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Report of the Committee on Capital Account Convertibility

Shri S S Tarapore, Chairman to the Committee on Capital Account Convertibility (CAC) today formally presented the Report of the Committee to Dr. C Rangarajan, Governor, Reserve Bank of India. While presenting the Report of the Committee, Shri Tarapore appreciated the valuable contribution made by each member of the Committee. The members of the Committee included Dr. Surjit S. Bhalla, Shri M. G. Bhide, Dr. Kirit Parikh and Shri A V Rajwade. Shri Tarapore mentioned that as part of its deliberations, the Committee had meetings with several associations/chambers of commerce and industry. Shri Tarapore also acknowledged the dedicated support rendered by the Secretariat to the Committee. Smt. Usha Thorat, Chief General Manager, Department of External Investments and Operations, RBI was the Secretary of the Commit tee who along with Shri C.R. Gopalasundaram, General Manager, Exchange Control Department and Shri Michael Debabrata Patra, Director, Department of Economic Analysis and Policy, RBI formed the Secretariat.

Dr. Rangarajan placed on record his appreciation for the excellent work done by the Committee on CAC and stated that it was indeed commendable that the Committee has abided by the timeframe despite the volume and complexity of the job. Dr. Rangarajan also stated that the report would be examined expeditiously. The Committee was appointed by the Reserve Bank on February 28, 1997 in pursuance of the commitment made by the Finance Minister Shri P. Chidambaram in his Budget for 1997-98. The Reserve Bank had at that time indicated that the Committee will complete its work by May 30, 1997. The report was submitted as scheduled on May 30, 1997.

Terms of reference

The terms of reference of the Committee were to: (i) review the international experience in relation to capital account convertibility (CAC) and to indicate the preconditions for CAC, (ii) recommend measures for achieving CAC, (iii) specify the sequence and time frame for such measures, and (iv) suggest domestic policy measures and changes in institutional framework.

The outline of the Report

The Report of the Committee is organised into five Chapters, supported by eleven Annexures. Chapter 1 sets out the background against the Committee was appointed and the broad approach of the Committee in the context of its terms of reference. The macro economic developments in the Indian economy leading up to the appointment of the Committee and issues relat ing to CAC, particularly the potential benefits of CAC,

are also addressed in this Chapter. Chapter 2 sketches out the international experience with CAC. Chapter 3 examines the preconditions/ signposts relevant for the institution of CAC in India. Chapter 4 presents the road map for CAC in India with specific focus on the timing and sequencing of measures necessary to usher in CAC. A summary of the Committee's recommendations is contained in Chapter 5.

Current status of convertibility

The Committee has, in its Report, noted that India had already adopted current account convertibility in August 1994 by formally accepting the obligations under Article VIII of the Articles of Agreement of the International Monetary Fund (IMF). Furthermore, CAC is already instituted for foreign investors, both direct and portfolio, non resident depositors and resident corporates contracting external commercial borrowings (ECB). Controls, however, continue to operate on the ability of resident individuals and corporates to send capital abroad as also on inflows and outflows of capital associated with banks and non bank financial entities.

International experience

A review of the international experience with CAC shows that, in general, liberalisation of the capital account induces large capital inflows which can cause real appreciation in the exchange rate and erode the effectiveness of domestic monetary policy. Furthermore, an open capital account imposes tremendous pressures on the financial system and brings weaknesses in the financial system into sharper focus. While it is necessary to recognise that these weaknesses could precipitate systemic hazards irrespective of whether or not CAC is introduced, the move to CAC would demand a strong discipline from the financial system and would warrant early rectification of infirmities in the system.

Indian context

Given the attainment of stable and sustainable growth in India and the progress achieved in entrenching structural reforms, the Committee has recommended that the time is now appropriate to initiate a move towards CAC in India. It has noted that over a period of time capital controls turn ineffective, costly and even distorting. Moreover, there are distinct benefits of CAC, such as, availability of a larger capital stock at international prices to supplement domestic resources, risk diversification, allocative efficiency and improvement in intermediation of financial resources, development of financial markets and a disciplining influence on macro economic policies. Accordingly, the Committee has recommended that alongside further measures to liberalise capital inflows, it is desirable to simultaneously liberalise controls on outflows as a means of contending with capital inflows. An early, albeit cautious beginning to allow capital outflows is desirable as the system is attuned to a totally rigid band on certain outflows. There is a need to develop confidence that some capital outflows, far from being destabilising, would be conducive to the overall efficiency of deployment of resources. Moreover, in the context of large capital inflows, CAC would relieve pressure on the exchange rate, the monetary aggregates and thereby enhance the effectiveness of domestic policies.

Timetable for CAC in India

Recognising that there are certain weaknesses in the system and that the entrenchment of preconditions can be achieved over a period of time the Committee has recommended a phased implementation of CAC over a three year period : Phase I

(1997-98), Phase II (1998-99) and Phase III (1999-2000). The implemen tation of measures contemplated for each phase should be based on a careful and continuous monitoring of certain preconditions/signposts and certain important attendant variables identified from the lessons of the international experience and the specifics of the Indian situation. The Committee viewed the preconditions/ signposts and the attendant variables as processes rather than one-time indicators. Depending on the assessment regarding the attainment of these milestones, the timing and sequencing of the measures of CAC could be accelerated or decelerated. Furthermore, the Committee has recommended that at the end of the three year phasing, stock taking of the progress in establishing preconditions/signposts as well as the impact of the measures already instituted should be undertaken. CAC is a continuous process and further measures could be undertaken thereafter in the light of the experience gained.

Preconditions/signposts

The Committee has recommended that fiscal consolidation, a mandated inflation target and strengthening of the financial system should be regarded as crucial preconditions\signposts for CAC in India.

Fiscal consolidation

There should be a reduction in the Centres Gross fiscal deficit to GDP ratio from a budgeted 4.5 per cent in 1997-98 to 4.0 per cent in 1998-99 and further to 3.5 per cent in 1999-2000 accompanied by a reduction in the States' deficit as also a reduction in the quasi fiscal deficit. Recognising that the practice of financing the amortisation of Government borrowings out of fresh borrowings is clearly unsustainable and would inevitably result in a crisis, the Committee has recommended introduction of a Consolidated Sinking Fund (CSF) as part of a more transparent fiscal system. The Committee has urged that any increase in the profit transfer from the RBI to the Government as well as the proceeds from disinvestment should be used entirely towards building up a CSF. Furthermore, there should be an early introduction of a system of fiscal transparency and accountability on the lines of the New Zealand Fiscal Responsibility Act. The Government should set up its own office of public debt. The RBI should totally eschew from participating in the primary issues of Government borrowing.

Mandated inflation rate

The mandated rate of inflation for the three year period should be an average of 3-5 per cent. There should be an early empowering of the RBI on the inflation mandate approved by Parliament and only Parliament should alter that mandate. Once the mandate is given, RBI should be given freedom to attain the target. There should be clear and transparent guidelines on the circumstances under which the mandate could be changed. Such a mandate would necessarily need to provide for greater independence for the RBI.

Strengthening of financial system

The Committee viewed the strengthening of the financial system as the single most important precondition to the move to CAC and therefore weaknesses in the financial sector need to be addressed early on in the process of CAC. Interest rates should be fully deregulated in 1997-98 and there should be no formal or informal interest rate controls. The average effective Cash Reserve Ratio (CRR, which was 9.3 per cent in April 1997) should be reduced to 8.0 per cent in 1997-98, 6.0 per cent in 1998-99 and

further to 3.0 per cent in 1999-2000. Furthermore, drastic measures should be taken to bring down gross Non-Performing Assets (NPAs) from the tentative estimate of 13.7 per cent of total advances in March 1997 to 12.0 per cent in 1997-98, 9.0 per cent in 1998-99 and 5.0 per cent in 1999-2000. Noting with concern that some of the weak banks are growing at rates faster than the system, the Committee recommended that weak banks should be converted into narrow banks, i.e., banks whose incremental resources are deployed only in investments in government securities; in extreme cases of weakness, restraints should be applied on liability growth.

Monitoring of attendant variable indicators

The Committee has also recommended that certain important macro economic indicators, i.e., the exchange rate, the balance of payments and the adequacy of reserves should be monitored while determining the appropriate timing and sequencing of CAC. In the conduct of exchange rate policy, the RBI should have a monitoring band of +/- 5 per cent around the neutral Real Effec tive Exchange Rate (REER) and ordinarily intervene as and when the REER is outside the band. The neutral REER could be changed as warranted by fundamentals but there should be transparency in the exchange rate policy i.e., the REER band should be declared, published contemporaneously and changes in neutral REER made public. As a broad rule of thumb, over the three year period, external sector policies should be designed to ensure a rising trend in the Current Receipts (CR) to GDP ratio from the present level of 15 per cent and the endeavour should be to reduce the debt service ratio from 25 to 20 per cent. The Current Account Deficit (CAD) to GDP ratio would need to be consistent with these parameters.

In the context of CAC, the Committee noted that since capital flows would have a more significant effect on the balance of payments, the conventional indicator of reserves in terms of import cover does not provide a good measure of the adequacy of reserves. The Committee has provided four alternative indicators to be used in the Indian context for evaluating the adequacy of reserves. While defining three of these alternative measures in terms of imports, debt service payments and volatile capital flows cover augmented for leads and lags, the Committee has recommended that to prevent an unbridled increase in currency without adequate backing of foreign exchange reserves, a minimum Net Foreign Assets (NFA) to currency ratio of 40 per cent should be stipulated by law in the RBI Act.

Preparing the financial system for CAC

In order to prepare the financial system for CAC the Committee has made several recommendations for bringing about a level playing field between various participants in the financial system, removing market segmentation, uniform treatment of resident and non-resident liabilities for purposes of reserve requirements, improving risk management systems in the financial system, introduction of more stringent capital adequacy standards and prudential standards, effective supervisory system and greater autonomy for banks and FIs.

Phased liberalisation of capital controls

The Committee's recommendations for a phased liberalisation of controls on capital outflows and inflows over the three year period which have been set out in detail in a tabular form in Chapter 4 of the Report, inter alia, include :

i. Indian Joint Ventures/Wholly Owned Subsidiaries (JVs/WOSs) should be allowed to invest up to US $ 50 million in ventures abroad at the level of the Authorised Dealers (ADs) in phase I with transparent and comprehensive guidelines set out by the RBI. The existing requirement of repatriation of the amount of investment by way of dividend, etc., within a period of 5 years may be removed. Furthermore, JVs/WOSs could be allowed to be set up by any party and not be restricted to only exporters/exchange earners.
ii. Exporters/exchange earners may be allowed 100 per cent retention of earnings in Exchange Earners Foreign Currency (EEFC) accounts with complete flexibility in operation of these accounts including cheque writing facility in Phase I.
iii. Individual residents may be allowed to invest in assets in financial market abroad up to $ 25,000 in Phase I with progres sive increase to US $ 50,000 in Phase II and US $ 100,000 in Phase III. Similar limits may be allowed for non-residents out of their non-repatriable assets in India.
iv. SEBI registered Indian investors may be allowed to set funds for investments abroad subject to overall limits of $ 500 million in Phase I, $ 1 billion in Phase II and $ 2 billion in Phase III.
v. Banks may be allowed much more liberal limits in regard to borrowings from abroad and deployment of funds outside India. Borrowings (short and long term) may be subject to an overall limit of 50 per cent of unimpaired Tier I capital in Phase I, 75 per cent in Phase II and 100 per cent in Phase III with a sub-limit for short term borrowing. In case of deployment of funds abroad, the requirement of section 25 of Banking Regulation Act and the prudential norms for open position and gap limits would apply.
vi. Foreign direct and portfolio investment and disinvestment should be governed by comprehensive and transparent guidelines, and prior RBI approval at various stages may be dispensed with subject to reporting by ADs. All non-residents may be treated on par for purposes of such investments.
vii. In order to develop and enable the integration of forex, money and securities market, all participants in the spot market should be permitted to operate in the forward markets; FIIs, non-residents and non-resident banks may be allowed forward cover to the extent of their assets in India; all India Financial Institutions (FIs) fulfilling requisite criteria should be allowed to become full-fledged ADs; currency futures may be intro duced with screen based trading and efficient settlement systems; participation in money markets may be widened, market segmentation removed and interest rates deregulated; the RBI should withdraw from the primary market in Government securities; the role of primary and satellite dealers should be increased; fiscal incentives should be provided for individuals investing in Government securities; the Government should set up its own office of public debt.
viii. There is a strong case for liberalising the overall policy regime on gold; Banks and FIs fulfilling well defined criteria may be allowed to participate in gold markets in India and abroad and deal in gold products.

FEMA

The Committee has also stated that the timing and sequencing of capital account convertibility would be greatly facilitated by the proposed changes in the legislative framework governing foreign exchange transactions as envisaged in the Foreign Exchange Management Act(FEMA).

(Alpana Killawala)
Deputy General Manager

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