Capital Account Covertibility: A Big Gamble

It is widely perceived that the convertibility can be a boon as well as a bane, and a lot depends on the strength of the underlying economy and its institutions. The article discusses the pros and cons of capital account convertibility in Indian perspective.

The Reserve Bank of India-appointed committee, under Chairmanship of Dr.S.S.Tarapore (Who also chaired a similar committee in 1997) to prepare roadmap towards Full Capital Account Convertibility (FCAC), has completed its task and delivered its report at the end of the July 2006. This second Tarapore Committee was setup at the behest of Prime Minister Dr. Manmohan Singh. In Mumbai, on March 18, 2006, while addressing the audience at the Reserve Bank of India (RBI), he said "Given the changes that have taken place over the past two decades, there is a merit in moving towards fuller capital account convertibility within a transparent frame work, I will, therefore, request the Finance Minister and the Reserve Bank to revisit the subject and come out with a roadmap based on current realities'.

Definition of CAC

Convertibility is a two-step process- current account and capital account. Current account convertibility refers to freedom in respect of Payments and transfers for current international transactions. In other words, if Indians are allowed to buy only foreign goods and services but restrictions remain on the purchase of assets abroad, it is only current account convertibility. This facility has been in force since 1994 when India had accepted obligations under Article VIII of the IMF's Articles of Agreement in August 1994.

The Tarapore Committee (I) had defined capital account convertibility as "The freedom to covert local financial assets into foreign financial assets and vice versa at market determined rates of exchange.

– Dr. S.B. Kamashetty

(The author is faculty at SS Margol College, Shahabad, and Karnataka. He can be reached at drkamashetty2003@yahoo.com)

In other words, it means allowing Indians to purchase both the physical and financial assets abroad and vice-versa.

The first committee, the report of which was released on June 3, 1997, had recommended a three-year timeframe (1997-2000) for complete convertibility, subject to the fulfillment of pre-conditions (Table-1). However, the Southeast Asian currency crisis simply put the CAC on the backburner.

The present committee has proposed a five-year timeframe, from 2006-2011, to move towards convertibility in three phases. 2006-07 (Phase-I), 2007-08 & 2008-09 (Phase-II) and 2009-10 & 2010-11 (Phase-III). The panel has said that it would enable authorities to undertake a stock taking after each phase before moving on to the next phase.

Unlike earlier report, this report appears to be too lengthy, which has 213 pages. The report provides an insight into India's financial sector and government finances reforms to date. Therefore, the details vary but both reports (Tarapore I & II) focus on fiscal consolidation and financial sector reforms as crucial preliminaries to full convertibility of the rupee.

It is clear, from the Table-1 on next page that even after a decade we could not meet all the conditions enumerated in the report. Though some of the pre-conditions such as maintaining inflation rate, reduction in non-performing assets (NPAS) and debt servicing have been attained. Several other crucial pre-conditions like low fiscal and current account deficit, CRR are yet to be met.

The committee had recommended that

Table-1					
Pre-conditions and Actual Status					
Sl. No.	**Items (%)**	**1997 (Actual)**	**Targeted by 2000**	**2000 Actual**	**31st March 2006**
1.	Centre's gross fiscal deficit to GDP	4.1	3.5	5.4	4.1
2.	WPI inflation (Average)	4.6	3-5	4.5	5.01*
3.	Gross NPAs of banking sector	15.7	5.0	12.7	5.25
4.	Cash Reserve Ratio	9.3	3	9-10.5	5.00
5.	Debt-Servicing ratio	25	20	17.1	10.2
6.	Current Account deficit	1.6	-	-	4.5
* As on 26th August 2006					

gross fiscal deficit must be contained at 3.5% of gross domestic product (GDP) before going fully convertible. As against this, the current gross fiscal deficit stands at 4.1% and is likely to come down to 3.8% by next fiscal.

Fiscal fundamentalists also talk of sustainable level of the deficit, which is 5-5.5% of GDP for the centre and states combined. But, the present combined fiscal deficit of both centre and states is around 8%.

The committee has made several recommendations (Table-2 on next page):

- Removal of tax benefits to NRIs.
- Greater autonomy to RBI.
- Complete cheek on fiscal deficit.
- Disallowing investment channel led through a particular country (like Mauritius).
- Reduction of government stake in banks from 51 per cent to 33 per cent.
- Allowing industrial houses a stake in existing banks or allowing them to open a new banks.
- Allowing enhanced presence of foreign banks.
- 10 per cent voting limit for investment in banks should be scrapped.
- Non-resident corporates should be allowed to invest in Indian markets.
- All individual NRIs should also be allowed to invest in Indian Market.
- Revenue deficit of both central and states should be eliminated by 2008-09 and building a revenue surplus of 1 per cent by Financial Year 2011.

The committee has suggested that the annual limit of remittance by individuals to open foreign currency accounts overseas be enhanced to $ 50,000 in phase one from the present level of $ 25,000 and be further raised...

- Raising the ceiling on External Commercial Borrowing (ECB).
- Banning Participatory Notes (PNs) and phasing out the existing PNs within one year.
- Enhancing the ceiling on government debt from $2 billion to 10 per cent of issuance and $1-5 billion to 25 per cent of new issuances in a year of corporate debt.
- Building adequate reserve and limiting the current account deficit to under 3% of GDP.
- All banks should be brought under Companies Act.

The committee has suggested for providing greater financial freedom for all the three key stakeholders of this process-- resident individuals, domestic companies and foreign investors. The committee has suggested that the annual limit of remittance by individuals to open foreign currency accounts overseas be enhanced to $ 50,000 in phase one from the present level of $ 25,000 and be further raised to $ 1,00,000 in phase two and $ 2,00,000 in phase three.

What the Indian resident may be allowed to remit and that too in 2008-09, is about 30 per cent less in real terms than a person was recommended to remit in 1999-2000.

It is worth to note here that the Fuller Capital Account Convertibility (FCAC) report from the six-member committee has voices of dissent from two members – A.V. Rejawade and Dr. Surajit.S.Bhalla. Financial consultant A.C. Rajwade has opined that the freedom given to individual to transfer $25,000 per calendar year carries potential hazards.

Both the Rajwade and Dr. Bhalla have a north-south opinion on the issue of enhancing this limit. Rajwade feels that this freedom may carry risks and therefore he is not in favour of providing this facility. Dr. Bhalla says that the committee makes a bold move by recommending that Indian residents be allowed to remit up to $1,00,000 per year by the end of 2008-09, it is useful to recall that the 1997 committee's recommendation was that this limit should have been reached fully nine years earlier, in 1999-

Table-2

Proposed Changes by Tarapore Committee

Investment Relaxation	Phase-I 2006-07	Phase-II 2007-09	Phase-II 2009-11
External commercial borrowing	Status quo on ECB limit of $18 billion	Gradual increase, but automatic limit to be raised from $500 million to $750 million	Gradual increase, but limit to be raised to $1 billion per financial year
Resident individual's overseas investment	$25,000 limit should be hiked to $50,000 per calendar year	Raised to $1,00,000	Raised to $2,00,000
MFs overseas investment	$2 billion investment limit to be raised to $3 billion	Further raised to $4 billion	Further raised to $5 billion
FII investment	Fresh participatory notes should be banned	Ban to continue	Ban to continue
FIIs' debt investment	G-Sec investment limit of $2 billion to be modified as 6 per cent of gross borrowing	8 per cent of total gross borrowing	10 per cent of gross borrowing
JVs / Wholly-owned subsidiary abroad investment	200 per cent of net worth limit should be raised to 250 percent	Further raised to 300 per cent of net worth	Further raised to 400 per cent

Source: RBI appointed Tarapore Committee Report 2006

2000, so in a bid to reform, the committee has actually regressed backwards. What the Indian resident may be allowed to remit and that too in 2008-09, is about 30 per cent less in real terms than a person was recommended to remit in 1999-2000. This is surely not a move towards "full capital account convertibility".

The panel also suggests that the bank's limit for overseas borrowing should be linked to paid-up capital and free reserve (i.e., net worth) and not to unimpaired Tier-I capital, as at present and raised substantially to 50 per cent in Phase-I, 75 per cent in Phase-II and 100 per cent in Phase-III. The committee has also said that all types of external liabilities of banks should be within an overall limit.

Participatory Notes

The most unexpected suggestions from the panel is banning of fund inflows under participatory notes. The committee is of the view that foreign institutional investors (FIIs) should be prohibited from investing fresh money raised through participatory notes (PNs) and the existing PN-holders may be provided an exit route and phased out completely within one year.

The panel also suggests that the bank's limit for overseas borrowing should be linked to paid-up capital and free reserve (i.e., net worth) and not to unimpaired Tier-I capital, as at present and raised substantially to 50 per cent in Phase-I, 75 per cent in Phase-II and 100 per cent in Phase-III.

Participatory notes or contract notes are the financial paper or instruments representing Indian shares, issued by foreign financial institutions to overseas Investors who are not eligible to invest in India. In fact, net FII inflows through PNs were more than 50 per cent in March 2006, which was just 15-20 per cent in 2002-03.

The committee observes that "in case of PNs, the nature of the beneficial ownership or the identify is not known unlike in the case of FIIs. These PNs are freely transferable and trading of these instruments makes it all the more difficult to know the identity of the owner".

But Dr. Bhalla does not agree with this view and strongly feels that PNs have become popular particularly because of the transaction costs involved in other forms of investments. He also said that these suggestions are tantamount to retaining licence raj in financial sector rather than dismantling it.

Anil K. Agarwal, President of Assocham says that "the risks perceived in continuation of PNs are overstated and will dampen the spirits of FIIs and others to park their surplus in Indian stock market and any misjudgment of risks related to these instruments will also stifle the country's $4 billion derivative market. These investments have added to the depth of the secondary and derivatives market and improved market sentiment in the primary market".

Rajwade said that the "Report, which recommend the banning of fresh inflows in the form of PNs, should be seen in the context of the Lahiri Committee, which has gone into the issue in more detail and its views should be respected".

In November 2005 a committee, appointed by the Ministry of Finance under the chairmanship of Dr. Ashok Lahiri, Chief Economic Advisor to the Government of India strongly suggested widening the scope of PNs.

Insisting on greater transparency would be more appropriate than calling for a ban. If the PNs are banned, fund flows into Indian Markets are likely to dry up.

Tax Benefits Schemes

This time, unlike the first report, the committee makes certain suggestions, which are eye-opener. The panel suggests that all non-resident should be treated on equal footing and special treatment given to non-resident Indians should be done away with. The committee feels that the review should take place since movement towards FCAC would imply that all non-residents are treated equally.

A recent study by IMF says that there are important collateral benefits to full convertibility in the form of better banks, stronger capital markets and more macro economic discipline.

In fact, India is only country in the world which has this hybrid category styled Non-Resident Indians (NRIs). It also makes a suggestion for the review of double taxation treaties, which favour some countries as source of investment. These two are really good suggestions as these are a costly source of finance.

Benefits and Flip side

The experts on the capital account convertibility have had divergent opinion about India. Some economists strongly vote for moving towards CAC while others argue against it. The proponents of CAC argue that now the time is ripe and it would be advisable for the country to move towards CAC (Table-3). The Assocham, an apex industry body, has called for immediate introduction of CAC on the back of strong economic fundamentals and buoyant economic condition.

Table-3

Divergent Opinions about CAC

Proponents	***Opponents***
1. India has been growing at 9% of GDP for three consecutive years.	❖ China has maintained a growth rate of 8-10% over a more than a decade without going for CAC. A Deputy Governor of the people's Bank of China ruled out CAC in that country.
2. India is attracting FDI around $6 billion every year	❖ China gets more than 25 per cent of total FDI flows to developing countries and around 10 per cent of total global FDI flows. India gets only 0.8% of total global FDI flows and less than 3% of total FDI flows to developing countries.
3. India's Forex reserves have touched about $189 (as on Feb 16, 2007) billion, which is much higher than recommended level of $22 billion (Tarapore-I). This level of reserves covers around 15 month's imports.	❖ The ratio of volatile capital flows to reserves has increased from 35.2 per cent in March 2004 to 43.2 per cent in March this year.
4. External debt is less than its Forex Reserve	❖ India's debt to GDP ratio is more than 90 per cent.
5. It helps to attract more inflows and it will give Indian entities greater access to global market	❖ Opportunities come with risk. Quality of India's ratings will matter considerably more when CAC is introduced. As India does not yet qualify for an investment grade rating, it has wide implications. It means that even best rated Indian companies can borrow the foreign fund at cheaper rate.

The Assocham said that "the strong economic fundamentals such as adequate forex reserves and growth in manufacturing and services is picking up faster, more than support and substantiate the argument that

The government must pay attention to develop the financial markets, provide autonomy to state-led banks and prepare them for Basel-II and reduce its unproductive expenditure, which will help in reducing fiscal deficit.

India should introduce CAC without any further delay".

Rajiv Malik, an economist with J.P.Morgan in Singapore, says; "overall the committee's phased approach to CAC appears to be cautious and incremental in nature, with measures being conditional on the government improving its finances, lowering inflation and implementing banking sector reforms.

Proponents argue that there are plethoras of benefits; it helps the Indian companies to access unhindered funds from abroad, make it much easier for foreign companies to invest in India, and it maximises the efficiency in the use of capital across the world. A recent study by IMF says that there are important collateral benefits to full convertibility in the form of better banks, stronger capital markets and more macro economic discipline.

Conclusion

The Tarapore committee report on FCAC encompasses good, bad and unnecessary recommendations. Though the report is too large, still it fails to address several issues. It does not answer questions as to what would happen to the time line for convertibility if the government fails to stick to the FRBM targets. The panel does not attempt any stress-testing for the liberalisation schemes suggested, particularly in connection with the two new suggestions; providing the same treatment to all non-resident and removing the differential status attached to NRIs, ban fund inflows under participatory notes and provide PNs holders exit route.

During the last three decades, several countries, both developing and developed have allowed their currencies to flow freely. In a study of sample covering 100 countries, developing and developed, undertaken by Prof. Dani Rodrik of Harward university in 1998, with reference to the period 1975-1989, found *"no evidence… that countries without capital controls are essentially uncorrelated with long term economic performance as measured by per capita GDP growth, investment (as a share of GDP), and inflation."*

Nobel Laureate Hayek opines in his book titled *The Road to serfdom* (1944) that controls on convertibility suppress equity, enterprise and economic growth.

It is widely perceived that convertibility can be a boon or a bane and a lot depends on the strength of the underlying economy and its institutions. I believe the India still not ready

Nobel Laureate Hayek opines in his book titled *The Road to serfdom* (1944) that controls on convertibility suppress equity, enterprise and economic growth.

for this game as a lot needs to be done on the fiscal and monetary fronts. The government must pay attention to develop the financial markets, provide autonomy to state-led banks and prepare them for Basel-II and reduce its unproductive expenditure, which will help in reducing fiscal deficit. ❐