenomenon should allow for a more efficient allocation of financial resources across countries and also permit countries to share their country-specific income risk more efficiently thereby increasing economic welfare on both counts (*Prasad, 2009*).
- Capital controls are being rendered increasingly ineffective by the rising sophistication of the international investors, the share quantity of money flowing across national borders, and the increasing number of channels for the evasion of these controls. Hence, emerging market economies, like China and India, are perforce grappling with the realities of financial globalization, wherein capital controls are losing their potency as a policy instrument.
- CAL will bestow ‘co-lateral benefits’. This include financial development and transparency and also making liberalization irreversible (*Prasad, 2009*).
- It has been noted that over a period of time capital account controls and restrictions tend to turn progressively ineffective, costly and even distortive. Hence the need for capital account convertibility.
- There will be gains from free inflow and outflow of capital. Indian residents, Indian banks, Indian mutual funds, Indian corporates (if the corporates find it remunerative with joint ventures), would be able to enhance their earnings, by investing a part of their money and resources.
- There will be an availability of a large dose of capital at international prices to supplement domestic resources and if there is large capital inflows CAC would relieve pressure on the exchange rate, the monetary aggregates and thereby enhance the effectiveness of domestic policy.
- The spread of financial intermediaries will come down as result of increased competition and as such the system would be more efficient
- Tax evasion and capital flight will reduce since tax levels would come down to international level.

- The cost of government borrowing will come down as the rate of interest would be low and ultimately fiscal deficit will reduce.
- Capital outflows will propel Indian authorities to initiate corrective macroeconomic policies, for which Indian interest rates and stock prices would be highly attractive and Indian holding foreign financial assets abroad would find it attractive to invest in India.

In this perspective, the advocates also argue that India just cannot remain isolated in an increasingly integrating world. If India does not plan for an orderly integration with the world economy, the world would integrate with it in a manner in which India would have no control over events. Thus the question is whether or not we should move to CAC by opening the doors to unfettered capital flows immediately but whether we want an orderly or a disorderly transition to CAC of the Indian rupee (Tarapore, 2003).

IV. India's Move From Exchange Control to Convertibility

Since 1950, licensing of imports, imposition of high duties and stringent foreign exchange controls were part of the package of policy measures in India. This import substituting self-reliance strategy during 1950-1980 with whom the Raj Krishna- mentioned Hindu (annual) rate of growth of 3.5per cent was intimately connected during the same period, has not eventually delivered significantly improved quality of life to the vast majority of population.

In the early and mid-1980s, policy changes were initiated. Relaxation of import controls enhanced export initiatives and reduced controls on selected industries marked the beginnings of mild or modest doses of economic liberalization. The exchange rate policy, too, for the first time, was flexibly administered, allowing steady depreciation of the real exchange rate through continuously downward adjustment in the nominal exchange rate.

During the 1990s and beyond, the exchange rate regime has undergone significant changes. From a managed floating system under which the exchange rate was officially determined, the regime has passed through several phases to reach a market based system. Since March 1993, the rupee has been convertible on trade account, and the exchange rate of the rupee has been determined on the basis of underlying demand and supply conditions in the inter-bank market. Current account transactions like trade, tourism, travel, education abroad and in India and remittances into and out of India for purchasing health-care products etc. have been freed of exchange control regulations and controls over several transactions on capital account have been eased. While the central bank of the country intervenes in the foreign exchange market, it does so primarily to prevent volatility and instability.

The rupee has been convertible on current account on the logic that it would *minimize the need for enforcement*. In a country where enforcement is weak, exchange control simply encourages black market (hawala) transactions and corruption among enforcement officials. Therefore, it is imprudent to have exchange controls which encourage currency smuggling and black money and an increase in Bhagwatian 'DUP' activities. Secondly, *attracting foreign investments* is impossible if there exists far too many controls, licenses and permits Raj. Importantly, if remittances of profits and interest receipts in the case of bank deposits and dividends/earnings

from portfolio investments are subject to exchange controls, the regime will act as a disincentive for foreign investors in the present day scenario where there are other countries which are keen to offer better facilities and fewer restrictions. Thirdly, the trade and exchange control regime in India did not generate a healthy export growth until the late 1970s and 1980s. Moreover, both per capita export and the export to GNP per centage were both relatively low in India in comparison with China, Indonesia, South Korea, Malaysia and Thailand. Controls on exchange transactions imply an overvalued exchange rate. The overvalued exchange rate may dissuade exporters to reap the benefits of export earnings into the country and dampen domestic savings. A similar reasoning applies to inward remittances. The country lost billions of dollars through the so-called processes of under-invoicing of exports and over-invoicing of imports. Lastly, a market-based exchange rate and a well-functioning exchange market provide an appropriate benchmark prices for goods and services as well as promote domestic economic efficiency, especially when currency convertibility is accompanied by trade liberalization. So bereft of other two arguments, current account convertibility is necessary as *an incentive to exports and inward remittances* as well as *a promoter of efficiency*

The above arguments pointed to the need for convertibility on current account. However, export growth, inward remittances, FDI and allocative efficiency will not depend on currency convertibility alone; in most cases, other complementary measures suited to the context like trade liberalization in general, expanding outlets for foreign currency conversion and simplification of procedures for industrial investment are also important.

With growing strength of the BoP, in the post-1991 reform period, in August 1994, by accepting obligations under Article VIII of the articles of agreement of the IMF, the Rupee was made full convertible in India on the current account of the BoP, which essentially means transactions in goods and services. In order to reduce delay and thus further facilitate all current transactions, there has been further relaxation of restrictions on current transactions in 1996-97. In January 1997, the RBI announced major relaxation in exchange control. The monetary ceiling prescribed for remittance of foreign exchange was removed and authorized dealers were empowered to allow remittances for these purposes without prior clearance from the RBI. Now India is walking towards the road to capital account convertibility. In view of the rapid changes that have taken place and the growing integration of the Indian economy with the world economy with the external sector now accounting for almost 40 per cent of GDP, for which the economy cannot be fully immune to international developments, the RBI has set up a committee (Tarapore II) for have a suggestion for a roadmap for fuller CAC The committee is required to, in this context, examine the implications of fuller CAC on monetary and exchange rate management, financial markets and the financial system. The main recommendation of the Committee is outlined in Section I.

We address here the question whether time is ripe for full capital account convertibility in India.

To pave the way for the success of Indian CAC, the First and the Second Tarapore Committee provide a certain set of pre-conditions, sequencing and

**Table I: Precondition for Capital Account Convertibility in India:
Tarapore I Vs Actuals**

| Item | Recommendation of Tarapore Committee (1997) for 1999-2000 | Actual Position in 2005-06 |
|--|---|---|
| FISCAL CONSOLIDATION : Gross Fiscal Deficit (GFD) of the Central Govt. as per cent of GDP | 3.5 | 4.1 |
| The Rate of Inflation (Mandated) | 3.0-5.0 (average for 3 years) | 4.6 (average for 3 years) |
| Strengthening of the Financial System i) Gross Non-performing assets NPAs as a per centage of total advances ii) Average effective Cash Reserve Ratio for the banking system | 5.0 3.0 | 5.2 (2004-05) 5.0 |
| Important macroeconomic indicators : Debt service ratio to be reduced from 20per cent from 25per cent of total exports The Forex Reserves should not be less than 6 months of imports | | Debt service ratio declined to 10.2per cent 14 months coverage |

Source: RBI, Report on Currency and Finance 2001-02 and RBI (2006): Report of the Committee on Fuller Capital Account Convertibility.

timing of measures. For example, India must maintain inflation rate at 3.5 per cent, fiscal deficit at 3.5 per cent of GDP, current account deficit at 1.6 per cent of GDP, but the present statistics for India goes other way around. For example, average rate of inflation for 3 years in 2005-06 was 4.6 per cent against the recommended range of 3-5 per cent, which goes against the Tarapore target rate. It is also difficult task before the Government to achieve Tarapore target of fiscal deficit to the tune of 3.5 per cent of GDP, while the actual average fiscal deficit in 2006-07 is found to be 3.6 per cent of GDP. Financial sector gross NPAs were 3.3 per cent of total advances in 2005-06 compared with the 5 per cent recommendation. Average CRR (Cash Reserve Ratio) was 5 per cent in 2005-06 against 3 per cent. The CAC committee has also recommended that the ratio of short term debt plus portfolio stock as a per centage of forex reserve should not exceed 60 per cent. Recent RBI Annual Report has indicated that this ratio is around 75 per cent. So we may articulate that India should embark on full CAC from a position of strength- a satisfactory real rate of growth, relatively low inflation and a high level of forex reserves, a low current account deficit in BOP and a falling debt service ratio. Besides, D.M. Nachane (2011) has pointed out that it is not very evident that especially Tarapore Committee II have really gone into a detailed examination of all the risks attached to CAC and devoted sufficient attention for insulating the economies from the future financial crises.

V. Rupee Convertibility, Long-Run Exchange Rate Mechanism and BoP in India:

The Rupee Convertibility can be well explained with the behaviour of exchange rate variation and its implications in India’s BoP situation. Rangarajan (1991) estimated the following export equation based on time series data for 1977-1990.

$$\log(\text{export volume}) = 4.28 + 0.71 \log(\text{world GDP}) - 0.66 \log(\text{REER}).$$

$$R^2 = 0.94, \text{D.W.} = 1.7$$

All regression coefficients are statistically significant at 5per cent level.

The above regression clearly points out the impact of the exchange rate on exports. A 1per cent reduction (depreciation) in the exchange rate promotes 0.66per cent increase in exports and higher is the elasticity of real REER, the higher is the value of exportables. Similar results have been obtained by Trivedi (1992). Thus one may opine that an appreciation of the currency hurts exports. Also, the depreciation of REER is associated with growth in the volume of exports which can promote competitiveness and stabilize external value of rupee (Kumar & Joseph, 1994). There are lacunae of this view. The study of Sarkar (1992) reveals that there exists no significant impact between BoT and exchange rate where BoT is measured in terms of ` , Dollar or SDR. His regression analysis during 1971-91 confirmed that the depreciation of rupee had no favourable impact on Dollar value and volume of export.

But the above relationship is not unanimously true because there is no unique relationship between increasing growth of exportables and downward REER. In our regression analysis, it is found that in the pre-reformed period from 1976 to 1991, 1per cent decrease in NEER promotes increase in exports by 2.9756per cent and imports by 2.9166per cent per year. On the other hand, 1per cent decrease in REER led to increase in export by 3.192per cent and imports by 3.2568per cent per year respectively.

TABLE 2

| Pre-reform period (1975-76 to 1990-91) | Post-reform period (1991-92 to 2008-09) |
|--|--|
| Log (export) = 22.4392 – 2.9756 log (NEER) (-8.7977)* (14.220)* R ² =0.763, DW = 0.35, F = 77.40* | Log (export) = 6.739 + 0.922 log (NEER) (1.622) * (0.991)* R ² =0.061, DW = 0.112, F = 0.983* |
| Log (export) = 23.6147 – 3.9120 log (REER) (16.276)*(-10.370)* R ² =0.817, DW = 0.853, F = 107.721* | Log (export) = 7.088 + 0.783 log (REER) (1.871) * (0.947)* R ² =0.056, DW = 1.907, F = 0.896* |
| Log (import) = 22.517 – 2.9166 log (NEER) (10.262)*(-6.2017)* R ² =0.615, DW = 0.261, F = 38.46* | Log (import) = 638969 + 0.964 log (NEER) (1.505)*(0.944)* R ² =0.056, DW = 0.137, F = 0.891* |
| Log (import) = 24.2732 – 3.2568 log (REER) (12.254)*(-7.456)* R ² =0.714, DW = 0.639, F = 60.162* | Log (import) = 7.384 + 0.829 log (REER) (1.577)*(0.817)* R ² =0.043, DW = 0.121, F = 0.667* |

| | |
|--|--|
| <p>Log (export) = 7.1764 + 0.1035t (109.53)*(24.396)* R²=0.926 Log (NEER) = 5.0817-0.02738t (134.058)*(-11.156)* R²=0.838</p> <p>For NEER Co-efficient of variation = 26.187per cent Skewness = 1.576 Kurtosis = 6.353</p> <p>For REER Co-efficient of variation = 23.856per cent Skewness = 0.837 Kurtosis = 3.4044 Log (EID) = 0.05758 + 0.00049t (0.208) (-1.58) R² = 0.0018</p> | <p>Log (export) = 9.672 + 0.132t (115.79)*(16.126)* R²=0.945, DW = 0.326, F = 260.44 Log (NEER) = 4.381 + 0.009t (47.116)*(1.040) R²=0.067, DW = 1.413, F = 1.081</p> <p>For NEER Co-efficient of variation = 14.456per cent Skewness = 1.3162 Kurtosis = 3.2109</p> <p>For REER Co-efficient of variation = 6.1294per cent Skewness = 0.1732 Kurtosis = 3.1032 Log (EID) = -0.1845 - 0.04104t (-10.15)* (-16.10)* R² = 0.962</p> |
|--|--|

EID = NEER/REER = Effectiveness Index of depreciation,

* = Significant at least 10per cent level.

But during the post-reform period from 1991-92 to 2008-09, one per cent increase in NEER leads to an increase in exports by 0.922per cent and one per cent decrease in NEER leads to an increase in import by 0.829per cent per year. The relation between NEER and export is found insignificant. Again, one per cent increase in REER leads to an increase in import by 0.829per cent per year and was found insignificant. And, one per cent decrease in REER led to 0.783per cent increase in export per year and was found significant (**Table 2**). It is interesting to note that the volatility of NEER and REER affects the behaviour of export and import but the volatility of both the NEER and REER is higher in the pre-reform period than the post-reform period. For example, the coefficient of variation of NEER is 26.187per cent in the pre-reform period and 12.765per cent in the post-reform period.

Again the coefficient of variation of REER is 23.8566per cent in the pre-reform period and 6.2994per cent in the post-reform period. Not only that, the downward trends of NEER and REER are not confirmed in all the periods, such as, REER shows increasing trend in the post-reform period, which is verified by the semi-log linear model. This may be corrected through deft exchange rate management.

Table 3
India's Foreign Exchange Reserves

(US \$ million)

| Years | Gold Holding of the RBI | RTP | SDRs | Foreign Currency assets held by the RBI in major convertible currencies | Total Forex Reserves (2+3+4+5) | Import Cover (no. of months) |
|---------------------------|-------------------------|------|------|---|--------------------------------|------------------------------|
| 1 | 2 | 3 | 4 | 5 | 6 | 7 |
| 1990-91 | 3496 | | 102 | 2236 | 5834 | 0.8 |
| 1991-92 | 3499 | | 90 | 5631 | 9220 | 2.3 |
| 1992-93 | 3380 | | 18 | 6434 | 9832 | 2.5 |
| 1993-94 | 4078 | | 108 | 15068 | 19254 | 5.4 |
| 1994-95 | 4370 | | 7 | 20809 | 25186 | 5.7 |
| 1995-96 | 4561 | | 82 | 17044 | 21687 | 6 |
| 1996-97 | 4054 | | 2 | 22367 | 26423 | 6.5 |
| 1997-98 | 3391 | | 1 | 25975 | 29367 | 6.9 |
| 1998-99 | 2960 | | 8 | 29522 | 32490 | 8.2 |
| 1999-00 | 2974 | | 4 | 35058 | 38036 | 8.2 |
| 2000-01 | 2725 | | 2 | 39554 | 42281 | 8.6 |
| 2001-02 | 3047 | | 10 | 51049 | 54106 | 9.6 |
| 2002-03 | 3534 | 672 | 4 | 71890 | 76100* | 12 |
| 2003-04 | 4198 | 1311 | 2 | 107448 | 112959* | 12.2 |
| 2004-05 | 4500 | 1438 | 5 | 135571 | 141514* | 13 |
| 2005-06 | 5755 | 756 | 3 | 145108 | 151622* | 13.2 |
| 2006-07 | 6784 | 469 | 2 | 191924 | 199179* | 13 |
| 2007-08 | 10039 | 436 | 18 | 299230 | 309723* | 16 |
| 2008-09 | 9577 | 981 | 1 | 241426 | 251985* | 14 |
| 2009-10 | 17986 | 1380 | 5006 | 254685 | 279057* | 14.7 |
| 2010-11 (end of December) | 22470 | 1972 | 5078 | 267814 | 297334* | 15.6 |

* Includes Reserve Tranche Position (RTP) in IMF

Source: Economic Survey, Government of India, 2010- 2011

VI. Conclusions

In what follows is that CAC in India has and had been no doubt a hotly debated topic nowadays in India and the subject matter of three officially-sponsored Reports: Tarapore II Reports (2006), Mistry Reports (2007) and Rajan Reports (2008). Of them, while the Tarapore II Committee recommends a much slower space of liberalization compared to other two Reports, the latter two lays out a fairly aggressive time table, noting thereby that large benefits would accrue from financial openness and boost financial sector reforms. One can reasonably argue in this context that all of these reports need to be reviewed, rethought and revisited in the light of the recent global economic and financial crisis which was triggered by the US sub-prime mortgage market in early 2007 and then spread all over the world and abated not yet because a semi-open country like India is more and more integrating with the global capital market and the large magnitude of its impact is vigorously felt on its economy. The recent global financial Tsunami after crossing the Atlantic and the Pacific ocean swept on the Indian shore in September 2008 through trade,

financial and confidence channels, suggests a high degree of caution in further opening up of the India's capital account, because we all know how the global financial crisis eventually has led to considerable contraction in India's exports, widens current account deficits (it would have been more bigger if invisibles and private transfers would be smaller), reverses capital flows, with concomitant pressures in the domestic foreign exchange market (felt through the dollar liquidity shocks emanating from the very lower level of net capital inflows) and drawdowns of reserves — which ultimately make an inroad to have a dramatic structural changes in India's BoP. For example, the forex reserves of India reached their peak at US \$314.6 billion at end-May 2008, before declining to US \$252.0 billion at the end of March 2009. The decline in reserves in 2008-09 was *inter-alia* a fallout of the global crisis and strengthening of the US dollar vis-à-vis other international currencies (**Table 3**).

CAC in India requires several prerequisites in terms of strong macroeconomic policy framework and soundness and efficiency of financial systems and markets in the light of macro-prudential regulations instead of the existing system of purely microeconomic regulation. Even the policy makers of India may alter in any way the current macroeconomic policy toward CAC, if necessary for India's growth from a development perspective. Jagdish Bhagwati's interesting comment on the risks of CAC in this context becomes more relevant when he says, "cease and desist from moving rapidly to full convertibility until you have gained political stability, economic prosperity and substantial macroeconomic expertise—and not just transparency and better banking supervision." However, the management of the external sector must be accompanied here by a flexible exchange rate, sustainable current account deficit, preference to non-debt creating resource flows, limits on the quantum, use and cost of external debt, and a highly restrictive approach to short-term debt along with encompassing a spectrum of other policy choices, which include the appropriate level of reserves, monetary policy objectives related to liquidity management and interest rates and maintenance of healthy financial market conditions with financial stability : the exchange rate not to be in any way out of alignment with the fundamentals for a prolonged period of times. The currency must not be imbibed with overvaluation as because overvaluation in that case could act as a catalyst when there will be a run on the currency. The speculators and the private traders in that case will do the massacre for the economy. The liberalization of financial markets should be accompanied by an increase in regulation and strict supervision. Today's financial markets are very sensitive to new information and also exhibit risks and volatility. Under such circumstances, to meet the emerging challenges before India, a cautious and calibrated approach with enough regulatory and prudential safeguards as well as self-insurance against recent financial crises is urgently called for, before moving towards full CAC. Attention should also be given to maintain the domestic drivers to growth and to avoid running into the classical 'Dutch Disease' situations, the term associated highly with surge in capital inflows. These surge in foreign capital flows, usually comes to a country (domestic) to take the advantage of interest rate differentials (carry trade), high stock market returns and better growth prospects but cause real appreciation of that country's currency, that is, these flows make the domestic economy's goods more expensive as compared to the rest of the world. This real appreciation occurs irrespective of whether the inflows consist of FDI, portfolio inflows, or bank lending. The real appreciation in that case may cause a current account deficit big enough to put the liberalization process at risk. Apart from currency appreciation, the

periodic surge in capital flows (the majority of the capital flow in India is in the form of FIIs, which are volatile in nature) may lead to the problem of absorptive capacity in the economy, fuelling asset price bubbles and stoking inflation.

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