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List of Abbreviations

ADR	American Depository Receipt
AD	Authorised Dealer
ALM	Asset Liability Management
BOP	Balance of Payments
BR ACT	Banking Regulation-Act
CAC	Capital Account Convertibility
CAD	Current Account Deficit
CD	Certificate of Deposit
CPI	Consumer Price Index
CR	Current Receipts
CRR	Cash Reserve Ratio
CSF	Consolidated Sinking Fund
DSR	Debt Service Ratio
DVP	Delivery Versus Payment
ECB	External Commercial Borrowings
EEFC Account	Exchange Earners' Foreign Currency Account
EOU	Export Oriented Unit

EPZ	Export Processing Zone
EU	European Union
EXIM Bank	Export Import Bank of India
FCCB	Foreign Currency Convertible Bond
FCNR(B) Account	Foreign Currency Non Resident (Banks) Account
FDI	Foreign Direct Investment
FEDAI	Foreign Exchange Dealers' Association of India
FERA	Foreign Exchange Regulation Act
FI	Financial Institution
FII	Foreign Institutional Investor
FIPB	Foreign Investment Promotion Board
FRN	Floating Rate Note
GDP	Gross Domestic Product
GDR	Global Depository Receipt
GFD	Gross Fiscal Deficit
GOI	Government of India
IMF	International Monetary Fund
JV	Joint Venture
LIBOR	London Inter-Bank Offer Rate
MF	Mutual Fund
MMMF	Money Market Mutual Fund
NBFC	Non Banking Financial Company
NCD	Non Convertible Debenture
NFA	Net Foreign Exchange Assets
NPA	Non Performing Assets
NRE Account	Non Resident External Account
NRI	Non Resident Indian
NRNRRD	Non Resident Non Repatriable Rupee Deposits
NRO Account	Non Resident Ordinary Account
OCB	Overseas Corporate Body
OECD	Organisation for Economic Co-operation and Development
OPD	Office of Public Debt
PD	Primary Dealer
PLR	Prime Lending Rate
REER	Real Effective Exchange Rate
ROA	Return On Assets
SD	Satellite Dealer
SDR	Special Drawing Right
SEBI	Securities And Exchange Board Of India
SIA	Secretariat of Industrial Approvals
WOS	Wholly Owned Subsidiary
WTO	World Trade Organisation

Chapter 1

Introduction

The Union Finance Minister, Shri P. Chidambaram, in his Budget Speech for 1997-98 had indicated that the regulations governing foreign exchange transactions need to be modernised and replaced by a new law consistent with the objective of progressively liberalising capital account transactions. To quote :

> " I also believe that the time has come for preparatory work towards capital account convertibility. This is a cherished goal. It is also a matter of great sensitivity. Hence, I shall not make any commitment. For the present, I am asking RBI to appoint a group of experts to lay out the road map towards capital account convertibility, prescribe the economic parameters which have to be achieved at each milestone and work out a detailed time table for achieving the goal. I believe the appointment of such a group will send a powerful signal to the world about our determination to join the ranks of frontline nations". (Part-A, Paragraph 41).

Dr. C. Rangarajan, Governor, Reserve Bank of India, on February 28, 1997 appointed a Committee on Capital Account Convertibility consisting of the following:

1. Shri S.S. Tarapore, Chairman
2. Dr. SurJit S. Bhalla, Member
3. Shri M.G. Bhide, Member
4. Dr. Kirit Parikh, Member
5. Shri AN. Rajwade, Member

Smt. Usha Thorat, Chief General Manager, Department of External Investments and Operations, Reserve Bank of India was the Secretary of the Committee, who together with Shri C.R. Gopalasundaram, General Manager, Exchange Control Department and Shri Michael Debabrata Patra, Director, Department of Economic Analysis and Policy formed the Secretariat.

1.2 The terms of reference of the Committee were :

(i) To review the international experience in relation to Capital Account Convertibility and to indicate the preconditions for introduction of full Capital Account Convertibility.

(ii) To recommend the measures that should be taken to achieve full Capital Account Convertibility.

(iii) To specify the sequence and time frame in which such measures are to be taken.

(iv) To suggest domestic policy measures and changes in institutional framework with the specified sequencing and

(v) To make such other recommendations as the Committee may deem relevant to the subject.

The Committee was required to submit its report by May 30, 1997. The Memorandum appointing the Committee is at Annexure I.

1.3 Setting out the background which preceded the decision to set up the Committee, Governor Dr. C. Rangarajan while addressing the Committee recalled that India had already undertaken a move to current account convertibility and in fact there was a formal acceptance by India of the obligations under Article VIII of the IMF in August 1994. The IMF does not have a clear mandate on capital account convertibility though in the recent period there has been considerable discussion on the matter in international fora. In this context, in a recent address at the IMF, Dr. Rangarajan noted :

> "There is a proposal to amend the Articles of Agreement to incorporate capital account convertibility as one of the obligations of the Fund membership. Mr Chairman, as you know, the Government of India has already announced certain steps towards capital account convertibility. Thus, purely from the Indian perspective, we welcome the move towards capital account convertibility. However, several staff studies have shown that there are important preconditions for introducing capital account convertibility. Given the differences among countries with regard to progress made towards structural reform and stabilisation, it may be unwise to put all the members in a strait-jacket where they lose their independence to take corrective action in times of crisis. This is particularly so when the ability of the Fund to come to the rescue of its members in case of a balance of payments crisis is somewhat limited." (Statement at the Forty-Eighth Meeting of the Interim Committee of the IMF, Washington, April 28, 1997, Paragraph 9).

1.4 Outlining the tasks of the Committee on Capital Account Convertibility, Governor urged that a working definition of Capital Account Convertibility (CAC) could be evolved. Governor explained that in India, CAC already exists for non residents and while the Committee could look into the question of facilitating inflows from non residents, the Committee would also need to specifically look into the feasibility of allowing capital outflows by residents. The Governor asked the Committee to lay down explicit goals and the sequence of measures for increased capital account liberalisation and to enlist the specific

domestic policy measures which are necessary to facilitate such liberalisation of capital controls. Furthermore, in view of the fact that the response of markets to volatile flows depends upon the width and depth of the markets and the hedging instruments that are available, Governor indicated that the measures to develop domestic money, securities and forex markets in an integrated manner should be examined. He stressed that the preconditions for capital account convertibility should be clearly laid out. Governor underscored the importance of crafting and sequencing these measures carefully so as to avoid any back tracking in future.

1.5 The Committee had discussions with Deputy Governors Shri RV. Gupta and Dr. Y.V. Reddy, Shri M.S.Ahluwalia, Finance Secretary and Dr. Shankar N. Acharya, Chief Economic Adviser, Ministry of Finance, Government of India. A list of organisations with whom the Committee had discussions or from whom the Committee received material as also a list of persons who provided help to the Committee is set out in Annexure II.

1.6 The Committee would like to place on record that the contribution to the work of the Committee made by the Secretary Smt. Usha Thorat, Shri C.R. Gopalasundaram. and Shri Michael Debabrata Patra was nonpareil. These three officials of the Reserve Bank of India brought to bear their intimate knowledge of the issues relating to the Committee's work and they participated fully in all the deliberations of the Committee and provided exemplary support all along the line in the preparation of the Committee's Report. The Committee also wishes to record its appreciation of the unstinted support provided by the Department of External Investments and Operations, the Exchange Control Department and the Department of Economic Analysis and Policy.

Working Definition of Capital Account Convertibility

1.7 While there is no formal definition of CAC, the Committee recommends a pragmatic working definition for purposes of its Report. CAC refers to the freedom to convert local financial assets into foreign financial assets and vice versa at market determined rates of exchange. 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.

The Backdrop

1.8 In 1990-91, the Indian economy faced an unprecedented external payments crisis. The symptoms of the crisis were evident in the second half of the eighties in the form of unsustainable macro economic imbalances. Pressures generated by the monetisation of large and persistent fiscal deficits and exacerbated by a persistently overvalued exchange rate, high tariffs and the inefficiencies generated by the inward looking industrial policies spilled over onto the balance of payments. Adverse global developments in 1990-91 i.e., the slowdown in world trade following recession in the industrial world, the disruption in Eastern Europe, the Gulf crisis of August 1990, the drying up of external financing partly due to a conscious attempt of international banks to reduce exposures in order to meet capital adequacy norms and partly reflecting an erosion in the country's international confidence aggravated the crisis. The current account deficit soared to a level of 3.2 per cent of GDP which, in 1990-91, was unsustainable. With the collapse of the capital account due to the drying up of capital flows and withdrawals of deposits by non resident Indians, there was a massive haemorrhage of the foreign exchange reserves. Despite drawals of US $ 2.5 billion from the IMF under the Reserve Tranche, the first Credit Tranche under the Standby arrangement and under the Contingency and Compensatory Financing Facility, the foreign currency assets dipped from US $ 3.4 billion at the end of March 1.990 to a low of US $ 975 million on July 12, 1991, equivalent to barely a week's imports.

1.9 The response to the crisis was in the form of the simultaneous implementation of measures of stabilisation and structural reform. Stabilisation measures consisted of import containment, raising of loans against the pledge of gold, launching of the Remittances in Foreign Exchange (Immunities) Scheme to encourage one time transfers and the India Development Bonds to recoup the loss of non resident deposits, negotiation of facilities with the IMF and contracting fast disbursing loans from the World Bank and other multilateral/bilateral donors. Furthermore, in order to induce price switching corrections in the balance of payments as also to rectify the overvaluation of the rupee and restore external competitiveness, the exchange rate was adjusted downwards in two stages on July I and July 3, 1991 which amounted to a cumulative downward adjustment of about 18 per cent.

1.10 Structural reforms, centred around a progressive liberalisation of the trade and payments regime, provided the underpinning for a reorientation and opening up of the economy. The downward adjustment of the exchange rate of the rupee in July 1991 set the stage for liberalisation of trade, industrial and foreign investment policies. A major rationalisation of the trade policy was introduced under which export subsidies, licences and other quantitative restrictions were abolished and the EXIM scrip, which linked freely tradeable import entitlements to export performance, was introduced. Simultaneously, a progressive reduction and rationalisation of tariffs was undertaken. The structure of tariff rates was drastically simplified and their dispersion was substantially reduced. Significantly, a process of bringing down the height of the tariff wall was set in motion by a progressive reduction of the peak rate of Custom duty from 150 per cent in 1990-91 to 40 per cent in the Union Budget for 1997-98. Industrial policy changes were sweeping, involving the virtual abolition of industrial licensing and the concept of monopoly, shortening of the list of industries reserved for the public sector and the infusion of a strong element of competition. Foreign investment policy underwent a radical change, underscoring the priority attached to foreign direct investment flows in the emerging scenario. The central plank of the new tegime was a system of automatic approval of proposals for foreign equity participation up to 51 per cent in high priority industries. Proposals for higher foreign equity participation were also considered subject to the approval of the Secretariat of Industrial Approvals (SIA)/ Foreign Investment Promotion Board (FIPB), the latter specially set up to invite, negotiate and facilitate substantial investment by non resident corporations involving high technology transfer. Free repatriability of disinvestment proceeds, profit and dividend was allowed and the rate of withholding tax was aligned with international levels. Restrictions imposed on the operations of companies with significant foreign equity holdings were removed through amendments to the Foreign Exchange Regulation Act (FERA), thereby placing them on par with Indian companies. As a result of these sweeping policy changes, net inflows of foreign direct investment which averaged US $ 100 million per annum up to 1990 surged to an average of US $ 2 billion in recent years. A programme of fiscal correction and consolidation was also launched to reduce the gross fiscal deficit to sustainable levels, to simplify and rationalise the taxation system and to widen the tax base. Consequent upon the

submission of the report of the Committee on the Financial System (Chairman: Shri M. Narasimham), substantial reductions were effected in reserve requirements, interest rate reforms were initiated and prudential regulations were introduced. A strengthened system of supervision was put in place with the establishment of the Board for Financial Supervision.

1.11 In view of the fact that the EXIM scrip introduced earlier partook the character of a licence and was limited in scope, measured adjustments in the exchange rate regime marked the move from the 'basket' arrangement to a transitional dual rate system in March 1992 which insulated essential payments from exchange rate fluctuations while simultaneously enabling the market to determine the exchange rate for a host of external transactions. The dual exchange rate system was accompanied by ongoing trade liberalisation including the liberalisation of baggage rules to allow non resident Indians and Indians returning from abroad to bring in gold and silver at concessional rates of duty, foreign investment policy changes and external debt management strategies. The transitional system gave way in March 1993 to a unified market based exchange rate regime. Unification of the exchange rates was supported by progressive liberalisation of the trade and payments regime. Convertibility for foreign direct investors was extended to portfolio investments by foreign institutional investors in Indian stock exchanges. Inflows of portfolio investment which were negligible up to 1992 have risen to an annual average level of US $ 2 billion in the period 1994-97. Furthermore, Indian corporates were allowed access to overseas financial markets in the form of Global Depository Receipts (GDRs) and Foreign Currency Convertible Bonds (FCCB s). Net -inflows against these instruments amounted to an annual average ofabout US $ 2 billion during 1993-1995. New deposit schemes for non resident Indians i.e. the Foreign Currency Non Resident (Banks) [FCNR(B)] and the Non Resident Non Repatriable Rupee Deposits [NRNRRD] schemes were launched with attractive features and schemes which carried exchange guarantees were phased out. At the same time, access to external commercial borrowings was made flexible.

1.12 A cumulative process of wide ranging financial sector reforms was also launched to provide the financial system with the resilience and the capability to intermediate in the context of an economy integrating with the rest of the world. Prudential norms relating to capital adequacy, income recognition and provisioning were combined with capital injections and asset recovery mechanisms to strengthen the banking system. There was a progressive deregulation of interest rates and the preemptions embodied in reserve requirements were reduced. At the same time, competitive efficiency was infused through freer entry. The ongoing programme of structural reforms was supported by the stance of monetary policy under which the commitment to hold down inflation was reinforced through adherence to monetary targets and explicit inflation goals. Monetary policy underwent strategic changes to accommodate the process of financial sector reforms. Furthermore, coordination between monetary and fiscal policy was enhanced through a commitment to phase out automatic monetisation of fiscal deficits.

1.13 Current account convertibility for both inflows and outflows by residents and non residents was established with the acceptance of the obligations under Article VIII of the IMF's Articles of Agreement in August 1994. Controls, however, continue to operate on the ability of resident individuals and corporates to send capital abroad as also on both inflows and outflows of capital associated with banks and non bank financial entities.

1.14 Country experience shows that in phases of transition, in the wake of the institution of structural reforms, countries are vulnerable to volatile capital flows which can offset domestic monetary policy and destabilise real and nominal exchange rates, interest rates and output. In India, in the face of surges in capital inflows since the second half of 1993-94, the foreign exchange reserves were built up and sterilisation, reserve requirements and capital controls were used to mitigate the potentially destabilising effects of capital inflows. Proceeds from GDR issues were required to be held abroad, approvals for commercial borrowings were rigidly linked to import finance, reserve requirements were imposed on non resident deposits and banking capital remained restricted by very tight open position and borrowing limits.

1.15 Restoration of the momentum of growth was accorded the highest priority in the agenda of reform. Given the external crisis of 1990-91, recourse to external resources to support the

resumption of growth had to be marked by caution with current account deficits contained within prudent limits and strategies were put in place to bring down the burden of external debt and reduce debt servicing to sustainable levels. Over the first half of the nineties, the current account deficit came down sharply from 3.2 per cent of GDP in 1990-91 and averaged around 1 per cent over the period 1992-93 to 1996-97. The ratio of external debt to GDP moderated from 30 per cent in 1991 to 29 per cent in 1995-96 and the debt service ratio fell significantly from over 35 per cent in 1990-91 to around 25 per cent in 1995-96.

1.16 Given the need for prudent external sector management, the recovery of growth had to be supported by domestic mobilisation of resources. In retrospect, the acceleration of real growth from 0.8 per cent in 1991-92 to over 7 per cent, on an average, over the three years 1994-95 to 1996-97 represents one of the fastest recoveries from a macro economic crisis. Furthermore, gross domestic saving which had averaged around 21 per cent on the eve of reforms rose to 25.6 per cent in 1995-96.

1.17 The recovery of growth has occurred in an environment of stability. The gross fiscal deficit of the Centre has declined from 8.3 per cent of GDP in 1990-91 to 5 per cent in 1996-97. Reform of the tax system has been a key element of the reform process. Tax reforms have helped in restructuring the tax system by increasing the role of direct taxes and reducing that of Custom duties. An important achievement has been the reduction in the point-to-point inflation from a peak of over 16 per cent in September 1991 to slightly below 6.0 per cent in early May 1997. The emphasis on price stability as an important objective of monetary policy and the supportive role of fiscal policy in phasing out automatic monetisation are policy efforts in the fight against inflation. Alongside the containment of current account deficits in the balance of payments at around 1 per cent of GDP, there has been an unprecedented build up in foreign exchange reserves (comprising foreign currency assets, gold and SDRs) which at US $ 26.4 billion at the end of March 1997 stood cover for over seven.months of imports.

Issues Relating to Capital Account Convertibility

1.18 With the strong resumption of stable and sustainable growth and the progress achieved in entrenching the process of structural reform, it is opportune now to address various issues relating to CAC.

1.19 Capital controls can be useful in insulating the economy from volatile capital flows during transitional periods and in providing authorities time to pursue discretionary domestic policies to strengthen initial conditions. Over longer periods, however, the international experience shows that capital controls turn progressively ineffective, costly and even distortive. Indeed, the massive scale and speed of global capital movements facilitated by the cross-border integration of financial markets has rendered capital controls porous in the presence of opportunities for arbitrage. This brings to the fore the issue of the explicit and implicit costs of maintaining capital controls even when they have become ineffective. The existence of exchange controls in several countries has provided the impetus for the growth of grey segments in the economy. As new channels continuously emerge for moving funds abroad, the costs of enforcing capital controls rise. Progressively ineffective controls with inappropriate macro economic policies sustain each other in a vicious circle. The implicit costs of capital controls are embodied in the distortions that are created, the inefficiencies in the domestic financial system, restrictions on competitive efficiency and risk diversification and vulnerability to shocks. By creating distortions in resource allocation and consequent errors in decisions, both by the market and at the level of the authorities, ineffective capital controls compound the costs of inefficiency.

1.20 In India, the porosity of capital controls has been accentuated after the move to current account convertibility. With the progressive liberalisation of current transactions, the balance of payments has recorded realisation of exports proceeds far in excess of the value of physical shipments as well as a surge in private unrequited transfers. At the same time, import payments have been substantially higher than the value of physical landings of goods at Customs frontiers. Thus, there is reason to believe that capital movements could have adopted the guise of trade transactions and the cross border movement of gold. In this context, it is necessary to recognise that CAC is a natural corollary of current account

convertibility.

1.21 Convertibility for capital of non resident investment has all along been a basic tenet of Indian foreign investment policy albeit subject to administrative procedures. Reforms instituted since July 1991 imparted relatively more transparent convertibility for foreign direct and portfolio investment.

1.22 In the Indian context, the time is now apposite to undertake an assessment of the benefits of a more open capital account. There are the traditional benefits of capital account liberalisation: the availability of a larger capital stock to supplement domestic resources and thereby higher growth, reduction in the cost of capital and improved access to international financial markets.

1.23 More recent arguments in favour of CAC emphasise the gains from trade in international financial assets as CAC allows residents to hold an internationally diversified portfolio which reduces the vulnerability of income streams and wealth to domestic shocks. This also enables lower funding costs for borrowers and allows savers prospects of higher yields.

1.24 An associated gain from CAC is the dynamic gains from financial integration. Competition is intensified among financial intermediaries and as margins are reduced there is more efficient intermediation. The quality of financial assets improves as a result of greater liquidity and deeper markets. Freer capital flows enable the realisation of efficiency gains created by specialisation in financial services. Allocative efficiency improves as a result and this can stimulate innovation and improve productivity.

1.25 CAC enables an alignment of domestic financial prices with international levels and this provides the impetus for domestic tax regimes to rationalise and converge to international tax structures to avoid inducements for domestic agents towards evasion and capital flight.

1.26 CAC has a disciplining influence on domestic policies. While CAC does not eliminate the effectiveness of monetary policy, it does not permit monetary policy to take on an excessive burden of the adjustment. Imperfect asset substitutability continues to allow monetary policy to operate on interest differentials brought about by risk premia and targeting the interest rate enhances the effectiveness of monetary policy. Moreover, the conduct of monetary policy is strengthened by the pursuit of a realistic and appropriate exchange rate policy which reflects fundamentals and is flexible enough to equilibrate the balance of payments. Furthermore, CAC enhances the effectiveness of fiscal policy by (i) reducing real interest rates applicable. to public sector borrowing, (ii) bringing about an optimal combination of taxes through a reduction of the inflation tax and in the rates of other taxes to international levels with beneficial effects for tax revenues and, (iii) reducine, crowding out effects in the access to funds. In fact, prudent fiscal policy can play a major role in channelising capital flows into productive investments. An unsatisfactory fiscal policy can, however, erode credibility and create conditions for capital flight. In the ultimate analysis, consistent and coordinated macro economic policies can contribute substantially towards reaping the benefits of CAC.

1.27 Financial sector reforms introduced in the post 1991 period brought into the open several deep seated and endemic weaknesses which have been in the Indian financial system for a long time. An open capital account could bring these weaknesses into sharper focus; however, it is necessary to recognise that these weaknesses precipitate systemic hazards irrespective of whether or not CAC is introduced. While the problems in the financial system are being addressed through ongoing reforms, the introduction of CAC would require even more proactive policy action as CAC would demand a strong discipline from the financial system and would warrant early rectification of infirmities in the system. CAC would usher in a variety of derivatives and risk management products. Simultaneously, there would be widening and deepening of markets and these developments would enable the financial system to provide for the spreading and distribution of risks and allow economic agents to identify and unbundle specific risks in their portfolio and manage them individually using a wide variety of hedging products.

Outline of the Report

1.28 Against the backdrop of progress of overall reforms and the achievement of a sustainable rate of growth in a stable economic environment, this Report attempts to set out the approach to CAC in India. 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 Chaptser 5.

CHAPTER 2

International Experience With Capital Account Convertibility

Introduction

Over the past two decades several countries have undertaken measures to open the capital account of their balance of payments as part of a broader process of financial liberalisation and international economic integration. For most industrial countries, the evolution of CAC was relatively slow over the sixties and seventies. The process of liberalisation of the capital account gathered momentum in the eighties and early nineties contemporaneous with the globalisation of financial markets. The move to CAC in the industrial countries was facilitated by the introduction of the Code of Liberalisation of Capital Movements by the OECD and the Second Directive of Liberalisation of Capital Movements by the European Union. As of June 1995 all industrial countries had eliminated exchange controls on both capital inflows and outflows. For developing countries the evolution of CAC has been varied. Prior to the eighties a few of these countries began to liberalise the capital account, drawing strength from a healthy balance of payments position. In recent years, however, a number of developing countries have moved fairly rapidly to institute CAC despite initially weak macro economic conditions. While a majority of developing countries still retain capital controls *de jure, de facto* controls are less prevalent. As at the end of December, 1996 the IMF classified 57 countries as not having restrictions on payments for capital transactions (Annexure III.1). The IMF has conducted a survey of capital controls in 155 developing countries (Annexure III.2).

2.2 The Chapter draws heavily upon an extensive survey of the literature on various issues relating to CAC. The Committee examined theoretical research on conceptual issues in CAC as well as empirical and stylised assessments of country- specific experiences. The Committee also relied on reviews of the evolution of CAC in industrial and developing countries documented by international organisations as also information provided by central banks of countries covered in the Committee's survey. The Committee undertook a detailed study of the experiences of ten countries in instituting CAC. Of these, Argentina, Indonesia, Malaysia and New Zealand are classified by the IMF as not having restrictions on payments for capital transactions. The other six countries chosen by the Committee viz., Chile, Korea, Mexico, Thailand, the Philippines and South Africa have had varied experiences in pacing the liberalisation of capital transactions. The Committee felt that the on-going experience of these ten countries would be of relevance while attempting to chalk out a programme for India. This Chapter encapsulates the lessons emerging from the country experiences with CAC. Beginning, with the approach of international organisations to CAC, the Chapter examines the initial macro economic conditions in the selected countries at the time of the move to CAC. This is followed by an assessment of the preconditions for CAC emerging from the country experiences such as fiscal consolidation, liberalisation and reform of the financial system including the experience of banking crises, inflation control, exchange rate policy, balance of payments and the adequacy of reserves. Issues arising out of the timing and sequencing of CAC in the selected countries are then examined. An evaluation of the developments following liberalisation of the capital account is attempted and in the final section, the lessons emerging from the international experience are drawn.

The Approach of International Organisations to CAC

2.3 A number of international organisations have developed a framework for the liberalisation of capital transactions. While the Organisation for Economic Co-operation and

Development (OECD) Codes of Liberalisation of Capital Movements and the European Union (EU) Directives have provided momentum to the process of instituting CAC in industrial countries, the IMF and regional organisations have also addressed CAC in the context of developing countries. A new impetus for liberalising capital accounts is expected to emerge from the World Trade Organisation (WTO) through agreements on trade in financial services and associated capital movements.

IMF

2.4 Until recently the IMF had not considered CAC in a comprehensive way but rather in the context of surveillance, the use of Fund resources and technical assistance. While it has recognised the freedom for countries to impose or maintain capital controls for balance of payments reasons and exchange rate stability, the IMF has welcomed steps to liberalise capital transactions where this was considered to be a crucial element of broader structural reforms. In the recent period, the IMF has taken a keen interest in issues relating to CAC in the context of the progressive integration of the world's capital markets. For industrial countries, the IMF has welcomed initiatives to achieve the OECD and EU Codes. For developing, countries, the IMF has adopted a case by case approach. While it has generally supported a gradual process with concerns expressed about the appropriateness of the large capital inflows which were not in relation to strong fundamentals, it has encouraged an acceleration of this process in some cases. Furthermore, the IMF has underscored the crucial importance of prudential regulations and supervision in the context of strengthening the intermediation by the financial system in the face of freer capital flows. In general, the IMF's treatment of CAC has been selective. It has generally eschewed urging rapid liberalisation but has encouraged some countries to liberalise capital restrictions (Central and Eastern Europe). Furthermore, there has been a general discouragement of the use or reimposition of capital controls, though, unlike under current account convertibility where reimposition of controls is not permitted, the IMF recognises the need for temporary reimposition of capital controls if the emerging situation so warrants.

2.5 While the surveillance mandate given to the IMF under Article IV of the Articles of Agreement enjoins the IMF to take into account the introduction or modification of restrictions/incentives relating to capital flows, it has not explicitly made recommendations or set performance criteria for CAC. Moreover, Article VI of the Articles of Agreements allows members the right to maintain capital controls. In the recent period, the IMF has been considering a proposal to amend the Articles of Agreement to incorporate capital account convertibility as one of the obligations of Fund membership. At the meeting of the Interim Committee of the Board of Governors of the IMF on April 28, 1997 it was agreed that the IMF's Articles should be amended to make the promotion of capital account liberalisation a specific purpose of the IMF and to give the IMF appropriate jurisdiction over capital movements; the scope of such jurisdiction would need to be carefully defined and sufficient flexibility should be allowed through transitional provisions and approval policies. The Interim Committee asked the Executive Board to continue its work in this area, with a view to making specific recommendations on key elements of an amendment by the time of the Committee's next meeting.

OECD

2.6 The OECD has adopted a non-compulsory approach towards capital account liberalisation, based on the uniformity of treatment under different national rules. The Code of Liberalisation of Capital Movements first adopted in December 1961 sets out the general aim that "members shall progressively abolish between one another, ... restrictions on movements of capital to the extent necessary for effective economic cooperation" (Article I a). Liberalisation refers to the abolition of official restrictions on the conclusion or execution of both transactions and transfers. The obligation to liberalise goes beyond restrictions on foreign exchange because the underlyinc, transactions should not be frustrated by legal or administrative regulations.

2.7 The OECD Codes have a legal status and are binding on all members. The Codes have been amended four times. As a result of the revision in 1989, the Codes now apply to all capital movements. They provide for transitional arrangements for retaining controls if a

member's economic and financial situation does not justify liberalisation and if there are adverse developments in the balance of payments.

EU Directives

2.8 The EU assigned low priority to the liberalisation of capital movements. Capital controls were to be eliminated only to the extent necessary to ensure proper functioning of the Common Market. As a result, there was no commitment to liberalise capital movements. By the early eighties, only five of the member countries had abolished exchange controls on capital movements. Over the eighties, emphasis on liberalising capital movements gained momentum in the context of financial integration within the EU. These efforts culminated in the ratification of the Single European Act in 1987. The Act specifically required all restrictions on capital movements be removed and explicitly recognised full liberalisation as a necessary condition for creation of the Common Market.

2.9 Three broad categories of capital movement have been identified : (i) capital operations including commercial credits, direct investments and other capital, (ii) operations in financial market securities and (iii) operations in money market instruments. Capital transactions have been ranked itito four Lists : List A and B contain operations to be unconditionally liberalised , the latter not necessarily at the official exchange rate; List C contains operations to be liberalised conditionally with a possibility of reintroduction of restrictions under certain conditions; List D contains operations in which no undertaking regarding liberalisation was made.

2.10 Liberalisation of capital movements in the EU has proceeded in two stages. In the first stage liberalisation of those capital transactions were undertaken which were most directly necessary for proper functioning of the Common Market. Transitional periods for compliance were allowed to some countries for a variety of reasons including adverse balance of payments positions, high external debt and less developed financial systems. A safeguard clause has been provided that permits reintroduction of controls if capital movements seriously endanger the member's exchange rate and monetary policy. The protective measures can be applied for up to six months.

WTO

2.11 The WTO was established in 1995 to provide a common institutional framework for conduct of trade relations among its members. Although the primary objective of the WTO is to ensure freedom to trade goods and services, the obligations under the General Agreement on Trade and Services proscribe certain restrictions on capital transactions which are associated with specific commitments intended to liberalise trade in services.

Initial Conditions at the Time of Move Towards CAC

2.12 In the assessment of the initial conditions prevalent in various countries on the eve of the move towards CAC, the Committee studied the experience of ten selected countries (hereafter referred to as the selected countries). These country experiences reveal wide variations in the macro economic conditions, the strength of the balance of payments and the progress of overall financial liberalisation and as such, any generalisation is difficult. Nevertheless, for purposes of presentation, the selected countries are grouped into two categories, namely, those which are considered to have instituted CAC by the IMF's classification (Argentina, Indonesia, Malaysia, New Zealand) and those which have made considerable progress in liberalising capital transactions (Chile, Mexico, the Philippines, South Africa, Korea and Thailand). Macro economic indicators for the selected countries for the period 1990-95 are set out in Annexures III.3 and III.4.

2.13 A common feature of the countries drawn from the IMF's classification is that the run up to CAC was set against the backdrop of inward looking economies pursuing import substitution and extensive government intervention.. High levels of tariffs and proliferation of non-tariff barriers provided protection to domestic industry and allowed inefficiencies to take root. Financial repression was widespread. Furthermore, with the exception of Argentina and Malaysia, countries in this group undertook CAC as part of an adjustment

to crises in their economies involving reversal of growth, balance of payments difficulties and rise in external indebtedness.

2.14 At one end of the spectrum is Malaysia where strong initial conditions, embodied in high rates of growth, a relatively deep financial structure and a strong fiscal position were reversed in 1985 due to a sharp decline in exports and a collapse in asset prices which adversely affected the portfolios of the financial institutions. In the hostile investment climate which ensued, real GDP declined by 1 per cent, the current account deficit was at 3 per cent of GDP and external debt rose to 65 per cent of GDP. The crisis exposed deep seated weaknesses in the financial system. A policy package including liberalisation of capital transactions in 1985-86 brought about a recovery in 1987.

2.15 In Argentina, CAC occurred in two phases i.e., in 1976-81 and in 1989-91. The process of CAC was interrupted by the reimposition of capital controls following real exchange rate appreciation, balance of payments deterioration, explosion in the external debt and capital flight. The first phase of CAC was undertaken though the economy was in severe macro economic disequilibrium with acute foreign exchange shortage, negative net foreign exchange reserves and hyper-inflation. The approach to the second phase of CAC starting in 1989 centred on fiscal discipline, inflation control, strengthening of the balance of payments embodied in a surplus in the current account and the build up of reserves; the final move to CAC was rapid with the setting up of the Currency Board and the Law of Convertibility in 1991.

2.16 New Zealand presents another shade of the spectrum where weak initial conditions were sought to be addressed by a rapid move to CAC. Prior to 1984, New Zealand was one of the slowest growing economies in the OECD with real GDP growth averaging less than 3 per cent. The inflation rate rose from 3 per cent in the mid sixties to an average of 14 per cent during 1975-84. Balance of payments difficulties had become chronic and a substantial accumulation of official debt had occurred prior to 1984. The oil shocks together with expansionary financial policies undermined macro economic stability. A combination of unsatisfactory fiscal and monetary management, a pegged exchange rate, persistent expectations of devaluations and frozen interest rates culminated in a severe foreign exchange crisis in 1984. The policy response was rapid and extensive including a large devaluation, removal of interest rate controls, price freeze and a swift process of abolition of exchange control. Policies were designed around an explicit inflation target under a legislated mandate and strong fiscal consolidation.

2.17 Indonesia's approach to CAC was unique in the sense that despite weak initial conditions it established an open capital account in the early seventies; moreover, the capital account was liberalised before the current account. It was not until the late eighties and early nineties that the domestic financial system was deregulated. On the eve of instituting CAC, import substitution and inward orientation had resulted in a continuous deterioration in the performance of the economy. Real GDP growth averaged around 2 per cent. The domestic saving rate had declined throughout and turned negative by 1966-67. Monetary policy played a subservient role in accommodating expanding fiscal deficits. Inflation was well above 100 per cent up to 1968. Simultaneously, the balance of payments deteriorated with the foreign exchange reserves being totally eroded. The stabilisation plan announced in 1966 brought forth immediate results. Thereafter, Indonesia benefited from the oil boom during the seventies, suffered downturn and adjustment during the eighties and entered a period of export led growth since 1989. CAC has acted as a catalyst in accelerating financial and real sector reforms and helped in maintaining confidence among foreign investors. At the same time, it exposed the Indonesian economy to the discipline of external pressures and brought to the fore the vulnerability of the financial sector.

2.18 The group of countries which do not qualify as being convertible on the capital account by the IMF's classification but have nevertheless progressed considerably in the liberalisation of capital transactions reveal heterogeneous initial conditions. There is the experience of Chile and Mexico where capital account liberalisation was undertaken first in the early seventies in an effort to restructure their economies with a distinct tilt towards outward orientation; the reform processes were therefore anchored on a fixed nominal exchange rate. In contrast, Thailand and the Philippines reveal typically Asian approaches to capital

account liberalisation marked by efforts to concomitantly strengthen initial conditions.

2.19 Chile's experience with liberalisation of the capital account falls into two phases. Prior to the first phase (1974-8 1), there was a massive intervention of the State in economic activity. As a result, the fiscal deficit exploded and was monetised. By 1973, inflation reached an annual rate of 600 per cent, the public sector deficit was 25 per cent of GDP and international reserves were wiped out with a current account deficit of nearly 3 per cent of GDP. Real GDP had declined by a precipitous 6 percent in 1973. The first phase of relaxation of capital controls formed part of a rapid and drastic *laissez faire* type reform. Price controls were lifted and subsidies eliminated. Quantitative restrictions on trade were removed and tariffs were cut. The liberalisation of capital controls brought about a surge in capital inflows. While growth resumed with the introduction of reforms, macro economic instability persisted and financial liberalisation proceeded at a fast pace without the provision of proper regulation and control. In 1978, the nominal exchange rate came to be used as an anchor for the price level in the face of runaway inflation. The result was a steep real effective exchange rate appreciation due to surges in private capital flows. The large overvaluation of the Peso led to a loss of credibility in the sustainability of the exchange rate and external debt. As real interest rates rose and a severe international recession set in, foreign capital inflows dried up. Domestic output dropped by nearly 15 per cent and unemployment rose to 20 per cent of the work force in 1981. Capital account liberalisation was reversed as part of the policy response to the debt crisis. Tight fiscal policy, privatisation, increases in tariffs, debt conversion and rebuilding of the financial system around an autonomous central bank formed the other elements of the policy strategy. The overall reform process led to resumption of real growth, decline in inflation, fiscal and external current account surpluses, decline in external debt and a steady increase in international reserves during the nineties.

2.20 Mexico's approach to liberalisation of capital account was in an environment of stable growth. Mexico had a tradition of a relatively open capital account from the mid fifties. Rapid industrialisation had occurred under protection. Sound macro economic policies, particularly prudent fiscal policy yielding low public sector deficits, cautious monetary policy keeping inflation moderate, wage indexation and a fixed exchange rate provided the environment for a strong growth of real GDP. Capital inflows mostly took the form of foreign direct investment, changing in favour of commercial credits in subsequent years. The oil boom of the seventies triggered expansionary fiscal policies which, in the context of a fixed exchange rate, led to the currency being overvalued. With the the current account deficit rising to nearly 8 per cent of GDP in 1976 and a *pari passu* increase in external debt to 50 per cent of GDP, there was sizeable capital flight which aggravated the crisis of 1982. Exchange controls were reimposed in 1982 and quantitative restrictions were applied to imports as part of the measures to counter insolvency. Since May 1989, liberalisation of capital account has been pursued selectively. Although capital inflows resumed, the weakness of the initial conditions, in particular, the overvaluation of the exchange rate remained camouflaged under surpluses in the budget and in the external current account, and these weaknesses were exposed in the crisis of 1994. Subsequently, Mexico has been able to make significant progress in financial sector reforms, fiscal consolidation and inflation control.

2.21 The experiences of Thailand and the Philippines are set in the Asian mould, wherein natural resources and a strategy of import substitution growth resulted in strong initial conditions.

2.22 Thailand's experience with capital account liberalisation began in the nineties from a position of distinct strength. In the late eighties, Thailand emerged as a rapidly industrialising economy with an exceptionally dynamic private sector. Fiscal deficits came down sharply and turned into surpluses. In the second half of the eighties, inflation declined to an average of 3 per cent although there was an upward drift to an average of 5 per cent in the first half of the nineties. Since 1986, the exchange rate was pegged to a basket of currencies of Thailand's major trading partners. A sustained investment boom powered double digit growth which strained against an infrastructure bottleneck. While the overall balance of payments has been in surplus due to strong capital flows, current account deficits have widened to accommodate the growth momentum and capital flows. In fact, the infrastructural constraint, increasing overvaluation due to the fixed exchange rate and

the large current account deficit represent the weak elements in Thailand's approach to CAC.

2.23 In the Philippines, a comprehensive economic programme supported by an eighteen month arrangement with the IMF in 1986 resulted in a distinct strengthening of the initial conditions. The entrenchment of the economic recovery during 1987-90 enabled trade reform, deepening of the foreign exchange market and the introduction of the investment code for foreign investors, followed by selective financial sector reform in 1990. On the eve of removal of restrictions on capital transactions in 1992, however, real growth faltered. The pursuit of'expansionary fiscal policies and accommodative monetary policy was reflected in a deterioration of the balance of payments. Inflation which had declined to below 1 per cent in 1985 soared to nearly 19 per cent in 1991 reflecting macro economic instability.

2.24 In the years following imposition of economic sanctions in 1985, the South African economy went into recession and suffered an acute external financing constraint which compelled it to run current account surpluses of the order of 5 per cent of GDP. This was a period of tight exchange controls for both current and capital transactions. South Africa operated a dual exchange rate system which created distortions and financial crisis and provided incentives for residents to take capital out of the country. On the eve of liberalisation of exchange control in 1994-95, a debt rescheduling agreement was put in place and the exchange rates were unified. The resumption of capital flows, however, brought considerable turmoil to the foreign exchange market, resulting in overvaluation, widening of the current account deficit, inertial inflation and a deterioration in the terms of trade. This led to the postponement of relaxation of restrictions on outflows to March 1997.

2.25 Over the past three decades, Korea has achieved remarkable success in strengthening initial conditions. Real growth has averaged little less than 9 per cent over the nineties with a large reliance on domestic savings rather than external resources. The investment rate has averaged 34 per cent over the last decade. The current account deficit has averaged around 1.5 per cent during the nineties with reserves being steadily built up to over US $ 32 billion by the end of 1995, equivalent of three months of imports. Inflation has trended downwards to around 4.5 per cent in 1995. Monetary policy is conducted within a framework of annual target ranges for the M2 aggregate. Fiscal conservatism helped in keeping government debt at relatively low levels. The exchange rate operates under a managed floating system with variations allowed within a range of the average rate of the previous day; this provided a strong boost to export competitiveness. Korea's approach to CAC has been clearly set out in a preannounced three stage programme encompassing complete liberalisation of capital and foreign exchange markets by 1998-99.

The Preconditions for CAC

2.26 A survey of the selected country experiences shows that while some countries such as Malaysia, Korea and Thailand approached the liberalisation of capital transactions by undertaking reforms to strengthen certain preconditions, others such as New Zealand, Mexico, Argentina, the Philippines and South Africa undertook capital account liberalisation as part of a broader package of reform and preferred to establish the preconditions simultaneously with the opening up of the capital account. For countries such as Chile and Indonesia where capital account liberalisation was initiated much before the institution of other reforms, the relatively open capital account acted as a catalyst for policy action towards entrenching the preconditions.

2.27 For all the selected countries, fiscal consolidation and financial sector reforms were assigned priority among the preconditions. While countries in the Asian region (Malaysia, Thailand, Indonesia, Korea and Philippines), New Zealand and South Africa placed emphasis on bringing down inflation to manageable levels either prior to or concomitantly with the opening up, countries in the Latin American region except Mexico undertook strong policy action to reduce inflation only after hyper-inflation emerged. Exchange rate management was in general structured around a stable nominal exchange rate. In countries where the exchange rate was used as an anti-inflationary tool, real appreciation was a

significant factor in weakening the preconditions. Even for those countries which did not use the exchange rate as an anchor for inflation but attempted to maintain exchange rate stability through aggressive interventions and sterilisations in the face of capital inflows, incipient overvaluation was unavoidable. While Argentina, Thailand, Mexico and Malaysia allowed current account deficits to widen and accommodate strong capital flows as well as the pressure of domestic demand, other countries undertook policy action to strengthen the balance of payments. Capital flows coming in the wake of opening up were, in general, absorbed into the reserves which, except for South Africa, were built up to exceed the traditional norm of three months of import cover.

Fiscal Consolidation

2.28 Among the countries which undertook CAC early, Indonesia, given its history of large fiscal deficits, moved to fiscal consolidation fairly slowly. Throughout the seventies and eighties the fiscal deficit was expanded, buoyed first by the oil windfall and then by the need to provide fiscal stimulus to an economy in adjustment. It was not until 1989-93 that fiscal prudence in the form of cutting expenditures, widening the tax base, postponement of capital intensive projects and restraint on spending on state-owned enterprises began to yield low and manageable fiscal deficits.

2.29 In contrast, Chile which also began liberalising capital transactions in the early seventies, embarked upon fiscal consolidation almost simultaneously. By 1975, the fiscal deficit was cut to 1 per cent of GDP. Throughout the exchange rate based stabilisation period (1978-8 1) and the debt crisis of 1982 fiscal consolidation was well under way and tight fiscal policy was pursued to revive domestic saving although in the face of a relatively fixed exchange rate, this allowed for overvaluation to build. Since the recession of 1983, the public sector has generated surpluses consistently. Fiscal consolidation has provided the bedrock of the reform process in Chile in 1980 and in the nineties.

2.30 Malaysia represents the example of an economy with entrenched preconditions prior to the opening up of the capital account. Throughout the sixties and seventies a balanced budget and a net creditor position of the government vis-a-vis the central bank marked the conduct of fiscal policy. While expansionary fiscal policy was used to counter the weakening of external demand during the recession of the early eighties and the fiscal deficit rose to 17 per cent of GDP in 1982, this policy stand was soon reversed through expenditure restraint and retrenchment of public investment. The strong fiscal adjustment pursued since the mid-eighties contributed significantly to strengthening the preconditions. With the overall public sector finances turning into surplus in the nineties, prepayment of foreign debt and sterilisation of the monetary effects of capital inflows strengthened the measures of fiscal consolidation.

2.31 In Thailand,- the impulses for growth emanated from a dynamic private sector. Prudent fiscal management resulted in the public sector's fiscal deficit coming down from 4.5 per cent of GDP in the first half of the eighties to 2 per cent by 1986-87 and thereafter there were sustained surpluses. Fiscal adjustment supported the exchange rate policy and contributed to price stability.

2.32 For Argentina as well as Mexico, the failure of the first phase of capital account liberalisation was essentially attributable to the absence of fiscal discipline. In Mexico, the primary fiscal deficit was in excess of 5 per cent of GDP during the second half of the seventies and this was financed by external borrowings. Similarly, in Argentina the harmful effects of financial liberalisation in the first phase were accentuated by large fiscal deficits. The financing of the deficit was a fundamental source of inflationary pressure leading to huge real effective exchange rate appreciation and the abandoning in 1981 of the *tablita* (schedules of future exchange rate changes involving progressively slower depreciation and ending in a fixed exchange rate). In contrast, the second phase of liberalisation in both countries was characterised by a marked fiscal adjustment. In Mexico, the primary balance was transformed into a surplus of more than 7 per cent of GDP during 1988-90. In Argentina, the adoption of a Currency Board in 1991 ensured that the reform process centred on fiscal discipline. The fiscal accounts were kept in approximate balance throughout the first half of the nineties and this enabled the consolidation of public debt.

2.33 The fiscal situation in Korea was sound as a result of a long tradition of fiscal conservatism. Over the years, fiscal expenditure, which is relatively low by international standards, has been kept broadly in line with revenue, resulting in relatively low levels of government debt and high government savings. Taking into account its financial assets, the government has been a net creditor in recent years.

2.34 Against the backdrop of expansionary fiscal deficits, averaging 6 per cent in the early eighties in New Zealand, the reforms of fiscal policy have attracted international attention on account of the innovative institutional approach, the comprehensiveness and vigour of adjustment and the success in achieving a turnaround from a difficult situation. The promulgation of the Public Finance Act in 1989 and the Fiscal Responsibility Act in 1994 established transparency and accountability, financial delegation and a measure of fiscal performance.

Financial Sector Liberalisation and Reform

2.35 Countries such as Chile, Argentina, Indonesia and Malaysia embarked upon liberalisation of the capital account in the seventies and eighties against the backdrop of financial repression. In Chile, interest rate ceilings were removed and non-banks were provided a relatively open market; however, financial intermediaries remained relatively restricted and were discriminated against in the ability to intermediate in foreign funds. As a result of real interest rates being high and an absence of supervisory competence many banks accumulated bad loans, eventually leading to the crisis of 1982. It was only in the aftermath of the crisis that prudential norms, deposit insurance and recapitalisation of the financial system was undertaken, supported by capital market reforms. Argentina's experience was similar in that financial repression in the form of ceilings on domestic interest rates and quantitative ceilings on external borrowings were removed simultaneously. In the absence of proper supervision and a lack of credibility in the Government's control of inflation, real interest rates rose leading to capital inflows, with real appreciation precipitating capital flight, loan defaults and banking crisis. While in the post 1991 phase, financial reforms have been implemented in consonance with the Currency Board, the vulnerability of the financial system remained a fundamental weakness in Argentina's approach to CAC. Mexico's experience was similar in that the neglect of financial sector reforms in the first phase of capital account liberalisation precipitated the crisis of 1982 . During 1982-88, there occurred financial di s intermediation reflecting the highly regulated financial system. Major financial sector reforms took place late in the process i.e. during 1989-1991, when it became apparent that the efficiency of the financial system lagged in the liberalisation process. Reserve requirements were eliminated in favour of open market operations and controls on interest rates and maturities were eliminated. Development banks and trust funds were restructured as rediscounting institutions to enhance their complementarity with commercial banks.

2.36 In Malaysia the reform process began with a relatively deep financial structure. Nevertheless, opening up of the capital account exposed weaknesses in the financial system, in particular, the health of the banking system and the inadequacy of the regulatory and supervisory framework. Since the late eighties, strengthening of the financial system became the focus of the process of reform. The supervisory role was strengthened, the capital base was increased and management of ailing institutions was reorganised. Simultaneously, interest rates were freed and non-performing assets in the banking system were reduced.

2.37 In Indonesia, the sequencing of financial liberalisation was unorthodox. While the capital account was opened in the early seventies, the financial sector remained repressed and interest rates were freed as late as 1983 and institutional aspects of the financial system were deregulated in 1988.

2.38 In Thailand and the Philippines, financial reforms have been undertaken at a late stage in the process of liberalisation i.e. in the nineties. The Bank of Thailand launched a three year Financial Reform Plan (1990-92) encompassing removal of interest rate ceilings, foreign exchange liberalisation, relaxation in financial institutions' portfolio management to a

minimum level necessary to maintain stability and solvency of the financial system, expansion in the scope of the operation of financial institutions to allow greater competition in the supply of financial services, improvement in supervision and monitoring of financial institutions, development of financial instruments and improvement of the payments system to enhance its efficiency.

2.39 In the Philippines, financial reforms were selectively introduced in 1990. The system of taxation of financial transactions was reviewed with the objective of making it more conducive to private sector saving and investment. Priority was given to investment in the energy sector, agriculture, rural development and social services. The process of reform of the public enterprises sector was carried forward with 130 of the 296 government corporations earmarked for disinvestment and the rest slated for restructuring in the form of mergers, absorption as line agencies or departments, conversion to private non-profit bodies or abolition. By the end of 1991, the government intended to complete the privatisation process. For the corporations that remained in the public sector, the government provided increased flexibility and operational autonomy while maintaining control over their overall financial and economic performance. The reform of the two major government financial institutions - the Philippine National Bank and the Development Bank of the Philippines was largely completed with their balance sheets restructured by transferring most of their non performing assets and related liabilities to the Asset Privatisation Trust and the national government, respectively. In the banking sector, the legal framework for bank supervision was strengthened while arrangements were improved for depositor protection by enlarging the role of the Philippine Deposit Insurance Corporations. To improve competition in the banking sector, the requirement to purchase government securities as a condition to open new branches was lifted, while restrictions on the opening of new branches in rural areas by specified institutions was removed.

2.40 Korea's financial system is layered with different degrees of regulation and control. While the Ministry of Finance and the Central Bank jointly regulate the commercial and specialised banks, financial intermediaries are less strictly regulated. Throughout the seventies, the government used its financial institutions, particularly the commercial and specialised banks, to direct credit at preferential rates to strategic industries such as steel, shipbuilding, machine tools and chemicals. At the beginning of the eighties, financial markets were deregulated to a limited extent and to meet these objectives new financial instruments were permitted. A new policy, announced in December 1988 envisaged a number of measures to deregulate interest rates. Actual deregulation has, however, fallen short of what was provided for in the 1988 plan. The regulation of the domestic financial sector is matched by extensive controls on capital account transactions, based on the Foreign Exchange Control Act of 1961.

Banking Crises

2.41 The incidence of banking crises in the eighties and nineties in developing countries has been significantly higher and far more severe than in preceding decades. Policy makers in emerging economies have discovered in the nineties that spots of vulnerability in the defence against speculative attacks on the exchange rate were not fiscal deficits but potential quasi-fiscal deficits lodged in banking systems. A factor behind the banking crises is the volatility in international interest rates and real exchange rates induced by private capital flows. Fluctuations in interest rates have affected the cost of borrowings for emerging markets and altered the relative attractiveness of investing in these markets. Real exchange rate volatility has caused currency and maturity mismatches, creating large losses for bank borrowers. In the Mexican crisis of 1994, the gap between Mexico's liquid banking liabilities and the stock of foreign exchange available to meet these liabilities in case of a run widened progressively. On the eve of the crisis, the dollar value of M2 was almost five times higher than the maximum value of international reserves the country had ever recorded. In Chile, the gap was one half of that of Mexico and thus it was much less vulnerable to attack. Furthermore, large capital inflows have led to lending booms and unsound financing during the expansionary phase. Accumulation of bad credit risks and swings in asset prices then cause the bubble to burst and intensify the crisis.

2.42 When domestic interest rates are high, the temptation for the banking system and bank

customers to denominate debt in foreign currency is strong. Such strategies can come unstruck when a devaluation occurs. Between December 1993 and December 1994 the foreign currency denominated liabilities of Mexican banks more than doubled; at the same time the credit risk on these loans increased as interest rates rose and as economic activity fell.

2.43 In general, the banking crises are precipitated by inadequate preparation for financial liberalisation as witnessed in Chile, Indonesia and Mexico, with the government taking over the troubled banking system in 1982 in Mexico. Rapid rates of credit expansion coincided with high interest rates in the wake of financial liberalisation. Lifting restrictions on bank lending and lower reserve requirements permitted banks to accommodate pent up demand for credit in liberalised sectors. Furthermore, new competition and easy access to offshore funds allowed banks to undertake risky activities. In the absence of strong supervisory and regulatory frameworks, therefore, financial liberalisation can trigger banking crises.

2.44 The exchange rate regime can enhance vulnerability to speculative attacks. In Latin America, the adoption of exchange rate based stabilisation plans often led to successes in cutting inflation but were accompanied by significant real exchange rate appreciation. Fixed exchange rates have been found to increase the fragility of the banking system to external shocks through balance of payments deficits, a decline in the money supply and higher domestic interest rates. Sharp appreciations in the real exchange rate have been shown to be a useful leading indicator of banking crises. By contrast, under flexible rates, external shocks are absorbed in a depreciation in the nominal exchange rate and a rise in the domestic price level. This has served to reduce the real value of bank assets and liabilities to a level more consistent with bank solvency. Countries which allowed some nominal exchange rate flexibility showed fewer signs of real exchange rate appreciation and were less vulnerable to Mexico type financial crises (Indonesia, Korea and Malaysia).

2.45 Discipline in monetary and fiscal policies help to contain volatility induced by capital flows and thereby forestall banking crises. A key issue in this regard is whether bank lending booms are discouraged more effectively by high reserve requirements or by binding capital constraints. Criticisms of reserve requirements are that they are costly to banks, they encourage substitution of other forms of liquidity for bank deposits and they put banks at competitive disadvantage *vis-a-vis* the rest of the financial system. The most marked change is found in the increasing strength of non banks, powered mostly by capital markets. In Malaysia, the Philippines and Thailand, market capitalisation in the equity market is already larger than the total domestic currency assets in the banking system. Similarly, in Korea, non bank financial intermediaries have more deposits and assets than the banks which are highly regulated. In most Asian and Latin American countries, however, reserve requirements were found to be important in keeping the size of the money multiplier under control during periods of capital surges (Argentina). On the other hand, binding capital constraints stand a better chance of preventing sharp declines in credit quality in the face of capital flows without penalising well run banks (Malaysia).

2.46 A critical issue is that of prudential regulations and their relationship with the sequencing of financial liberalisation. In the absence of freer entry of privatisation being accompanied by " fit and proper" tests, bad loans may be accumulated and bank insolvency may quickly result (Chile in the seventies). Bank supervision needs to be strengthened before liberalisation. Training of supervisors, better evaluation of risks are important elements of this dispensation. Supervisory shortcomings played an important role in overextension of Mexican banks in the crisis of 1994. The Mexican authorities have recently tightened accounting rules. Chile's banking law has several features conducive to good provisioning practice. Based on a current assessment of the repayment capacity of the borrower, the borrower's past record and the value of collateral, rather than 'past due' payments, banks are required to classify assets in four risk groups. Chile has also moved towards market accounting without accepting the principle as a formal requirement. Government auditors assign each bank a summary credit rating similar to CAMEL (Capital, Assets, Management, Earnings and Liquidity) ratings and publish it in major newspapers while private rating firms offer their appraisal twice a year. Inspectors from the Superintendency of Banks and Financial Institutions visit banks regularly and evaluate the risks of assets

with the purpose of quantifying estimated losses and monitoring the impact of any non-provisioned losses on the solvency of banks. This information along with capital convergence ratios and credit risk ratings is published every quarter. A similar example is found in New Zealand where this information must be displayed prominently in every bank branch. Here, these norms were adopted in the wake of capital injection of almost one per cent of GDP in one state owned bank which accounted for one fourth of total banking assets. Argentina has recently required banks to be rated by credit rating agencies with ratings displayed with the interest rates offered for different types of deposits. Almost all developing countries assess the adequacy of the provisioning made by banks. While there is wide variation across countries, the emerging economies with the highest share of non performing loans (Mexico, Indonesia) tend to display the lowest provisioning coverage with some notable exceptions (Argentina, Malaysia) where coverage in the face of a relatively high incidence of bad loans looks relatively strong (Indicators of the banking industry for various countries are set out in Annexures III.5, III.6 and III.7). A particularly relevant financial aspect of diversification is the role of foreign owned banks. With their access to external resources and concentration on tradeable sector lending foreign banks are able to weather a shock to the local economy better than domestic banks. In Chile and Malaysia, the share of foreign banks is high; in contrast, this share is low in Korea and Mexico.

2.47 In the Argentine banking crisis of the early eighties, the extent of non performing loans and the number of bankrupt firms had a direct impact on the profitability of the financial system. Loan portfolios were deteriorating just as financial institutions were experiencing a steep increase in liabilities, resulting in steep capital losses. Supervisors tended to focus on compliance of rules rather than on qualitative assessment of assets. Information with banks about their clients was limited and this allowed speculative and distress borrowing. Accounting was weak. Nine per cent of loans were non performing in 1980 and 30 per cent in 1985. Interest rate spreads rose sharply and credit and payments systems were disrupted. There was a substantial redistribution of wealth in favour of debtors. Emergency credit to banks rose to 100 percent of their reserve holding. The direct fiscal cost of bank rescue operations was 4 per cent of GDP. The money multiplier rose and became volatile, making monetary control difficult and interest rate controls were reintroduced. The crisis of 1989 had its roots in the large expansion in public spending. Banks lent heavily to the public sector. Public sector banks were weak and inefficient and had very high levels of employment. Monetary expansion was absorbed through remunerated reserve requirements and directed investments which repressed the banking system. In the inter-firm market, participants avoided these regulations and financial institutions tended to dedicate themselves entirely to inter-firm activity. The high level of risk in inter-firm operations led to solvency crises in some institutions when massive withdrawals of inter-firm deposits could not be met by the resources from counterpart loans. These institutions had to use the funds from the formal market to pay off inter-firm deposits and given the central bank's deposit insurance system, central bank aid to troubled institutions led to a large expansion in the monetary base. The realised losses of public sector banks were covered through capitalisation financed by monetary emissions from the central bank. This merely obscured the extent of bank losses. By December 1988, 206 financial institutions were under central bank liquidation. In 1995, reserve requirements were reduced to aid banks and the differential between buying and selling pesos was reduced to minimise transaction costs.

2.48 The banking crisis in Malaysia was brought about by the sharp deflation in the Malaysian economy in 1985-86 underscoring the dangers of overexpansion. Deficiencies in supervision and delay in recognising the magnitude of the portfolio problem of non bank financial intermediaries were chiefly to blame for the crisis. Banks were under family ownership and lacked internal controls. Sporadic bank runs throughout 1986 culminated in the failure of 24 deposit taking cooperatives with the potential danger of systemic failure. The authorities intervened in various banks, finance houses, deposit taking institutions and insurance companies. The response, on two fronts i.e., monetary and regulatory, was sometimes contradictory. Tighter monetary policy raised interest rates but also increased the level of non performing loans. As a consequence, some monetary and prudential deregulation had to be made: liquidity and reserve requirements were reduced during the crisis to aid bank profitability; deposit rates were freed to give banks greater flexibility although controls were reimposed from 1985-87. Minimum capital adequacy requirements

were introduced, effectively raising the average capital - asset ratio from 7.4 per cent at the end of 1984 to 8.1 per cent at the end of 1987. Holdings of individuals in the equity of financial institutions were limited to 10 per cent and those of companies or cooperatives, to 20 per cent. Bank credit to single customers was restricted to 30 per cent of shareholders funds and lending to directors and staff were prohibited. The central bank took over ailing financial institutions or injected capital. A secondary mortgage market to aid bank liquidity was established. It also introduced guidelines on suspension of interest on non performing loans, provisioning and standardisation of accounting practices. Off site and on site monitoring, as well as statistical reporting was improved. Legal changes were promulgated which improved the central bank's ability to intervene in an emergency. Non performing loans were estimated at 32 per cent of total loans in 1988.

2.49 In Chile, rapid expansion and excessive risk taking by domestic and foreign financial institutions in the form of large loans to under capitalised and highly indebted enterprises carried the seeds of the banking crisis of 1981-83. The Chilean crisis showed how long repressed financial markets fail to immediately adapt to liberalisation and cope with financial bubbles. Financial liberalisation occurred in a rapid and extensive manner under little supervisory control and in direct competition with the banking system. A large reliance on external saving served as the unsustainable cause of growth in financial assets. Furthermore, there was high concentration in the banking system and corporate ownership leading to the emergence of unregulated conglomorates which practised oligopoly pricing, extremely high real interest rates and moral hazard arising out of the government assuming private sector debt. The result was bankruptcy, a disruption of the payments system and capital flight with a depletion of international reserves. The initial response was in terms of reimposition of capital controls, devaluation and raising of tariffs. In 1980, a fuller response was in the form of risk classification, provisioning, bank classification under the CAMEL system, diversification of loans, rescheduling, a preferential exchange rate scheme for debt servicing and swap facilities, deposit insurance and recapitalisation. The authorities intervened in 4 banks and 4 non bank financial institutions in 1981. Nine other banks and 2 more non banks were subject to intervention in 1982-83 and many others were assisted. At the end of 1983, 19 per cent of loans were non performina. When the crisis ebbed and a new banking law was enacted in 1986, bank supervision adopted an orthodox stance and stiff requirements for market information were introduced. The law also attempted to eliminate the practice of related lending through a precise definition of the concept of client. A mechanism for bank rescues was set up alongside the tightening of capital adequacy standards and compliance sanctions. Banks were required to dispose of acquired assets quickly or to write them off fully. The scope of state deposit guarantees was scaled down to protect only small depositors.

2.50 In Indonesia, monetary expansion was rapid in the wake of liberalisation in 1988-89. Periodic surges in capital inflows complicated monetary management. High spreads led to disintermediation and growth in non bank financial institutions. Concerns over bank profitability affected authorities' willingness to raise domestic interest rates for monetary control. State banks were poorly managed and subject to political interference. Intragroup lending due to industrial ownership of private banks resulted in large exposures. Non performing loans which were concentrated in state owned banks, were over 25 per cent of total lending in 1993, but declined to 12 per cent in 1995. A large private bank was closed in 1992. The fiscal cost of recapitalisation of state banks and the conversion of the central bank's emergency credit into equity or subordinated debt was 2 per cent of GDP.

2.51 Non performing loans of deposit money banks rose significantly in the first half of the eighties in Korea, exceeding 7 per cent of total assets in 1986. The ratio of non performing loans declined subsequently to 0.9 per cent in 1995.

2.52 In the Philippines, the ratio of bank credit to GDP experienced a sustained increase before the crisis. The world recession hurt bank borrowers. The balance of payments crisis of 1983 spilled over onto the banking sector with the announcement of a moratorium on external debt repayments, provoking panic runs, capital flight and a depreciation in the exchange rate. Real interest rates rose and in the face of the recession there was a credit crunch. Growth suffered an absolute decline before the crisis. During the banking crisis of 1981-87, banks accounting for 1.6 per cent of banking system assets failed. Through the

mid eighties, a number of institutions failed or were taken over by the government. Non performing assets of two state-owned institutions were transferred to a government agency. These assets accounted for nearly 30 per cent of total banking assets. Thirteen per cent of GDP was contributed as bank equity. Inflation rose sharply and interest rate controls were reimposed. Emergency credit provisions conflicted with monetary policy and inflation soared. Segregation of commercial and development banks weakened competition as did high concentration at state banks and financial groups. There were weak accounting practices and portfolios were not diversified. Commercial ownership through groups were high, leading to connected lending, interlocking ownership and excessive risks. In 1986, 19 per cent of loans were non performing.

2.53 By 1985, banks in South Africa built up large short-term foreign liabilities owing to high domestic interest rates. When foreign banks reduced their exposure, the exchange rate depreciation and liquidity squeeze on banks resulted in an official moratorium on external repayments.

2.54 During the crisis of 1983-85 in Thailand, credit grew rapidly . Bank spreads fell and there was a sharp decline in loans from finance companies to the private sector. The central bank had to sterilise its liquidity assistance. Nevertheless, monetary policy was eased, banks' reserves grew quickly and interest rates fell. There was, however, a lack of competition and heavy concentration with 3 banks owning 57 per cent of total bank assets. While most interest rates were freed, the exchange rate was fixed in relation to a basket of currencies. Bank ownership was concentrated in a few families, accountability was weak with inadequate controls and management weaknesses were pronounced. Of bank loans, 15 per cent were non performing. There were runs on the financial system and 15 finance companies collapsed. Through 1987, 25 institutions were closed, 9 were merged and 18 supported

2.55 In the wake of the crisis of 1994 in. Mexico, non performing loans which constituted 9 per cent of total loans at the end of 1994 rose to 12 per cent in December 1995. The authorities intervened to support the ailing banks. Several banks were placed under the administration of a deposit insurance agency. At the end of 1995, 19 per cent of the bank loan portfolio was restructured into long term inflation-indexed units. The overall cost of support to the banking system is estimated at 6.5 per cent of GDP. Real interest rates, however, remain high affecting repayment capacity of borrowers. Credit to the private sector declined by about 20 per cent in real terms in 1995.

Inflation Control

2.56 The commitment to hold down inflation has varied. In the hyper-inflationary environment of Latin America, explicit inflation strategies have been weakened by loose macro economic policies although in the recent period the commitment to inflation control has been strongly reinforced through adoption of the Currency Board in Argentina, autonomy to central banks and explicit inflation goals. In the Asian countries, there has all along been a supportive environment of moderate inflation. Nevertheless, tight monetary and fiscal policies have contributed to holding down inflation at low levels. In New Zealand, an explicit inflation mandate has been tied to the autonomy of the central bank.

2.57 In Chile, on the eve of the first phase of capital account liberalisation (1974-81), inflation had reached an annual rate of 600 per cent. Restrictive monetary and fiscal policies impacted upon inflation so that after remaining inertial in the first two years following liberalisation, inflation declined to .37 per cent in 1978. Thereafter, the exchange rate became the primary focus of the anti-inflation programme. A system of pre-announced depreciation of the nominal exchange rate *(tablitas)* was introduced, followed by a fixed nominal exchange rate. Mandatory indexation of wages and the open capital account helped to keep inflation in the range of 20 per cent over the eighties. The second round of capital account liberalisation occurred alongside the establishment of an autonomous central bank in 1989 and tight macro economic policies have ensured a decline in inflation to around 8 per cent in 1995. Since 1990, the central bank has publicly announced an inflation target and has shown a readiness to raise interest rates when domestic spending has accelerated.

2.58 In Argentina, inflation was well above 100 per cent throughout the first phase of capital account liberalisation crossing 3,000 per cent in 1989. The Law of Convertibility which came into existence in 1991 established the Currency Board which, by linking the Peso to the U.S. Dollar, attempted to anchor inflation at the level of inflation in the USA and broke the chain of expectations fuelling hyper-inflation. The results were dramatic with inflation declining to 3 per cent by 1995.

2.59 In the first phase of capital account liberalisation in Mexico, capital inflows and expansionary domestic policies resulted in inflation rising from 3 per cent to nearly 17 per cent by 1976. Fragile public finances and large nominal devaluations resulted in an acceleration of inflation to over 100 per cent in 1983. In response to the crisis, Mexico tightened fiscal and monetary policies and reimposed exchange controls. Nevertheless, with wage indexation and the external constraint holding down growth, inflation remained inertial hovering around 120 per cent in 1987-88. In the wake of financial sector reforms and tight monetary and fiscal policy, inflationary pressures abated with inflation declining to 7 per cent in 1994, before rising again to 35 per cent in 1995 in the wake of a large devaluation of the Peso at the end of 1994.

2.60 The introduction of capital account convertibility in Indonesia accompanied by the frontal attack on instability resulted in inflation declining to 4 per cent in 1971. Over the seventies, however, expansionary fiscal policies supported by the oil boom resulted in inflation averaging at about 175 per cent. In the adjustment to the downturn in 1983, monetary policy was tightened and as a result consumer inflation declined to below 5 per cent in 1985. Thereafter, monetary policy proactively addressed itself to inflationary pressures, supported by flexibility in the conduct of exchange rate policy embodied in the widening of the intervention band. As a result, inflation has been below 10 per cent throughout the nineties.

2.61 In the Philippines, the commitment to control inflation stemmed from the stabilisation programme of early 1990-91 and supported by an arrangement with the IMF. Inflation, which had risen to 19 per cent in 1991 from a low of less than 1 per cent in 1986, declined to single digit levels in the nineties.

2.62 The institutional framework within which monetary policy operates was fundamentally changed by Reserve Bank of New Zealand Act which came into effect in February 1990. This Act gave the Reserve Bank the primary responsibility for formulating and implementing monetary policy with the sole objective of attaining stability in the general level of prices. The greater operating independence accorded to the Reserve Bank was however, tempered by requirements for much-enhanced accountability and policy transparency of the Bank. This policy objective acquires operational meaning through the Policy Target Agreement (PTA), a document signed by the Governor of the Reserve Bank and the Minister of Finance setting out inflation targets._The current PTA, covering the period 1992-98, specifies that the four quarter change in the consumer price index should be maintained within the tar-et band of 0-2 per cent. The PTA, however, makes allowance for the change in the CPI to move occasionally outside the target range. It gives the Reserve Bank the right to invoke "caveats" in the case of price shocks that are outside the direct influence of monetary policy like changes in indirect taxation or tariffs levied by the government, terms of trade movements, natural disasters and short-term impact of interest rate changes.

2.63 Thailand and Malaysia stand out as examples of countries where capital account liberalisation has occurred in an environment of low inflation. In Thailand, tight fiscal policy and an expansion in the current account deficit preempted demand pressures from impacting on inflation while simultaneously allowing monetary policy to contend with capital inflows. In Malaysia the Central Bank played a crucial role in the fight against inflation. Cautious financial policies and in particular tight monetary policy helped to sterilise the monetary effects of reserve accumulation and allow adherence to inflation targets.

Exchange Rate Policy

2.64 In the conduct of exchange rate policy, two clear strands can be distinguished among the selected countries: the Latin American type where the exchange rate, whether nominal or real, performed as an anchor for the economy and the Asian type where exchange rate policy is fashioned in a manner in which the balance of payments is targeted. While South Africa can be placed close to the Asian type, New Zealand stands separately with its exchange rate geared around a small open economy.

2.65 In Chile with substantial liberalisation of the capital account in the second phase, the fixed exchange rate system was abandoned in favour of a floating exchange rate system, the emphasis shifting from reducing inflation to promoting exports. The authorities aggressively intervened to counter a real appreciation. Exchange rate policy initiated an era of export led growth and contributed to substantial growth and productivity in the nineties.

2.66 Argentina followed an exchange rate policy of *tablitas* in the eighties. Daily rates of depreciation were below the existing difference between domestic and foreign inflation. As the rate of depreciation of the exchange rate declined with the implementation of tablitas, the spread between domestic interest rates (adjusted for the pre announced rate of depreciation of the exchange rate) and external interest rates widened, which provided domestic residents with an incentive to borrow external funds to finance domestic expenditures. The resulting inflows of foreign capital were accompanied by relatively slower fall in the inflation rate and there was real exchange rate appreciation. The Law of Convertibility adopted in 1991 introduced a Currency Board which set a fixed exchange rate guaranteeing one to one convertibility of the Peso into U.S. Dollars. The decision to link the Peso to the U.S. Dollar was written into the Constitution and strict rules were established concerning the creation of money. The adoption of the Currency Board enhanced the credibility of the new exchange rate system.

2.67 Mexico's exchange rate policy was the key factor precipitating the crisis of December 1994. In the wake of the stabilisation programme of 1987, exchange rate policy went through three distinct phases. First, following an initial devaluation of almost 40 per cent a fixed exchange rate *vis-a vis* the U.S. dollar was established to serve as a nominal anchor for an exchange rate based stabilisation programme. From January 1989, limited flexibility was adopted through a preannounced crawling peg with slower depreciations in each succeeding year and from November 1991, a crawling exchange rate band was adopted with the ceiling expanding by 0.0004 per day. The crawling band ushered in little variability until the end of 1993. Fiscal correction, a decline in inflation and continuing capital flows were conducive to the authorities' strong desire to continue reliance on a nominal exchange rate anchor. Persistent inflation differentials, a widening current deficit, the resulting accumulation of external debt and uncertainties in the form of a large increase in short-term interest rates in the U.S., political instability all contributed to an erosion in the credibility in an overvalued exchange rate with which the authorities persevered. The exchange rate began to fluctuate more widely within the broad band. During 1994, the loss of confidence was evident in capital flight which, in the face of the commitment to the fixed exchange rate, led to a massive loss of reserves. Ultimately, in December 1994, with a depletion of reserves of US $ 22.5 billion over the year the exchange rate was no longer defensible. The exchange rate band was widened by 15 per cent which only served to precipitate the crisis. Selling pressure on the Peso rose sharply and when the authorities exhausted reserves in trying to hold on to the new floor, the Peso was allowed to float. The float, however, did not immediately reverse expectations and it was not until February 1995 that the vicious circle was broken with the Standby arrangement with the IMF. In March 1995, an adjustment program was launched with a relatively free float with no intervention in the foreign exchange market as an integral element. The external value of the Peso is now determined in the inter bank market by the forces of demand and supply.

2.68 In the case of Indonesia, in 1978 the link with the dollar was severed with the central bank setting the middle rate by using the basket of currencies of Indonesia's major trading partners. A one per cent band was set on either side with the central bank clearing the market at the intervention rate. Recently, the intervention band has been widened to 4 per cent on either side.

2.69 In the case of Malaysia, intervention through the U.S. dollar kept the ringgit relatively strong *vis-a-vis* the U.S. dollar prior to 1984. The ringgit was subsequently allowed to move freely against the U.S. and Singapore dollars. This led to a sharp depreciation of the ringgit which contributed to gains in international competitiveness. The capital flows have been dominated by foreign direct investment mostly flowing into the tradeable sector. By aggressive sterilised interventions in the foreign exchange market, the authorities have been able to prevent any marked real appreciation except for a brief episode in 1994.

2.70 Since 1984, the Thai baht has fluctuated in a very narrow range against an undisclosed basket of currencies. The exchange rate is fixed on a daily basis by the Bank of Thailand through the Exchange Equalisation Fund (EEF). The EEF determines the mid-rate for the US dollar exchange rate and at this rate the central bank stands ready to buy or sell foreign exchange from and to commercial banks.

2.71 In the Philippines, in 1984 the exchange rate was allowed to float. The foreign exchange surrender requirement was terminated and allocations of foreign exchange by the central bank were abolished. No margins are maintained in respect of exchange transactions and the exchanae rate is determined on the basis of demand and supply in the exchange market. The authorities intervene when necessary to maintain orderly conditions in the exchange market. Sizeable nominal depreciations in 1990, 1991 and 1993 have been followed by modest appreciations since 1994

2.72 In Korea, under the market average exchange rate system introduced in 1990, the Won/US dollar exchange rate in the inter-bank market floats within a range centred around the previous day's weighted average spot rate. The daily exchange rate fluctuation band was widened on five occasions, most recently in December 1995, when it was increased to +/- 2 1/4 per cent. On a day-to-day basis, the Won has tended to vary marginally within the band. Foreign exchange banks are permitted to enter into forward exchange contracts with their customers provided that there is a bonafide underlying commercial transaction .

2.73 Consequent upon the imposition of economic sanctions on South Africa in January 1985, exchange control were imposed on capital transfers by non residents. A financial Rand i.e., dual exchange rate system was reintroduced. Inflows and outflows on the capital account were effectively regulated by the financial Rand. The financial Rand mechanism was meant to insulate the official forex reserves from non resident capital withdrawals. In March 1995 the financial Rand was abolished and a unified exchange rate system came into existence.

2.74 In New Zealand the move to capital account convertibility in 1984 was preceded by a devaluation of 20 per cent and a floating of the New Zealand dollar. As a result, the Reserve Bank effectively withdrew from the foreign exchange market, apart from discretionary trading associated with meeting the government's foreign exchange requirements on current account and minor transaction for market testing. It was felt that the float would ensure that the exchange rate does not again depart from its equilibrium level for long periods. This would enable maintenance of overall external balance in the medium term. It was also expected to improve resource allocation since the market value of the exchange rate and not the administratively determined value, is now used in private sector decision making. Again, changes in international competitiveness and in terms of trade could be signaled more rapidly to domestic producers and exporters' profitability should not be adversely affected by an inappropriate rate. Furthermore, it was felt that the float will also give a greater independence to monetary policy by the linking of monetary, fiscal and exchange rate policies, together with other policies for structural change. In addition to the resource allocation and monetary policy effects, it was felt that a floating exchange rate would allow greater control over the Government's external debt and would remove the possibility of speculators securing large windfall gains. In the latter half of the eighties, capital inflows caused the currency to appreciate in real effective terms. While the real appreciation moderated in the early nineties, upward pressures have reemerged since 1994.

Balance of Payments

2.75 In general, the selected countries have approached capital account liberalisation by using

resultant capital inflows to strengthen the balance of payments the exceptions being Thailand and Mexico.

2.76 In Chile, after a period of unsustainable current account deficits and an explosive increase in external debt up to the early eighties, the authorities took steps to hold the current account deficit within sustainable limits. The current account deficit narrowed steadily from 1985 onwards, turning into a small surplu,,s of 0.2 per cent of GDP in 1995. Capital inflows were absorbed into the reserves in the second phase of liberalization and at the end of 1995, the reserves stood cover for 11 months of imports.

2.77 In Argentina, in the period 1992-95, the surge in capital inflows was accommodated by an expansion in the current account deficit to aroun'd 3 per cent of GDP. Inspite of the expansion in the current account deficit the large capital inflows allowed for a rebuilding of the losses of reserves which had occurred until 1989. Since 1990 there was a steady accretion to the reserves which stood cover for 9.5 months of imports by the end of 1995.

2.78 In Mexico, the reforms launched in the wake of the debt crisis of 1982 turned the current account deficit into a surplus. Thereafter, however, the current account deficit reappeared and began to widen reaching an unprecedented level of 8 per cent of GDP in 1994. The behaviour of foreign exchange reserves have been erratic with periods of build up followed by large drawdowns. At the end of 1995 the reserves stood cover for 4.3 months of imports.

2.79 The weakness in Indonesia's balance of payments at the time of the institution of capital account convertibility was strengthened during the seventies by the oil boom. Despite the widening of the current account deficit to a little below 3 per cent of GDP during the period, international reserves were built up almost continuously. The high order of deficits witnessed in the first half of the eighties moderated in the second half as a result of prudent macro economic policie's and the restoration of export competitiveness. Over the eighties, the stock of external debt rose more than three fold to US $ 67 billion in 1990 and further to US $ 100 billion in 1996. The current account deficit widened again in the nineties under the pressure of domestic demand to around 3 per cent of GDP. The import cover of reserves has hovered around 4 to 5 months.

2.80 In Malaysia, in the early eighties, expansionary fiscal policies led to a large widening of the current account deficit to a peak of 12 per cent of GDP in 1984. Thereafter, although the current account deficits declined turning into surplus of 8 per cent of GDP in 1987, external debt rose to around 60 per cent of GDP. The reserves declined up to 1984 after which they began rising steadily. In the nineties, there has been a widening of the current account deficit which reached 8.3 per cent of GDP in 1995. Capital flows have been strong; however, the expanding current account deficit absorbed the capital flows necessitating a drawdown of reserves which at the end of 1995 were equivalent to less than 4 months of imports.

2.81 In Thailand, strong real growth has spilled over onto large current account deficits which in turn enabled capital inflows to meet the needs of growth. Over the eighties, weak external demand, reliance on imported petroleum, the fixed exchange rate and rising inflation were reflected in large current account deficits. Adjustment measures restored export competitiveness while imports declined. In 1985, the current account deficit turned into a surplus of one per cent of GDP. Thereafter, the current account deficits have been widening, exceeding 8 per cent of GDP in 1995. This has resulted in the external debt rising to 50 per cent of GDP. Since 1987 there has been a steady accretion to the reserves which presently equals a little over six months of imports.

2.82 Korea has adopted a cautious approach to the balance of payments. Large current account deficits in the early eighties turned into surpluses in the late eighties on the strength of export growth. In the nineties, current account deficits have reappeared but they have been contained at below 2 per cent of GDP. Net capital flows have been used to build up the reserves which stood at US $ 32.6 billion or three months of imports at the end of 1995.

2.83 In the Philippines, the current account deficits have ranged between 2 to 6 per cent in the

nineties, enabling the absorption of capital flows which have averaged around 6 per cent of GDP. The capital flows have allowed the import cover of reserves to be preserved at around four months of imports.

2.84 Prior to 1984, serious and persistent current account deficits characterised the New Zealand economy reflecting internal imbalances. After the implementation of reforms in 1984 there has been a conscious attempt to reduce current account deficits to sustainable levels. Capital flows have been relatively modest with net outflows in the early nineties. As a result, the reserves have covered a little less than four months of imports during the nineties.

Timing and Sequencing of CAC in Selected Countries

2.85 Among the selected countries, Chile, Malaysia, Thailand, Korea and Mexico approached the liberalisation of capital transactions in a gradual, phased approach, along with broader financial sector reforms, and macro economic policies were oriented to establishing the preconditions for attaining CAC. In Mexico, however, financial sector reform occurred late in the process. Indonesia represents an unusual example of establishing capital account convertibility early before the financial sector reform and the current account liberalisation occurred at a late stage in the process.

2.86 In countries such as New Zealand, the Philippines, Argentina and South Africa, the process of liberalising the capital account was relatively rapid and the removal of capital controls provided the momentum for the entrenchment of preconditions such as fiscal consolidation, financial sector reform and the pursuit of inflation control. While Argentina, South Africa and New Zealand established current account convertibility well before opening up the capital account, the Philippines accepted the obligations of Article VIII of the IMF's Articles of Agreement only in 1995. The South African experience has been marred by exchange market turmoil so that while measures to liberalise inflows have been put through, the elimination of controls on residents' outflows has had to be postponed.

2.87 While episodes of financial crash in the Southern Cone in the early eighties and fears of instability in the financial sector led to a gradual approach, the experience of the nineties indicates that some countries have been able to achieve a rapid opening of the capital account without damage to the financial system. What appears important is the timing of the capital account opening relative to pre-requisite institutional and policy measures.

2.88 As regards sequencing of measures of capital account liberalisation, the preferred approach across countries has been to relax restrictions on inflows by non-residents and related outflows before removing restrictions on capital outflows by residents. Argentina and New Zealand moved to CAC in a rapid manner and over a short period of time, similar to the approach of several developing countries in the nineties.

2.89 In Chile, by 1980, the capital account was completely open to nonresidents. Commercial banks, however, continued to be prevented from taking net positions in foreign exchange. By 1981, limits on investments by banks in equity abroad were raised and they were allowed to open branches abroad. Banks were allowed to take positions in the foreign exchange market with the maximum exposure limited to their capital and reserves. In response to the crisis, during the period 1982 to 1989 there was a reimposition of capital controls. Since 1990, the opening of the capital account has once again progressed gradually with liberalisation somewhat faster on outflows than on inflows. Residents were allowed to make investments abroad. Commercial banks were allowed to invest abroad up to 25 per cent of their foreign exchange deposits. Capital repatriations were liberalised in 1992. Domestic commercial banks were authorised to grant trade credits to other Latin American countries and the proportion of export proceeds exempted from surrender requirements was raised. Furthermore, measures were adopted to moderate capital inflows by the imposition of a stamp tax, non-remunerative reserve requirements and size restrictions and rating requirements for Global Depository Receipts issued by residents.

2.90 In Argentina, a significant degree of capital account liberalisation was undertaken in the late seventies but there was substantial back tracking in the early eighties. Argentina once

again initiated a liberalisation of capital transactions in 1989 and completed a rapid transition to full convertibility in 1991 with the introduction of a Currency Board (Annexure III.8).

2.91 Mexico had the tradition of a relatively open capital account for residents co-existing with quantitative restrictions on imports. Following the crisis of 1982 there was a reintroduction of capital controls. Subsequently, there was a very gradual process of liberalisation of the capital account. Several exchange controls were relaxed and restrictions on foreign direct investment were eased in 1989. Some controls on short-term capital flows were retained. With the exception of financial institutions located in the areas bordering the United States, bank deposits denominated in foreign currencies were not allowed in the domestic financial sector. At present outward direct investment, acquisition of real estate abroad by residents and issue of foreign currency denominated securities by residents are freely allowed.

2.92 In Indonesia, while the trade regime was marked by strong protection, by 1979 there were no limitations on inward remittances of capital. Both residents and non residents could hold foreign currency deposits with banks and a 15 per cent reserve requirement was applicable to such foreign currency liabilities with no such requirement for borrowings of non bank financial institutions and private companies. Entry barriers to the banking system were removed to allow greater participation for foreign banks and off-shore banking restrictions were removed. The ceiling on foreign borrowings by banks was removed and replaced by net open position ceilings linked to capital. The amount of short-term borrowings overseas by banks was restricted to 30 per cent of capital. In 1994, restrictions on foreign investment in the form of domestic partner requirement, minimum size requirement etc., were removed.

2.93 Malaysia's approach to capital account liberalisation has been gradual. In the seventies, foreign investment, both inward and outward were allowed under an approval procedure. Certain capital controls were relaxed in 1983 and commercial banks could approve payments to non residents without limits. In 1987, foreign currency loans from non residents up to certain limits were freed from authorisation and residents were no longer required to obtain prior approval to invest abroad subject to certain conditions on their domestic loan liabilities. Furthermore, residents could freely make remittance to non-residents against the purchase of shares listed in the stock exchanges as well as against immovable property located in Malaysia. In response to strong capital inflows and exchange market turmoil, controls on inflows were imposed in January -February 1994. They comprised (i) a ceiling on foreign liabilities of banking institutions other than those related to trade and investment; (ii) a prohibition on residents against selling short-term monetary instruments to non residents; (iii) an obligation for commercial banks to deposit with the central bank the ringgit funds of foreign banking institutions (vostro accounts of non resident banking institutions) in non-interest bearing accounts; (iv) a prohibition against all non-trade related swap transactions and outright transfers on the bid side with non residents; (v) a prohibition on sale of short-term private debt to foreigners; and (vi) imposition of maintenance charges on non-interest bearing foreign deposits. When the exchange rate stabilised, these controls were removed gradually and completely lifted by August 1994.

2.94 In Thailand, the liberalisation of capital transactions began with foreign investments and off-shore loans. In 1991, capital transactions like repatriation of investment funds and repayment of loans were liberalised and could be effected without limit. Resident investors were allowed to freely transfer up to US $ 5 million abroad for direct investment. Direct investment abroad below US $ 5 million do not require prior authorisation. Remittances to Thai emigrants with permanent residence permits abroad are allowed up to US $ 1 million per person from the emigrants' personal assets. Remittance of funds abroad between relatives were also allowed up to US $ 100,000 per person per year.

2.95 In the Philippines, the sequence of liberalisation began in 1984 with the termination of the foreign exchange surrender requirements. Limits on banks' holdings of foreign exchange were abolished in August 1985. In June 1991, a major step was taken to encourage foreign investment, with the passage of the new Foreign Investment Act. Under this Act, foreign nationals were allowed full ownership of export and domestic market enterprises except for

those on three negative lists such as foreign investments in defence-related activities and in those detrimental to public morals and health.

2.96 In the Philippines, inflows are free except in banking and specific sectors defined in the Foreign Investment Act of 1991. Outward investment is subject to prior approval by the Central Bank only if it exceeds US $ 6 million per investor per year and is funded by purchases of foreign exchange from the banking system (this limit set at US $ 1 million in 1992, was raised subsequently to US $ 3 million and further to US $ 6 million in November 1994). In February 1995, the minimum allowable oversold foreign exchange position of commercial banks was raised from 5 to 10 per cent of unimpaired capital, while the maximum overbought position was reduced from 25 to 20 per cent.

2.97 In New Zealand, relaxation of capital controls were rapid and extensive. In October 1984, limits on foreign exchange dealers' holdings of spot foreign currency balances and limits on private overseas borrowings were relaxed. Overseas owned companies operating in New Zealand were allowed unrestricted access to capital market. Domestic financial institutions were allowed to borrow more freely overseas to fund their day-to-day operations. In December 1994, all exchange control regulations were effectively removed. In August 1995, the Overseas Investment Amendment Act was enacted to streamline the processing of applications for FDIs by bringing all controls under one regime. Under the Act, only light screening of proposals is required. Non residents are freely permitted to acquire land.

2.98 In South Africa, the unification of dual exchange rates was supported by the announcement of measures of capital account liberalisation, which virtually ended capital controls on non residents. Contrary to the Plan, the relaxations could not be carried further following a run on the Rand. South Africa postponed the elimination of controls on residents' capital outflows. Subsequently, the following exchange control relaxations were announced in March 1997. (i) South African corporates are allowed to transfer up to R 30 million from South Africa to finance approved investments and South African corporates with projects abroad are permitted to borrow abroad. (ii) South African corporates are permitted to invest a percentage of their assets abroad for portfolio investments. (iii) Qualifying South African institutional investors were permitted to invest offshore up to 3 per cent of their inflow of funds in the previous calendar year. Similarly, in 1997 offshore investment of up to 3 per cent of the net inflow of funds for the calendar year 1996 would be permitted, subject to an overall limit of 10 per cent of total assets. Additionally, subject to the overall limit of 10 per cent of total assets, an extra 2 per cent of the net inflow of funds for the calendar year 1996 could be invested in securities on stock exchanges in certain countries in southern Africa. (iv) From July 1, 1997 registered tax payers in South Africa would be permitted to invest a limited amount of capital abroad. Such persons may alternatively hold foreign currency balances with banks in South Africa within a defined limit. (v) US $/Rand futures are being introduced in the South African Futures Exchange. Participation would initially be restricted to non residents and authorised dealers in foreign exchange. Residents would be allowed access only through authorised dealers. (vi) Documentation requirements for forex transactions are being significantly curtailed for transactions of R 40,000 or less as against R 2,000 earlier. This is expected to reduce some 60 per cent of the workload associated with implementation of exchange control requirement.

2.99 As part of a gradual and cautious approach towards capital account convertibility, Korea has drawn up, in June 1993, a detailed blue print encompassing capital transactions and financial markets involving three distinct stages (Annexure III.9).

Developments Following Liberalisation of Capital Accounts

2.100 The initial impact of the relaxation of capital controls has, in general, been reflected in the balance of payments. While the elimination of controls on inflows has expectedly resulted in large positive entries in the capital account of the balance of payments, the elimination of controls on outflows supported by appropriate financial policies, far from putting a pressure on the balance of payments has generated confidence and drawn a further surge in capital inflows. Apart from initial attempts of capital account liberalisation in Chile, Argentina and Mexico which were against the backdrop of inconsistent macro economic policies and weak financial systems, all.. the selected countries which took steps towards

CAC recorded overall improvement in the balance of payments. Argentina reversed a long period of overall deficits to record large overall surpluses in 1992 and 1993. It was only in the fall out of the Mexican crisis that overall deficits reemerged in the Argentine balance of payments in 1994 and 1995. For Mexico, the impact of capital account liberalisation was equally dramatic. Overall deficits recorded since 1982 were reversed into large surpluses immediately after capital account liberalisation in 1989, and resurfaced only in the face of the crisis of 1994. In Indonesia, the experience has been uneven; however, since 1989 strong capital flows have ensured consistent surpluses in the overall balance of payments. A similar experience is recorded for the Philippines since 1991. Malaysia has had a history of buoyant capital inflows which turned into surges since 1989. The overall balance moved into surplus reaching a peak of US $ 11.3 billion in 1993 before turning into a deficit in the following year, reflecting controls on capital inflows imposed in the wake of exchange market turmoil. Thailand has recorded overall surpluses since 1984 and since 1988 these surpluses were large. For Korea, large surpluses in the overall balance of payments have been recorded over the eighties especially in the latter half. Since 1992, capital inflows have resulted in massive overall surpluses which peaked at US $ 7.7 billion in 1995. New Zealand stands out as an exceptional case where overall deficits have been consistently recorded in the balance of payments except in 1995. In South Africa, a brief period of overall surpluses was reversed in 1993 when South Africa returned to the international economic mainstream. In the following years there was a resumption of strong capital inflows which generated large surpluses in the overall balance of payments. In early 1996, inability to cope with capital inflows ultimately turned into a confidence problem leading to run on the Rand.

2.101 The response to capital inflows in the wake of capital liberalisation can be broadly divided into two categories. Countries like Malaysia, Mexico, the Philippines, Thailand and South Africa expanded current account deficits to absorb the inflows. Of these countries, Malaysia, the Philippines and Thailand used the resulting inflow of external resources to supplement domestic resources and raise gross investment rates. Gross investment rates tended to decline in Mexico -and South Africa which was indicative of the use of external resources to boost consumption. In Mexico and the Philippines, rising current account deficits became unsustainable and had to be corrected in 1995. Among the second group of countries, current account deficits either declined (Chile, Korea) or were run at historical levels (Argentina, Indonesia, New Zealand). Argentina underwent a correction in the current account deficit in 1995. The current account deficits were expanded in Indonesia and New Zealand in 1995. For the second group of countries, however, gross investment rates trended upwards or were maintained, reflecting the relatively large reliance on domestic resources in preference to external resources.

2.102 Countries which did not expand current account deficits in relation to capital flows recorded accretions to international reserves (Argentina, Chile, Indonesia, Korea and New Zealand). While Argentina and Chile increased the import cover of reserves, Indonesia, Korea and New Zealand maintained the import cover of reserves at historical levels, reflecting the progressive liberalisation of the access to imports, spurred by capital account liberalisation. Countries such as Malaysia, Mexico, the Philippines, Thailand and South Africa which had expanded current account deficits to contend with the capital flows also experienced build up in reserves which was clearly indicative of the large volume of capital flows drawn by liberalisation programmes. Mexico and Malaysia reduced the import cover of reserves to accommodate import liberalisation while Thailand and South Africa increased the import cover of reserves. In the Philippines, the reserves/import ratio was maintained at historical levels .

2.103 Countries which did not expand current account deficits to absorb capital flows (Argentina, Chile, Indonesia, Korea) instead brought about a reduction in debt and in debt servicing. For countries which expanded current account deficits, Mexico and Thailand recorded accretions to debt and an uptrend in debt service ratios. In Malaysia and South Africa, debt service ratios were held stable.

2.104 While the selected countries experienced real appreciation in the wake of capital account liberalisation, nominal depreciation was in most cases insufficient to correct for overvaluation of the currencies. In Chile, Korea, Malaysia, the Philippines, Thailand and

South Africa nominal exchange rates, in fact, appreciated. In Indonesia and New Zealand steady nominal depreciations were recorded. Substantial nominal exchange rate corrections took place in the case of Mexico.

2.105 As regards growth performance, all selected countries with the exception of Mexico witnessed either acceleration in real growth rates or maintained high growth profiles. Argentina, Chile and South Africa succeeded in reversing earlier periods of declines in real growth.

2.106 All the selected countries recorded perceptible reduction in inflation, the strongest corrections being recorded in Argentina, Chile, Mexico, the Philippines and South Africa. By 1995, with the exception of Mexico which faced the pass through of a large nominal devaluation in 1994, all the selected countries had moved to single digit inflation rates.

Lessons from the International Experience with CAC

2.107 Profiles of the countries which were considered in the Report reveal a wide variety of experiences with the evolution of capital account liberalisation. Country experiences differ depending on the state of macro economic conditions prior to undertaking liberalisation, the pace and success in establishing the preconditions (such as fiscal consolidation, inflation control, financial sector reforms, exchange rate policy, balance of payments and adequacy of reserves) and the timing and the sequencing of measures of capital liberalisation. These factors have interacted in determining successes and failures, the realisation of gains of an open capital account and the episodes of back tracking embodied in the reimposition of controls. Each experience in many ways has been unique and specific to the country situation. Under these conditions, generalisations are difficult and run the risk of glossing over important facets of each evolutionary experience. Nevertheless, these experiences offer an opportunity to assess whether or not particular approaches or aspects thereof are suitable for adoption in the Indian context. In this sense, lessons can be drawn regarding the appositeness of the move to CAC on the basis of the prevailing macro economic situation, the state of the preconditions and the prospects of entrenching them as the process of CAC gathers momentum and the stage of progress of the overall reform process. In particular, a careful assessment of the international experience with CAC provides some useful insights into the sequencing of specific measures of relaxation of capital controls.

2.108 Drawing from the lessons of international experience, the Committee noted that in general, countries which initiated the move to CAC on the basis of strong fundamentals were able to modulate the pace of instituting CAC without undertaking large and dramatic shifts in the stance of macro economic policies. Furthermore, these countries were less vulnerable to backtracking and the reimposition of controls in the face of exogenous shocks. In fact, the pursuit of reforms in other areas by these countries instilled confidence in the process of opening up of the capital account. Countries with weak initial conditions adopted drastic macro economic policies to facilitate the move to CAC. Some of these countries had to face interruptions and reintroduction of capital controls in the evolution of CAC. Nevertheless, rapid moves to CAC did not inevitably lead to failure if prerequisites in terms of institutional arrangements and policy measures were assiduously pursued.

2.109 While most countries considered a strong balance of payments position as a necessary precondition for the move to CAC, in the view of the Committee this was not by itself sufficient and the introduction of CAC sparked off capital flows which strengthened initially weak balance of payments. While some countries responded to capital flows by expanding current account deficits, this led to an accretion in indebtedness and preemption of current receipts by debt servicing. Countries universally built up reserves. Based on country experience, therefore, the Committee felt that an adequate level of reserves emerged as a precondition although in view of problems of monetary and exchange rate management, several countries such as Indonesia, Korea, New Zealand and the Philippines took into consideration the cost of holding reserves

2.110 In the Committee's view, strengthening of the financial systems emerged as a high priority precondition across countries. The review of the banking crises in the countries studied

showed that a major factor behind banking crises in these economies was the volatility in interest rates and real exchange rates induced by surges in capital flows. Furthermore, capital flows encouraged lending booms, unsound financing and credit risks which precipitated the crises. Fixed exchange rates led to banks' borrowers maintaining large unhedged foreign liabilities which came unstuck when the exchange rate came under pressure thus exposing the borrowers and eventually the banking system to severe shocks. Appropriate monetary and fiscal policies help to contain volatility induced by capital flows and thereby forestall banking crises. Strengthening of prudential regulation and bank supervision is necessary before liberalising the capital account.. "Fit and proper" tests should accompany freer entry and exit and privatisation, failing which bad debts can accumulate. Good accounting, provisioning and disclosure practices are a *sine qua non* of a strong banking system.

2.111 The Committee recognised from the survey of international experience that fiscal consolidation emerged as another important precondition for CAC among all countries. In South Africa and the Philippines, the move to CAC was rendered fragile and the fisc operated as a drag on the process of liberalisation. In New Zealand, fiscal consolidation went hand in hand with a mandate for transparency and accountability. This, in the Committee's view was important as it intended to ensure that fiscal laxity did not occur in the guise of quasi-fiscal operations. The Committee noted that an inevitable consequence of capital account liberalisation was a tendency for a real appreciation of the exchange rate generally brought about by surges in capital flows. Despite restructuring of exchange rate regimes to endow them with flexibility to cope with capital flows, most countries could not undertake sufficient nominal exchange rate corrections in the face of overvaluation. While countries in the Asian region attempted to persevere with an undervalued exchange rate supporting a current account objective, intervention along with sterilisation failed to prevent real appreciation in the face of capital inflows. Consequently, intervention bands had to be widened from time to time.

2.112 As regards sequencing, with the exception of Indonesia and Argentina, current account liberalisation and financial sector reform preceded the opening of the capital account. In the specifics of capital account liberalisation, the Committee recognised that restrictions on inflows and related outflows by non residents were removed first, followed by the relaxation of restrictions on outflows by residents. Among residents, corporates and non banks usually received preferential treatment followed by banks and finally by individuals. Most countries preferred to liberalise long term flows before short term flows. Finally, an important lesson from the international experience, in the view of the Committee, is that most countries maintained some controls on capital flows during the period of transition to CAC.

Chapter 3

The Establishment of Preconditions/Signposts for Capital Account Convertibility in India

3.1 Taking into account the lessons from the international experience outlined in the preceding Chapter and the specifics of the Indian situation, this Chapter sets out the preconditions/signposts which are a necessary concomitant in the move towards CAC in India.

3.2 The firm establishment of the preconditions need to be viewed as processes rather than as one time indicators. A phased introduction of CAC implicitly provides for taking stock of the degree of success achieved in the establishment of preconditions. Based on the authorities' perception of macro economic developments, contemporaneous with the attainment of these milestones, the timing and sequencing of the move to CAC would need to be modulated i.e., speeded up or delayed depending on the success or failure in the attainment of preconditions. It is under this framework that the Committee has attempted to outline the road map of CAC.

Need for Preconditions/Signposts

3.3 The present macro economic environment in India ' is characterised by signs of resilience and strength. As set out in Chapter 1, structural reforms undertaken in the wake of the payments crisis of 1990-91 have led to a strong revival of growth in the economy. The recovery has been accompanied by distinct signs of stability and the momentum of growth of an average of 7 per cent in the past three years, appears sustainable. The gross fiscal deficit of the Centre has declined from 8.3 per cent of GDP in 1990-91 to 5 per cent in 1996-97, the lowest level in decades. The rate of inflation on a year-on-year basis has dropped from a high of 16 per cent in September 1991 to below 6 per cent in early May 1997. The current account deficit in the balance of payments has narrowed from the then unsustainable level of 3.2 per cent of GDP in 1990-91 to a little over one per cent in 1996-97. Between 1990-91 and 1995-96 there has been a reduction in the external debt - GDP ratio from 30.4 per cent to 28.7 per cent and in the debt service ratio from 35.3 per cent to 25.7 per cent. Furthermore, there has been a healthy build up of foreign exchange reserves to US $ 26.4 billion by the end of March 1997 which is equivalent to 7 months of imports. Despite signs of fragility and incipient weaknesses in the financial system, reforms launched in the financial sector have begun to yield positive results. Interest rates have been progressively deregulated and reserve requirements substantially reduced to enable the banking system to function competitively. At the same time, prudential accounting norms introduced since 1992-93 have been strengthened. As a result, 19 out of 27 public sector banks have attained the benchmark of 8 per cent capital adequacy by the end of March 1996. Furthermore, non performing assets (NPAs) of public sector banks as a proportion of total advances declined from 23.6 per cent in March 1994 to 17.3 per cent in March 1996 and are expected to show a further decline to 13.7 per cent in March 1997.

3.4 Based on an assessment of macro economic conditions, the Committee is of the considered view that the time is now apposite to initiate a move towards CAC. The Committee, however, recognises that the initial conditions do contain certain weaknesses, particularly, the structural drag in the fiscal accounts and the quasi-fiscal deficit, the size of non performing assets in the banking system, the persistence of visceral aspects of financial repression in terms of high cash reserve requirements and the vestiges of administered interest rates. While exchange rate management has moved towards a market determined system, further refinement of the policy would be required in the context of a move towards CAC. The entrenchment of preconditions can be achieved in the Indian context only over a period of time. The Committee, therefore, recommends that the implementation of CAC be spread over a three year period 1997-98, 1998-99 and 1999-2000. The institution of measures contemplated for each phase should be based on a careful and continuous monitoring by the authorities of the ongoing entrenchment of preconditions/ signposts which should be considered in the nature of traffic signals in the road map for CAC. The Committee stresses that implementation of measures towards CAC should be sequenced along with the authorities making an assessment of the progress towards the attainment of the preconditions/signposts stipulated for the relevant year and depending on this assessment the implementation of measures could be accelerated or decelerated.

3.5 In the view of the Committee, the initial impact of a move towards CAC could well induce large capital inflows which in turn could result in real appreciation of the exchange rate. The financial system would be exposed to external competition and could face difficulties. In this context, it is necessary that CAC should be preceded by, or at least accompanied with, certain policy actions which help to strengthen initial conditions in the financial system. The phased introduction of CAC could minimise risks of the need to reimpose capital controls. While recognising this, the Committee is of the view that certain overall conditions, not envisaged at the present time, could emerge where reintroduction of capital controls could become necessary, but the strategy set out by the Committee is by and large intended to avoid back-tracking.

Preconditions/Signposts

3.6 As set out earlier, the Committee views the establishment of certain precondition s/signposts as concomitants in the move to CAC and the authorities' perception of the progress achieved in entrenching these preconditions would act as a speed regulator for the evolution of CAC in India. The Committee recommends that fiscal. consolidation, a mandated inflation target

and strengthening of the financial system should be regarded as crucial preconditions/signposts for CAC in India. While the progress in achieving these essential preconditions should be carefully monitored, a few important macro economic indicators should also be assessed on an on-going basis. These are: the conduct of exchange rate policy, the balance of payments and the adequacy of foreign exchange reserves.

(a) Fiscal Consolidation

3.7 The most important precondition for CAC is a stable macro economy including a sustainable fiscal deficit. Accordingly, successful efforts to liberalise the capital account have typically been preceded by a strategy of fiscal reforms which significantly reduces the fiscal deficit and finances the remaining deficit with a minimal recourse to the inflation tax. In this context, a large fiscal deficit even when financed by bond issuances may not be compatible with an open capital account if it undermines the credibility in servicing debt.

3.8 In the Indian context, the Centre's gross fiscal deficit could be used as a summary measure for assessing fiscal performance. It is equally applicable in the federal framework of the Indian economy since a significant part of financing of States' fiscal deficits occurs through Central assistance. More importantly, the Centre's gross fiscal deficit (GFD) highlights the problem of the growing burden of internal debt. At the end of March 1997, total liabilities of the Centre accounted for about 54 per cent of GDP with over one half of the stock consisting of internal marketable debt. Large borrowings of the Centre preempt resources for the rest of the economy with crowding out effects. Furthermore, large market borrowings have kept nominal and real interest rates at high levels, thereby constraining overall economic activity. For 1997-98, gross interest payments of the Centre are budgeted at 44.4 per cent of revenue receipts. The mounting interest burden has prevented the consolidation of revenue deficits while repayment obligations have interacted with interest payments to impose cut-backs in capital expenditures. The Annual Report of the Reserve Bank of India, 1995-96 observed:

> "It, is, therefore, imperative that the growth in interest payments should be arrested over the medium-term through further reduction in GFD/GDP ratio so as to achieve a perceptible decline in the debt-GDP ratio". (Paragraph 4.25)

3.9 Following the move towards market related rates of interest, there has been a significant shortening of the maturity structure of debt. The proportion of loans of maturity below five years accounted for 65 per cent of the Centre's total loans in 1995-96. The shift towards short-term debt has meant an acceleration of repayment obligations thereby accentuating the amortisation burden. The Annual Report of the Reserve Bank of India, 1995-96 notes in this regard that :

> "... the increase in Government debt point to the emergence of debt management problems which have been accentuated by the significant shortening of the maturity structure of fresh issues of Government Securities together with the generally high interest rates being paid on Government paper. Large and persistent deficits would militate against the objective of pursuing growth along with non- accelerating inflation". (Paragraph 7.26)

3.10 The practice of financing the amortisation of Government borrowings out of fresh borrowings is clearly unsustainable and this practice would inevitably result in a crisis. The Tenth Finance Commission has recommended the institution of a Consolidated Sinking Fund (CSF) for the public debt and the Committee strongly endorses this recommendation. While it is sometimes argued that a CSF is not meaningful when there is a revenue deficit as contributions to such a fund would merely increase the revenue deficit, the Committee is of the view that a CSF must be introduced as part of a more transparent fiscal system. The Committee urges 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. The Committee feels that any attempt to achieve fiscal consolidation would not be meaningful if the problem of the repayment of the public debt is not satisfactorily addressed. Hence, the Committee stresses that the institution of a CSF is an important ingredient in achieving the precondition on fiscal consolidation.

3.11 There is an imperative need to work towards a reduction in the GFD. Drawing from the

initiatives taken in the Union Budget for 1997-98, the Committee recommends a reduction in the GFD/GDP ratio from a budgeted 4.5 per cent in 1997-98 to 3.5 per cent in 1999-2000. The reduction in the Centre's GFD should be accompanied by a reduction in the States' deficit as also a reduction in the quasi-fiscal deficit. Any slackening in the pace of fiscal adjustment would render the task of opening up of the capital account fraught with dangers of slippages, rollbacks and reversals of capital flows. The Committee, therefore, regards adherence to the projected track of fiscal consolidation as a critical precondition for CAC.

3.12 Monetary management is often clouded by the monetary authority's concern about the Government's borrowing programme and therefore, the Committee recommends that steps should be initiated to separate the debt management policy from monetary management and to this effect 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. The Committee is of the view that these measures would go a long way towards better fiscal management and also enable vastly improved monetary management which will be necessary in the context of CAC.

3.13 The Committee also recommends transparent and internationally comparable procedures for fiscal accounting which do not blur the true magnitude of the GFD/GDP ratio as also the constituents of the budget as a whole. The financial management regime that has been put in place in New Zealand under the Fiscal Responsibility Act, which is of considerable relevance to the Indian situation, has produced major advances in the transparency and accountability of fiscal policy decisions. The Act specifies that information and policy documents should be made public and establishes statutory accountability for the Government for fulfilling these requirements. In addition, it specifies principles of sound fiscal policy with the intention that any fiscal strategy proposed by the Government can be assessed in relation to these criteria through the information provided. It also provides for more open budgetary processes. The Committee recommends that the Government of India should consider an early introduction of a system of fiscal transparency on the lines of the New Zealand Fiscal Responsibility Act.

(b) Mandated Inflation Rate

3.14 There is an increasing convergence of views among central bankers that an inflation rate in the lower reaches of a single digit is a desired objective. In a number of countries a formal mandate is given to the central bank to contain inflation within the stipulated band. This in turn requires that the central banks be given a greater degree of independence to attain the desired objective. The inflation rate in the OECD countries has averaged less than 3 per cent during 1991-96. In an increasingly integrated and inter-dependent world economy and in the context of a progressive liberalisation of capital flows it will be necessary to break inflationary expectations in India and to put in place a mechanism for attaining an inflation rate not too far out of alignment with inflation rates in the industrial countries. As India moves towards CAC, an unduly high rate of inflation would be destabilising and would inevitably require very high nominal as well as real rates of interest which would adversely affect the overall growth of the economy. If interest rates are kept artificially low, there would be an exodus of capital out of the country.

3.15 India has always prided itself on being a low inflation country in the developing world. With a significant lowering of inflation rates in recent years in both industrial and developing countries, there is an imperative need to keep down the inflation rate in India.

3.16 There are clear advantages in having an explicit inflation target in that it provides a nominal anchor for monetary policy. While the RBI has, for years, advocated a strong line on inflation control, it has not as yet set out a formal demand for a mandate on inflation. The closest it comes to this is in its Annual Report for 1993-94 wherein it is argued :

> "...for a truly effective monetary policy, there must be a clear and unambiguous mandate and the central bank can then be required to be accountable for its actions. There are various viewpoints on what this mandate should be, but in most countries where the central banks have been given a higher degree of autonomy, the mandate has been the achievement of price stability. It is here that there is a need for a broader national consensus before prescribing a mandate for a central bank". (Paragraph

7.77, page 129)

3.17 In the Report on Currency and Finance, Volume 1, 1995-96, the RBI has explained the merits of inflation targeting :

> "...inflation forecasting has all the three attributes of an intermediate target viz. controllability, predictability and early leading indicator of final target i.e. price stability.
> ... Another major advantage is that a joint public commitment of inflation targeting by both the Central Bank and the Government will help in reducing inflationary expectations of economic agents thereby facilitating in lowering and stabilising the inflation rate. This makes the Central Bank as well as the Government more accountable to public scrutiny". (Box V11-1, Page V11-5)

3.18 In the monetary and credit policy announcement of April 15, 1997, it is stated that monetary policy would seek to maintain the expansion in M3 in the range of 15.0 - 15.5 per cent to keep the inflation rate at around 6 per cent in 1997-98. In the context of the move towards CAC, the Committee is of the view that it is necessary to take early and effective measures to evolve a more specific commitment on the inflation rate. The Committee recommends that there should be an early empowering of the RBI on the inflation mandate. There should be a medium-term inflation mandate approved by Parliament and only Parliament should alter that mandate. Once the mandate is given, the RBI should be given freedom to use the instruments at its command to attain the medium-term inflation target. Intensification or withdrawal of public intervention in price formation or a shock in the real sectors could warrant a review of the mandate but there should be clear and transparent guidelines on the circumstances under which the mandate could be changed.

3.19 The Committee recommends that the mandated rate of inflation for the three year period 1997-98 to 1999-2000 should be an average of 3-5 per cent. The Committee emphasizes that such a mandate would necessarily need to provide for greater independence for the RBI which would enable vastly improved monetary management which would be required in the context of CAC.

(c) Consolidation in the Financial Sector

3.20 The Indian financial system needs to be prepared to handle the structural changes that would emerge in the move to CAC. The financial sector in general and the banking system in particular is characterised by certain regulatory and operational constraints and these need to be addressed. The move towards CAC can be undertaken in measured steps commensurate with the strengthening of the financial system. While there are many weaknesses in the financial system which need attention, some of the key constraints are outlined below.

3.21 The banking system continues to face very high reserve requirements relative to international standards. Although measures are already afoot to reduce the reserve requirements in a phased manner, there are macro policy constraints in suddenly bringing them down to internationally acceptable levels without erosion of the effectiveness of monetary policy. It would, however, be necessary to reduce the tax on the banking system by quickly developing other instruments of monetary policy such as open market operations and interest rates.

3.22 In the area of interest rates, a significant element of deregulation has already been implemented and there is a need for removing the remaining areas of interest rate regulations. The main constraints on interest rates relate to market regulation and segmentation which stunt the development of an integrated financial market. Moreover, it is important that interest rate flexibility should emerge in the very near future and the transmission of interest rate signals needs to be more effective. The Committee recommends that interest rates should be fully deregulated in 1997-98 and there should be total transparency to ensure that there are no formal or informal interest rate controls -

3.23 The non performing assets (NPAs) of the public sector banks, estimated at 13.7 per cent of the total advances as at the end of March 1997, are still high. Quite clearly the load of such a level of NPAs cannot be borne by the banks if the financial system is opened up to forces of international competition. The Committee recognises that the strengthening of the financial system is the single most important precondition to the move to CAC. Drastic measures

should be taken to reduce the level of NPAs Noting the systemic dangers of some of the weak banks growing at rates faster than the system, the Committee recommends that the weak banks should be converted into what are called 'narrow banks'; the incremental resources of these narrow banks should be restricted only to investments in Government securities and in extreme cases of weakness not only should such banks not be allowed to increase their advances but there would need to be a severe restraint on their liability growth. The Committee recognises that such measures are unavoidable if the financial system is to be safeguarded during the move towards CAC.

3.24 The Committee recommends the following sequencing and time frame for signposts which should be attained in relation to CRR and NPAs, as part of a progressive move towards CAC.

	Present Level	**1997-98**	**1998-99**	**1999-2000**
i) Gross NPAs of the Banking sector (as a percentage of Total advances)	13.7* (as of March 1997)	12.0	9.0	5.0
ii) Average effective CRR for the banking system	9.3 (as of April 1997)	8.0	6.o	3.0

* Tentative estimates for public sector banks.

3.25 It is estimated that with progressive reduction in CRR from the present average effective level of 9.3 per cent to 3.0 per cent and decline in NPAs from 17.3 per cent in 1995-96 to an estimated 13.7 per cent in 1996-97 and further to 5 per cent by 1999-2000 and with other costs/returns remaining unchanged the spreads available to the banking system would increase by approximately 1.8 percentage points. Taking into account that there would be a squeeze on spreads as a result of financial liberalisation, the successful implementation of these signposts would result in a Return on Assets (ROA) comparable to the internationally acceptable level of 1.0 per cent. These preconditions are not easily attainable but the Committee would emphasize that attainment of the signposts of reducing NPAs to 5 per cent and CRR to 3.0 per cent and complete deregulation of interest rates is an ineluctable necessity if there is to be a meaningful move towards CAC and therefore the Committee recommends that these three measures should be central policy objectives in the ensuing three years. Analogously, the financial institutions should also be made to function with a targeted mandate to reduce the quantum of NPAs within a time -bound Programme.

Monitoring of Related Indicators

3.26 While the process of fiscal consolidation, the mandated inflation rate and financial sector preconditions need to be considered as crucial preconditions/signposts determining the move towards CAC as well as the timing and sequencing of measures, it is necessary to monitor certain important indicators, such as the exchange rate policy, the current account balance and the adequacy of foreign exchange reserves, with a view to assessing the viability of the country's external sector. These indicators, which would need to be given particular attention, must be regarded as vital attendant variables while determining the appropriate pace and sequencing of CAC.

Exchange Rate Policy

3.27 Exchange rate policy in the context of CAC assumes a role quite different, in both content and character, from that with comparatively lower capital mobility. To the extent CAC integrates both the real as well as the financial sectors with the international economy, the impact of external impulses would be felt more strongly as a consequence of which macro economic variables, both real and nominal, will have to respond expeditiously. With large capital inflows, the exchange rate would appreciate in both nominal and real terms, which would hurt India's international competitiveness. This also engenders larger borrowing

abroad by domestic entities which further appreciates the currency, bringing in its wake more borrowing. A debt-led expansion in economic activity may emerge, but there is always a possibility that either on account of a loss of credibility or when the real appreciation becomes obviously unsustainable or as a result of any unforeseen event, a reversal of the process could take place leading to reversal in exchange market sentiments causing a sudden and uncontrollable spiral of depreciation of the currency. An excessively overvalued exchange rate may trigger capital flight resulting in a crisis. Persistent overvaluation of the currency would militate against viability of the export sector. It would be desirable to evolve a system under which any corrections of the real effective exchange rate (REER) which may be necessary are brought about smoothly to avoid any sudden volatility in the exchange market. While sterilization as an exclusive instrument for dealing with excess liquidity is not feasible, sterilization along with monetary policy measures, relaxation of capital outflows and other measures can be effective. More specifically, in 1997-98, the Government's borrowing programme could be put through without recourse to the monetisation projected in the Budget and thereby, in effect, a sizeable portion of the large inflows can be sterilised quite effectively.

3.28 On the specific aspect of exchange rate policy, the Committee recommends that the RBI should have a Monitoring Exchange Rate Band of +/-5.0 per cent around the neutral REER. The RBI should ordinarily intervene as and when the REER is outside the band. The RBI should ordinarily not intervene when the REER is within the band. The RBI could, however, use its judgment to intervene even within the band to obviate speculative forces and unwarranted volatility. The Committee further recommends that the RBI should undertake a periodic review of the neutral REER which could be changed as warranted by fundamentals.

3.29 The Committee stresses that credibility of the exchange rate policy would be vital in the context of CAC and to this extent there must be transparency in exchange rate policy : (i) the neutral REER i.e., the base period should be announced (ii) the REER Monitoring Band should be declared (Iii) the REER should be published on a weekly basis with the same time lag as the publication of the reserves and (iv) changes in the neutral REER should be made public.

3.30 The exchange rate regime proposed by the Committee would provide greater transparency which would greatly enhance the efficacy of the exchange rate policy by encouraging orderly market behaviour. A Monitoring Band, built around the neutral REER could be expected to provide an environment to the market participants for anchoring their expectations. Also, an element of discretion in intervention by the RBI would be necessary. Ultimately, the RBI would need to use its best judgement in the evolving situation and operate its exchange rate policy as warranted by these circumstances.

3.31 The move towards CAC would logically ensure that the forward premia in the forex market reflect interest rate differentials between overseas and domestic markets. The Committee recommends that as part of exchange rate management greater attention should be focussed on ensuring that the forward exchange markets reflect interest rate differentials.

Balance of Payments Indicators

3.32 Most developing economies rely on global saving to supplement domestic resources to achieve desired levels of investment and growth. Therefore, current account deficits (CADs) are run in the balance of payments as a means of overcoming the domestic resource constraint in the pursuit of growth.

3.33 While the current account subserves the final target of growth, lessons from international experience underscore the need to set prudent limits on expanding CADs. The mirror image of the CAD is the accretion to external liabilities, and as the stock of external debt rises, debt servicing begins to preempt an increasing proportion of current external earnings,. As a result, resources which would have been otherwise available for imports are absorbed by the servicing of debt. The contraction in import purchasing power ultimately retards growth. Thus, an unbridled expansion in the CAD to support growth can lead to the external constraint choking the growth process.

3.34 In the Indian context, the experience of 1990-91 showed that a CAD of 3 per cent of GDP rendered it unsustainable in terms of the availability of financing and triggered off the most severe external payment crises since Independence. The unsustainability of the CAD was reflected in a rising proportion of current receipts preempted by debt servicing and in the reluctance of international creditors to extend new credits or roll over earlier loans to finance the CAD. The debt service ratio soared to 35 per cent in 1990-91. Thereafter, prudent external sector policies to contain the CAD and external debt resulted in a steady decline in this ratio. In this context, the High Level Committee on Balance of Payments (Chairman: Dr. C. Rangarajan) recommended in 1993 that the CAD must be limited to a level that can be sustained by normal capital flows. The High Level Committee then felt that a CAD of 1.6 per cent of GDP could be met through a sustainable level of net capital receipts.

3.35 In view of the growing degree of integration of the Indian economy with the rest of the world, it needs to be recognised that the CAD would need to be varied in the context of the opening of the economy. The size of the CAD which can be sustained without encountering external constraints is thus a function of the degree of openness of the economy which can be defined in terms of the ratio of current receipts (CR) to GDP. The size of this ratio is the crucial determinant of the ability of the economy to make current payments and meet the servicing of external debt. As the CR/GDP ratio rises, it would be possible for the economy to expand the CAD/GDP ratio without rendering the external debt unsustainable.

3.36 For India, the CR/GDP ratio is at present around 15 per cent. This would allow the economy to run a CAD/GDP ratio of about 2 per cent while holding the debt service ratio at around 25 per cent. This configuration. is consistent with the economy's requirement of external resources as well as a sustainable debt servicing burden. The CAD/GDP ratio can be modulated in accordance with the movements in the CR/GDP ratio, so that the debt service ratio gradually declines from the present level of 25 per cent. Accordingly, the Committee recommends that as a broad rule of thumb, over the three year period 1997-98 to 1999-2000, external sector policies should be designed to ensure a rising trend in the CR/GDP ratio from the present level of 15 per cent and the endeavour should be to reduce the debt service ratio gradually from 25 per cent to 20 per cent. The Committee views the decline in the debt service ratio as a necessary concomitant of a sustainable balance of payment position as non-debt liabilities are expected to show a significant increase in the next few years. The CAD/GDP ratio would need to be consistent with the above parameters.

The Adequacy of Foreign Exchange Reserves

3.37 In the context of CAC, an adequate level of foreign exchange reserves is essential to withstand cyclical changes in the balance of payments as well as unanticipated shocks which lead up to reversals of capital flows. Sufficient foreign exchange reserves strengthen the pursuit of a stable macro economic environment and anchors credibility in domestic policies. Furthermore, in recognition of the general acceptance of a stable and transparent exchange rate policy, the adequacy of foreign exchange reserves needs to be assessed in terms of the amount of foreign assets deemed necessary in the context of CAC.

3.38 Defining the adequate level of reserves in terms of a quantifiable norm is difficult and necessarily country- specific, depending on structural aspects of the country's balance of payments, the nature of shocks, the degree of flexibility in the exchange rate regime and access to international capital markets. A rule of thumb which has evolved in the context of developing countries with current account deficits is that foreign exchange reserves should be equal to at least three months of imports at any point of time. Measuring the adequacy of reserves exclusively in terms of imports or payments cover is more useful in a situation where capital flows are strictly controlled. In the context of a move towards CAC, since capital flows would have a more significant effect on the balance of payments, the conventional indicator in terms of import cover does not provide a good measure of the adequacy of reserves.

3.39 In situations where import payments can be advanced or locked into financing facilities due to exchange rate expectations (analogously, export receipts could be delayed or even advanced through recourse to export credit facilities), the simple measure of three months of

imports does not capture the role of expectations and the contingent charge on the reserves. Against the backdrop of the large volume of debt servicing impacting on India's balance of payments , and the lessons of the crisis of 1990-91, the High Level Committee on Balance of Payments recommended that payments liabilities in addition to imports should be taken into account while determining the target level of reserves. In recent years, the Annual Report of the RBI has been monitoring the level of reserves in terms of import cover and debt servicing liabilities. Thus, it may be desirable to have an indicator of adequacy of reserves derived as a combination of import cover, debt servicing and leads and lags.

3.40 Guarding against volatility of capital flows and possibilities of sudden reversals assumes priority in the objectives which are served by holding stocks of foreign exchange reserves. Accordingly, reserve adequacy can be measured in terms of a ratio of short-term debt and portfolio stocks to reserves. In the event of reversal of capital flows, the central bank would be able to prevent a precipitous depreciation of the exchange rate.

3.41 Another measure could be the net foreign exchange assets to currency ratio. In countries which have a Currency Board system this ratio is 100 per cent, while some countries have had a proportionate ratio prescribed by law. In India up to 1956, a foreign securities to currency ratio of 40 per cent was prescribed by law. Subsequently, in the context of the Plans this ratio was abandoned in the mid fifties ostensibly because the authorities wished to have greater flexibility in the creation of currency. With the abandoning of this stipulation in the RBI Act, the floodgates for automatic monetisation were opened up. While a full Currency Board would safeguard against any problems of shortage in foreign exchange there is the attendant problem that the exchange rate would get pegged to another currency and any discretion in policy, however desirable, would not be possible. As a pragmatic policy there are advantages in prescribing under law a minimum net foreign exchange assets to currency ratio which would ensure that an unbridled expansion of currency would not be possible and remedial measures would necessarily need to be put in place long before a balance of payments deficit reaches crisis level .

3.42 As a broad guideline, the Committee recommends that the following four indicators be used in the Indian context for evaluating the adequacy of reserves**:**

(i) Reserves should not be less than six months of imports; this ratio is higher than earlier norms as it would take into account the uncertainties and volatility in capital flows which can arise in the context of a move to CAC. Under this formulation, the foreign exchange reserves would, at present need to be about US $ 22 billion.

(ii) Reserves should not be less than three months of imports plus 50 per cent of annual debt service payments plus one month's exports and imports to take into account the possibilities of leads and lags. On this basis the present requirement would be US $ 24 billion. When more accurate data on leads and lags are available, the requirement for reserves could be adjusted appropriately.

(iii) The short term debt and portfolio stock which is equivalent to 70 per cent of the level of reserves should be. lowered to 60 per cent by using a formulation that incremental short term debt and portfolio liabilities should be accompanied by equivalent increases in reserves which would ensure that this ratio would decline to the desired extent. On this basis the reserves would need to rise from the present level of US $ 26 billion to US $ 31 billion.

(iv) The net foreign exchange assets to currency ratio (NFA/Currency ratio) should be prescribed by law at not less than 40 per cent . The present ratio is 70 per cent and the objective should be to maintain. it around the present ratio. The implication would be that at the present time the stipulation under the proposed ratio of a minimum of 40 per cent would be around US $ 15 billion; under the desired ratio of 70 per cent, the requirement would be a little over US $ 26 billion.

3.43 The advantage of alternative indicators would be that the authorities would have enough safeguards to ensure against any contingency. The Committee therefore recommends that the RBI should use four alternative measures of the adequacy of reserves and in particular it

recommends that a minimum NFA/Currency ratio of 40 per cent be stipulated in the RBI Act to ensure against an unbridled increase in currency without adequate backing of foreign exchange reserves.

Strengthening of the Financial System

3.44 Certain vital preconditions for CAC relating to the financial system have been outlined earlier. These relate to reduction in NPAs, reduction in CRR and complete deregulation of interest rates. A direct fall-out of CAC will be the increasing pressure on the margins of banks arising partly out of greater competition and partly due to the disintermediation process gathering momentum with strong domestic corporates accessing world markets directly. The resultant squeeze on the Return on Assets (ROA) of the public sector banks which was -0.07 per cent in 1995-96 is likely to render the banking system vulnerable. To minimise the impact of such vulnerability it is essential that close attention be given to preparing the financial system for CAC. This section therefore details the recommendations of the Committee for strengthening and developing the financial system in the context of the move to CAC.

(i) Level Playingfield between banks and non banks

3.45 The blurring of the distinction between banks and non banks and the entry of a large number of players in the country's financial markets opens up the obvious question of a level playing field amongst the players. The Committee has made several suggestions in Chapter 4 for removing the restrictions on non banks' participation in the financial markets thereby removing the existing market segmentation. Recently there has been relaxation of the restrictions on FIs' accessing the short-term segment of the market. While the banks are under a tighter regulatory regime, the FIs and non bank entities do not have any CRR and the prudential and supervisory regimes are less exacting than for banks. With the gradual dismantling of barriers, FIs will emerge as universal banks. In view of this, the Committee recommends that a uniform regulatory system needs to be put in place for banks and non banks particularly FIs in relation to prudential norms, market participation, reserve requirements and the interest rate regime. In particular, the Committee recommends that concomitant with a target of reduction in reserve requirements for the banking system, there should be a gradual introduction of reserve requirements on the total liabilities of FIs, and non banks with operations beyond a threshold size should be subject to more exacting reserve requirements than presently stipulated.

(ii) CRR- Treatment for non resident and resident liabilities

3.46 The present system of maintenance of cash reserve requirements (CRR) exempts a sizeable segment of liabilities of banks, or puts them on a concessional footing. The focus should be on reducing the average effective CRR. In particular non resident liabilities should be brought within the ambit of CRR; a step to this effect has already been initiated in the monetary and credit policy announcement of April 15, 1997. In the context of a move towards CAC, the Committee recommends that reserve requirements on banks' non resident liabilities and overseas borrowings should be at least on par with those on domestic liabilities. Furthermore, as one of the instruments for moderating capital inflows, the RBI should use the instrument of CRR to impose higher reserve requirement on non resident liabilities including overseas borrowings by banks. The graduation of reserve requirements could also reflect the policy preference as between different schemes of non resident deposits. To the extent financial institutions and other non bank entities have non resident liabilities, the Committee recommends that the question of reserve requirements for such entities should be considered in totality to ensure a level playing field between banks and non banks.

(iii) Risk Management in banks and non banks

3.47 As the economy gets more integrated with the world economy, the volatility of interest rates/exchange rates in international markets would get transmitted to the domestic markets and it is necessary to ensure that the domestic financial system is sufficiently equipped to withstand these risks. The banks are yet to put in place adequate asset liability management

(ALM) systems even for the risks on the rupee books and inculcate treasury culture which views the money, forex and gilt markets in an integrated manner. The Committee is of the view that risk management is a critical area to which banks and FIs must bestow immediate attention. Towards this the Committee recommends:

(i) The RBI should prescribe prudential norms for mismatches in the rupee book of the banks and FIs and prescribe a reporting system for monitoring mismatches.

(ii) The banks and FIs should be required to move progressively to a 100 per cent marked-to -market investment portfolio by the year 2000.

(iii) The best practices of risk management as outlined in the Report of the Expert Group on Forex Markets (Chairman: Shri O.P. Sodhani) may be adopted by all entities including corporates. This will require strong internal control systems to identify, measure, monitor and manage all types of risks.

(iv) Introduction of internationally accepted accounting and disclosure norms for banks, financial institutions as also corporates simultaneous with the introduction of new instr'uments/products.

(v) Capital adequacy requirements for market risk for balance sheet and off balance sheet items should be stipulated immediately for banks and non banks including FIs and made effective from the year ending March 1998.

(iv) Effective Supervisory System

3.48 A successful move to CAC requires an effective supervisory regime the importance of which cannot be over emphasised. Since most banking crises owe their origins to insolvency rather than illiquidity and since the former have a tendency to assume serious proportions only after a sufficient length of time, a vigilant and alert supervisory structure cannot lose sight of these problems at the incipient stage itself. Such a supervisory regime needs to be able to pick up warning signals and the weaker entities need to be monitored more closely and frequently. The supervisory system should take quick, strong and deterrent action in cases of inadequacies/deviations from norms. The supervisory regime should be supported by an efficient off-site surveillance mechanism monitoring the financial soundness of institutions through certain well-defined prudential parameters.

3.49 As risks faced by the financial sector are much higher in developing countries, the Committee recommends that the RBI should consider the imposition of even more stringent capital adequacy standards than the Basle norms and income recognition and asset classification norms should be tightened expeditiously. The tighter norms may be in the form of steeper capital requirements for banks with higher level of NPAs. The Committee recommends that all these prudential norms should be prescribed on the basis of an assessment of necessary safeguards to enable the Indian financial system to attain international standards and the norms should not be prescribed with a view to enabling the weakest segment of the financial system a cushion for survival. The prescription of more stringent capital adequacy norms for banks with higher NPAs would in effect mean that the weaker banks would not be able to increase their advances portfolio. As already stated the weakest segment would inexorably need to become narrow banks.

(v) Autonomy for banks and FIs

3.50 As the Indian banking system is still predominantly owned by the public sector, the lack of autonomy of these banks is a major constraint. Although there has been a significant degree of empowerment of banks in the recent period in managing their assets/liabilities, much more needs to be done in the internal management of public sector banks to enable them to operate with a greater degree of autonomy to cope with the rapidly changing environment. The public sector banking system can no longer function as a monolith. The Committee is of the view that while in the context of CAC competition from foreign banks and Indian private sector banks will increase, it is necessary to bring about a qualitative improvement in the Indian public sector banks. The Committee recommends that the more efficient public sector

banks need to be allowed, nay actively encouraged, to break away from the pack and their activities should not be hemmed in by concerns for the weak banks. The Committee recommends that the FIs should also be given a greater degree of operational freedom within the framework of strict prudential norms. While issues of autonomy are often posed as one of the regulator/owner giving freedom to the entities, there is also the issue of entities taking on their rightful autonomy. The Boards should be so constituted that they effectively operate as autonomous entitities. The Committee emphasises that autonomy is never given, it is always earned.

(vi) Legalframework

3.51 The banking system in the country remains handicapped in the absence of an adequate legal framework to ensure expeditious recovery of loans as also enforcement of security. The Committee recommends that a comprehensive banking legislation and an enforcement machinery be put in place not only to reduce the quantum of NPAs but also to ensure that such a framework serves as a deterrent for future defaulters. In the context of CAC, a comprehensive review of all banking and finance related enactments needs to be taken up, which have engendered inflexibilities/rigidities in the system.

(vii) Upgradation of technology for risk management

3.52 The participants in the financial markets with greater deregulation are prone to face greater risks arising out of market fluctuations. In order to mitigate the gravity of systemic risks arising on this account, banks and non-banks should be encouraged to build up strong internal control systems to identify, measure, monitor and manage these risks. These systems should adopt an integrated risk management approach. The Committee is of the view that without a greater degree of technology absorption, the Market participants will be ill-equipped to build strong risk-management systems and management information systems. Although the initial costs are likely to be heavy, the Committee recognises that superior technology will considerably enhance the quality of customer service, increase the volume of business and offset the cost factor within a reasonable time span. The Committee is also of the view that upgradation of technology can pave the way for an efficient payment and settlement mechanism which will strengthen the financial system considerably.

(viii) Upgradation o skills

3.53 The Committee underscores the need for strong initiatives on the part of market participants to upgrade their human resource skills by appropriate training inputs. In the long run, only skilled manpower can withstand vigorous competition and add value to the products and services rendered. In order that they attract the best talent and expertise, individual banks and FIs should have freedom to determine their personnel policies including recruitment and wage policies without being constrained by any rigidities. The Committee recognises that without appropriate changes in labour laws it will not be possible to create an environment conducive to operational efficiency which is a prerequisite for enabling Indian financial entities to compete meaningfully with their counterparts abroad.

3.54 The Committee has dealt with the financial sector in great detail as strengthening of the financial system should be high on the agenda of adjustments in preparation for CAC.

Gold and CAC

3.55 Gold is a surrogate for foreign exchange and because of its special features it is a hybrid between a commodity and a financial asset. Though imports and exports of gold fall within the ambit of trade policy, the Committee is of the view that CAC is inextricably linked with liberalisation of the gold regime in India. Countries like Indonesia, Malaysia and Turkey have freed imports and exports of gold prior to or concurrent with liberalisation on the capital account. The general experience in this regard has been that unless the premium on the domestic price of gold is brought down very significantly through removal of import restrictions, the illegal import route would continue to exist even when capital controls are relaxed.

3.56 Despite attempts in the past to restrict imports of gold and to curb private demand for gold, the consumption of gold in India has shown a rising trend over the years. According to the World Gold Council estimates, imports of gold (legal and illegal) increased from 190 tonnes in 1991 to 379 tonnes in 1996 and in value would be equivalent to about 12 per cent of the country's total imports in 1996. One noteworthy feature has been that in 1992, the NRI route was introduced and such imports in 1996 accounted for 44 per cent of total gold imports (legal and illegal).

3.57 Larger imports of gold in recent years do not appear to have put any visible pressure on the country's BOP or the exchange rate of the rupee. It is conceivable that a good part of the gold imports through the NRI route might be a return flight of capital to the country. Premium on the domestic price adds a strong element to demand for gold and a restricted import regime on gold, therefore, provides an added incentive for the parallel economy. In view of the foregoing, the Committee recommends that in the context of CAC there is strong case for liberalising the overall policy regime on gold. The Committee is of the view that its recommendations on gold are, to some extent, in the nature of a precondition as the measures on gold are vital to a successful move to CAC. The details of sequencing of measures on developing the gold market are set out in Chapter 4.

Concluding Observations

3.58 The establishment of preconditions/signposts set out in this Chapter assumes critical importance. In view of the assessment of the initial conditions, a phased three year path of the entrenchment of preconditions is contemplated, which would dovetail into the sequencing of measures of liberalisation. In this sense, the Committee views the establishment of preconditions as simultaneous with the progressive institution of CAC in India. The Committee emphasises that phasing the establishment of preconditions is not set out as a definitive time frame, but more as signposts and the time frame and the sequencing of the move towards CAC should be a function of the implementation of the preconditions; thus, the three year time frame of CAC could be speeded up or delayed, depending on the degree of success achieved in establishing the preconditions.

Chapter 4

Timing and Sequencing of Measures for Capital Account Convertibility

4.1 The establishment of preconditions/signposts have been outlined in Chapter 3. The timing and sequencing of phasing out of capital controls assumes operational significance in the move towards CAC and these issues are addressed in this Chapter.

4.2 Capital account convertibility is at present available for foreign direct investors under the extant FDI policy, portfolio investment for FIIs, NRIs and investment in non resident repatriable deposit schemes with banks in India. The international experience has shown that liberalisation of the capital account induces large capital inflows, which can cause a real appreciation of the exchange rate and erode the effectiveness of certain domestic macro economic policies. The Committee recommends that alongside further measures of liberalisation of 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 ban on certain outflows and 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. Capital outflows, in the context of larger inflows, could relieve pressure on the exchange rate and the foreign exchange reserves and thereby enhance the effectiveness of domestic policies.

4.3 The Committee recognises that while the timing and sequencing of CAC proposed in this chapter can be undertaken under the existing laws and regulations relating to foreign exchange, they would be facilitated by the proposed changes in the legislative framework governing foreign exchange transactions. In this regard, Shri. P. Chidambaram, the Union

Finance Minister in his speech while presenting the Union Budget for 1997-98 said

> " As we progress towards a more open economy with greater trade and investment linkages with the rest of the world, the regulations governing foreign exchange transactions also needs to be modernised it is generally acknowledged that the Foreign Exchange Regulation Act, 1973 needs to be replaced by a new law consistent with full capital account, convertibility ...." [Part A - Paragraph 38]

4.4 In this Chapter, the timing and sequencing of liberalising both inflows and outflows of capital are set out within the framework of a phased three year road map, classified in relation to various economic agents, viz., resident and non resident corporates, banks, non bank financial institutions and individuals. Concomitant measures for the development of financial markets to handle the enhanced mobility of capital flows are also set out.

4.5 The banking system in India has been insulated from overseas markets for decades. Severe restrictions have been placed on banks borrowing funds from overseas or investing/lending abroad. Arbitraging between domestic and overseas markets have been strictly prohibited. The Committee recommends several measures for liberalising capital transfers by banks. Having regard to the fact that large scale short-term borrowings can be destabilising, the Committee recommends limits on such borrowings by the banking system. At the same time, a level playing field is to be ensured and the phased relaxation of controls should be concurrent with measures undertaken to ensure such a level playing field. In the area of foreign direct investment and portfolio investment, the Committee recommends complete elimination of the prior approval process from exchange control for investment/disinvestment.

4.6 Having regard to the need to keep external debt within sustainable limits, the Committee has proposed continuance of the policy of ceilings on external commercial borrowings (except for loans with long maturities). The Committee recommends simplification of the procedure for investments overseas in joint ventures/subsidiaries and substantial increase in the value limit for such investments (without prior approval) which is expected to make Indian industry competitive. Moreover, the Committee recommends that the exacting repatriation stipulations for such investments should be totally removed.

4.7 The Committee is of the view that a start should be made to liberalize outflows by individual residents. This will lend credibility to the commitment for CAC and give confidence to both residents and non residents that their genuine requirements for capital transactions are adequately met.

4.8 The various measures for removing capital controls and the timings and sequencing thereof proposed by the Committee are tabulated in Chapter. The rationale for the measures is given in the paragraphs following the tabulated list of measures.

Capital Account Convertibility- Timing and Sequencing of Measures

($ indicates US dollars)

	Item	Present Position	Phase I 1997-98	Phase II 1998-99	Phase III 1999-2000
1.	**CORPORATES/BUSINESSES**				
A.	**Corporates/Businesses - Residents**				
1.	Issuing foreign currency denominated bonds to residents (only rupee settlement) and investing in foreign currency denominated bonds and deposits (only rupee settlement).	Not permitted .	To be permitted without any ceiling	Same as Phase I	Same as Phase I
2.	Financial capital transfers abroad including for opening current/ chequeable accounts.	Not permitted.	$ 25,000 per annum.	$ 50,000 per annum.	$ 100,000 per annum.
3.	Accessing capital markets abroad through GDRs & ADRs/ other forms of equity issues.	Permitted individually by Government. Approval under FERA given by RB1.	No approval to be taken from RBI/ Government Reporting within 30 days from close of issue	Same as Phase I	Same as Phase I

4.	External Commercial Borrowings(ECBs)	ECBs are subject to overall ceiling with sub-ceilings as indicated below: (i) Import linked short-term loans (Buyers/ Suppliers credit) for less than 3 years (i.e., 35 months) approved by RBI subject to sub- ceiling fixed by Government. ii) Loans beyond 35 months approved by Government. iii) US $ 3 million for a minimum period of 3 years for business related expenses including financing rupee cost of the project - approved by RBI within sub-ceiling fixed by Government. iv) All other loans are approved by Government (generally for financing requirements of infrastructure projects, etc.).	Queuing for purposes of implementing ceiling on ECB while ensuring that relatively smaller borrowers are not crowded out by a few very large borrowers. No restrictions on end use of funds. Loans for periods with average maturity of 10 years and above to be kept outside the ceiling.	Same as Phase I except for loans with average maturity of 7 years and above to be outside ceiling.	Same as Phase II
5.	Foreign Currency Convertible Bonds/Floating Rate Notes	Permitted individually by Government within overall ECB ceiling.	To be within ECB celling with same procedure viz. queuing vide item 4.	Same as Phase 1	Same as Phase I
6.	Loans from non residents	Allowed by RBI on a case-by-case basis for loans from NRIs on non repatriable basis with restrictions on interest payment and end-use.	To be allowed to borrow up to $ 250,000 per entity with payment of interest not exceeding LIBOR without restriction on period of loan, use of funds and repatriation of loan/interest.	To be allowed borrow up to $ 500,000 per entity with payment of interest not exceeding LIBOR without restriction on period of loan, use of funds and repatriation of loan/interest.	To be allowed to borrow up to $ 1 million per entity with payment of interest not exceeding LIBOR without restriction on period of loan, use of funds and repatria-tion of loan/ interest.
7.	Joint ventures/wholly owned subsidiaries abroad	Proposals for investments up to $ 4 million are cleared by the RBI. The extent of outflow is dependent upon the export performance of the Indian promoter and capability for repatriation by way of dividend, etc., within a period of five years. Cases not covered by these criteria are cleared by a Special Committee. Recently, an announcement has been made in the Budget that balances in EEFC accounts can be used for investments upto $ 15 million without the specific approval of RBI.	Direct investments abroad to be allowed for ventures up to $ 50 million by ADs subject to transparent guidelines to be laid down by the RBI. Above $ 50 million through Special Committee. The current stipulation on repatriation of earnings by way of dividend etc. within a specified time period should be removed. JVs/WOSs can be set up by all parties and not restricted only to exporters/exchange earners.	Same as Phase I	Same as Phase I
8.	Project Exports	Indian project exporters are required to approach the RBI for prior approval for variety of purposes while executing the projects abroad	Requirement of prior approval by the RBI may be dispensed with subject, to reporting to the RBI.	Same as Phase I	Same Phase I
9.	Establishment of offices abroad	Powers given to ADs to allow remittances for exporters with an average annual export turnover of Rs. 150 lakhs and above to open	Any corporate entity may open offices abroad without the need for prior approval from RBI. Capital expenditure towards opening of	Same as Phase I	Same as Phase I

		representative/non-trading offices. Further, EEFC account holders have been permitted to utilise their EEFC balances without any restriction for establishing any type of offices. Other cases require RBI approval.	the offices and current expenditure for maintenance could be subject to overall value limits to be allowed by ADs.		
10.	EEFC accounts for exporters and exchange earners	50 per cent for EOUs and 25 percent for others- restrictions on use of funds for current account and permitted capital account transactions.	100 per cent of earnings for all exporters/exchange earners to be allowed to be held in EEFC accounts in India. Use of funds allowed for current and permitted capital account transactions with cheque writing facility.	Same as Phase I	Same as Phase I with additional provision that EEFC ac counts can be held with banks outside India at the option of the exporter and the exchange earners.
B.	**Corporates - Non Residents (including OCBs)**				
1.	Foreign Direct Investment (FDI)	Currently OCBs are allowed facilities similar to NRIs. Other corporates are allowed to invest up to various proportions with RBI/Government approval under the FDI policy of the Government.	Prior approval of RBI not required for FDI. Reporting by ADs to the RBI.	Same as Phase I	Same as Phase I
2.	Portfolio Investment in India through stock exchanges in shares/ debentures.	Allowed within the 24 per cent limit (can be increased to 30 per cent at the option of the company) which includes portfolio investment by NRIs, FIIs & OCBs subject to approval by the RBI which is valid for a period of five years. The investment restricted to 1 per cent by individual NRIs/OCBs and 10 per cent by individual FIIs. Corporates, other than OCBs and FIIs, are not permitted.	To be allowed to all non-residents without prior approval by RBI. Designated ADs should be required to report to the RBI.	Same as Phase I	Same as Phase I
3.	Disinvestment	Disinvestment as approved by the RBI except where sales are made through stock exchange under portfolio investment scheme.	RBI approval to be dispensed with.	Same as Phase I	Same as Phase I
II.	**BANKS**				
A.	**Banks - Residents**				
1.	Loans and borrowings from overseas banks and correspondents including overdrafts in nostro account	ADs are permitted to borrow up to $ 10 million from their overseas offices/ correspondents without any conditions on end use and repayment of such borrowings.	(i) Each bank may be allowed to borrow from overseas markets, short-term (up to one year) and long-term (over one year), to the extent of 50 per cent of the unimpaired Tier I capital with a sub limit of one third (i.e., 16.67 per cent of unimpaired Tier I capital) for short-term borrowings. (ii) No restrictions on use of funds and repayment. Prudential norms regarding open position and gap limits to continue.	Same as Phase I except that the ceiling will be 75 per cent of unimpaired Tier I capital with a sub-limit of one third (i.e., 25 per cent of unimpaired Tier I capital) for short- term borrowings.	Same as Phase I except that the ceiling will be 100 per cent of unimpaired Tier I capital with a sub-limit of one third (i.e., 33.33 per cent of unimpaired Tier I capital) for short- term borrowings.
2.	Investments in overseas markets	Banks allowed to invest in overseas money markets up to $ 10 million.	Investments may be in overseas money markets, mutual funds and foreign securities. To be allowed subject only to (i) requirements	Same as Phase I	Same as Phase I

		of Section 25 of BR Act 1949* (ii) open position/gap limits.		
3. Fund based /non fund based facilities to Indian joint ventures and wholly owned subsidiaries abroad	Cleared by RBI/ Special Committee.	To be left to banks' discretion - only restriction to be Section 25 of BR Act.	Same as Phase I	Same as Phase I
4. Buyers' credit/acceptance for financing importer/their bankers for buying goods and services from India (including financing of overseas projects)	Depending on amount cleared by ADs/EXIM Bank/ Working Group. FERA approval required from RBI.	To be allowed subject only to Section 25 of BR Act.	Same as Phase I	Same as Phase I

* Note : Section 25 of the Banking, Regulation Act, 1949 stipulates that the assets in India of every bank at the close of business on the last Friday of every quarter shall not be less than 75 per cent of its demand and time liabilities in India.

5. Accept deposits and extend loans denominated in foreign currencies from /to individuals (only rupee settlement)	Not allowed other than under existing foreign currency deposit schemes.	To be allowed without any ceilings - assets/ liabilities mismatch to be taken into overall open position /gap limits	Same as Phase I	Same as Phase I
6. Forfaiting	Exim Bank alone has been permitted by RBI to do forfaiting	All ADs should be permitted to undertake forfaiting.	Same as Phase I	Same as Phase I
B. Banks - Non Residents				
1. Rupee Accounts of non resident banks	Used only for merchant based transactions - investments not allowed. Overdrafts allowed upto Rs. 150 lakhs for normal business requirements for temporary periods.	Forward cover to be allowed to the extent of balances. Cancelling/ rebooking to be allowed. The present overdraft limit could be increased and limited investments may be allowed in rupee accounts	Same as Phase I	Non resident banks may be allowed to freely open rupee accounts with banks in India without any restrictions on their operations.
III. NON BANKS - FINANCIAL				
A. Non Banks - Financial - Residents				
1. SEB I registered Indian investors (including Mutual Funds) investments overseas	Not allowed	Overall ceiling of $ 500 million and the ceiling should be so operated that a few large funds do not pre-empt the overall amount.	Overall ceiling of $ 1 billion.	Overall ceiling of $ 2 billion.
2. All India Financial Institutions	Borrowings from overseas markets or investments abroad subject to RBI/ Government prior approval	(i) Borrowings more than one year to continue within ECB ceiling with Government approval.	(i) Same as Phase I	(i) Same as Phase I
		(ii) Short-term borrowings to be allowed subject to limits. Investments in short term instruments to be permitted within limits up to the extent of liabilities maturing within one month.	(ii) Short-term borrowings to be allowed subject to limits. Investments in short term instruments to be permitted within limits up to the extent of liabilities maturing within 3. months	(ii) Short-term borrowings to be allowed subject to limits. Invest-ments in short term instru-ments to be permitted within limits up to the extent of liabilities maturing within 6 months.
B. Non Banks - Non Residents				
1. FIIs				
(a) Portfolio Investment	(a) Investments in secondary market allowed once FII is registered with SEBI subject to 24 per cent ceiling (can be increased to 30 per cent at the option of the	To be allowed without RBI prior approval. Designated ADs would be required to report to RBI	Same as Phase I	Same as Phase I

		company) which includes portfolio investment by NRIs, FlIs and OCBs with a 10 per cent limit for individual FlIs and 1 per cent by individual NRIs/ OCBs. FERA approval is given by RBI which is valid for a period of five years.			
(b)	Primary market investment/private	Primary market offering/private placement placement allowed with RBI approval up to 15 per cent of the new issue/ capital.	RBI approval not required. Designated ADs to report to the RB1.	Same as Phase I	Same as Phase I
(c)	Disinvestment	(i) Disinvestment through stock exchange allowed freely. (ii) Other routes of disinvestment require RBI approval	RBI approval for disinvestment to be dispensed with.	Same as Phase I	Same as Phase I
(d)	lnvestments in debt instruments	Permitted to invest in dated Government securities of Central and State Governments (excluding Treasury Bills) both in primary and secondary markets. ECB ceiling includes FII investment in rupee debt instruments. The Debt Funds of FIIs are also allowed to invest in corporate debt securities (NCDs, Bonds, etc.) listed or to be listed. FIIs can invest in equity and debt (NCDs, Bonds, etc.,) in the ratio of 70:30, Debt Funds of FIIs can invest upto 100 per cent in debt instruments subject to a ceiling, prescribed by SEB1.	Maturity restrictions on investments in debt instruments (including, treasury bills) to be removed. FII investments in rupee debt securities to be kept outside ECB ceiling but could be part of a separate ceiling	Same as Phase I	Same as Phase I
IV	**INDIVIDUALS**				
A	**Individuals -Residents**				
1.	Foreign currency denominated deposits with banks/corporates in India (only-rupee settlement)	Not permitted	To be permitted without ceiling	Same as Phase I	Same as Phase I
2.	Financial capital transfers including for opening current/chequeable accounts	Not permitted	$ 25,000 per annum	$ 50,000 per annum	$ 100,000 per annum
3	Loans from non residents	Residents are allowed to obtain interest free loans on non repatriation basis from non resident relatives for personal and business purposes other than investment. Other cases need RBI approval.	Residents to be allowed to take loans from non residents up to $ 250,000 per individual with payment of interest not exceeding LIBOR, without restrictions on period of loan, repatriation of principal/interest and use of funds.	Residents to be allowed to take loans from non residents up to $ 500,000 per individual with payment of interest not exceeding LIBOR, without restrictions on period of loan, repatriation of principal/ interest and use of funds.	Residents to be allowed to take loans from non residents up to $ 1 million per individual with payment of interest not exceeding LIBOR, without restrictions on period of loan, repatriation of principal/ interest and use of funds.
B	**Individuals : Non Residents**				

1	Capital transfers from non repatriable assets held in India (including NRO and NRNR RD accounts)	Not allowed; however, a few cases allowed on sympathetic grounds.	$ 25,000 per year*	$ 50,000 per year*	$ 100,000 per year*
2.	Foreign Direct Investment in India (FDI) (other than in real estate)	(a) FDI for NRIs with repatriation benefits are to be cleared by RBI/ Government under FDI policy. (b) FDI for other non resident individuals are to be cleared by Government and RBI.	No RBI permission for FDI subject to reporting by ADs.	Same as Phase I	Same as Phase I

* No fresh **NRNRRD** accounts from 1997-98. On maturity the balances in the accounts get merged with other non repatriable funds or depositors can shift the maturity proceeds to a special 3 year NRE account with full repatriation benefit on maturity. If prematurely withdrawn from special NRE account, funds will get merged with other non repatriable funds of the non resident. In case of investments permitted on non repatriation basis on maturity or on disinvestment, the proceeds will be merged with other non repatriable assets.

3.	Portfolio Investment in India through stock exchanges.	Allowed to NRIs within the 24 per cent ceiling (can be increased to 30 per cent at the option of the company) which includes portfolio investment by NRIs, FIIs and OCBs subject to approval by the Reserve Bank which is given for a period of five years. The investment restricted to 1 per cent by individual NRIs/OCBs and 10 per cent by individual FIIs.	Allowed to all non residents without RBI prior approval. Designated ADs would be required to report to RBI.	Same as Phase I	Same as Phase I
4.	Disinvestment	Disinvestment to be approved by RBI except where sales are made through stock exchange under portfolio investment scheme.	RBI approval to be dispensed with.	Same as Phase I	Same as Phase I
V.	**FINANCIAL MARKETS**				
1.	Foreign Exchange Market				
(a)	Forward contracts	Forward contracts are allowed to be booked on the basis of business projections in respect of exporters and importers. Also forward cover allowed for non residents for limited purposes such as dividend remittance and freight/passage collections.	To allow all participants in the spot market to participate in the forward market; FIIs, non residents and non resident banks having rupee assets can be allowed forward cover to the extent of their assets in India. Banks to be allowed to quote two way in rupee to overseas banks/ correspondents both spot and forward subject to their position/gap limits. Those with economic exposures to be allowed to participate in forward market.	Same as Phase I	Same as Phase I. No restrictions on participants in spot/forward markets i.e., participation allowed without any underlying exposure.
(b)	Authorised dealers	Authorised dealers at present are only banks.	All India FIs which comply with the reaulatorv/prudential requirements and fulfil well defined criteria should be allowed to participate as full-fledged ADs in the forex market.	Same as Phase I	To allow select NBFCs to act as full-fledged authorised dealers on the basis of criteria similar to FIs.
(c)	Products	Currently the only derivative in the rupee $ market is the forward contract.	All derivatives including rupee based derivatives to be allowed. Futures in	Direct access to overseas markets by corporates for	Same as Phase I & 11

		ADs have been allowed to enter into Rupee/$ currency swaps with counterparties in India subject to open position and gap limits. Cross currency derivatives and interest rate derivatives allowed for covering underlying exposures - to be routed through ADs	currencies and interest rates to be introduced with the system of screen-based trading and an efficient settlement mechanism.	derivatives without routing through ADs Phase I to continue.	
2.	Money Market	Banks allowed to lend and borrow freely. FIs allowed to lend with no limit/ allowed to borrow within small limits. Others allowed to lend to primary dealers for minimum amount of Rs. 10 crores. MFs participate only as lenders. Residual restrictions on deposit rates applicable to public deposits; minimum period for CDs/ MMMFs/fixed deposits specified.	Market segmentation to be removed. Deposit rates to be deregulated and minimum period restrictions to be removed. Restrictions on participants in the money market to be freed. Level playing field for all banks , FIs and NBFCs regarding reserve requirements and prudential norms.	Same as Phase I	Same as Phase I
3.	Government Securities Market	A number of measures have been taken to strengthen the market for Government securities such as a move towards market related rates of interest introduction of auctions and new instruments and measures to develop the secondary market through Primary Dealers (PDs) and Satellite Dealers (SDs).	(i) Access to FIIs in Treasury bill market. (ii) RBI to develop Treasury bill merket offering tow-way quotes. (iii) Government Securities (including Treasury bills) futures to be introduced. (iv) RBI to provide Liquidity Adjustment Facility to PDs through Repos and Reverse Repos. (v) Dedicated gilt funds to be given strong and exclusive fiscal incentives to individuals to develop the retail segment. (vi) Number of PDs and SDs to increase. Progressive increase in share of PDs in underwriting. Commission to PDs to be related to PDs to be related to underwriting commitment (vii). Government to initiate action for setting up of an Office of Public Debt (OPD) (viii) Delivery Versus Payment (DVP) system to be fully automated for all securities on a real time basis with proper safeguards for ensuring that risks are controlled.	(i) The OPD to take up part of issue of dated securities and all Treasury bills. (ii) RBI to discontinue participation in 91 day Treasury bill primary auctions and it should only participate in the secondary market. (iii) Number of PDs and SDs to be further increase with a quantum jump in share of PDs in underwriting with strong incentives through underwriting commission.	(i) The OPD to take full responsibility for primary issues of all Treasury bills and dated securities. (ii) Full underwriting of issues by PDs with RBI discontinuing participation in primary market for dated securities.
4.	Gold	At present, there are restrictions on import of gold. There are only three channels through which import of gold is allowed (1) through channels agencies (ii) through returning NRIs and (iii) through special import Iicences.	(i) Banks and financial institutions fulfilling well- defined criteria to be allowed to operate freely both in domestic and international markets. (ii) Sale of gold by banks and FIs included under (i) above to be freely allowed to all residents. (iii) Banks to be allowed to offer gold denominated deposits	Steps to be taken by Government and the RBI for developing, a well regulated market in India for gold and gold derivatives including, forward trading. Both residents and non residents to be allowed	Same as Phase I and 11

			and loans (iv) Banks fulfilling well-defined criteria may be allowed to mobilise household gold and provide working capital gold loans to jewellery manufacturers as also traders. (v) Banks may be allowed to offer deposit schemes akin to GAPs (gold accumulation plans)	to operate in this market.	
5.	Participation in international commodity markets	Not allowed	To be allowed	Same as Phase I	Same as Phase I

I. Corporates/Businesses

I.A. Residents

I.A.1. Issuing Foreign Currency Denominated Bonds to Residents and Investing in Foreign Currency Denominated Bonds and Deposits(only Rupee Settlement)

In order to familiarise residents with holding foreign currency denominated assets with banks and corporates and providing them with opportunities to diversify their investments by taking currency risk, the Committee recommends that corporate residents may be permitted. to issue foreign currency denominated deposits/bonds. Simultaneously, corporates get the advantage of lower cost of foreign currency denominated funds while having to bear the exchange risk. No limit on such issuance/investments is recommended as it is expected that the corporates will issue such liabilities only to the extent they are able to or are willing to bear the exchange risk. As there is only rupee settlement, this measure will not result in any outflow of foreign exchange.

I.A.2 Financial Capital Transfers Including Opening Current/Chequeable accounts

The Committee recommends outflows up to US $ 25,000 per annum in Phase I (with higher limits in subsequent phases) for financial capital outflows for resident individuals (Paragraph IV.A.2). Analogously, resident corporates could be allowed similar facilities.

I.A.3. Accessing Capital Markets Abroad through GDR/ADRs/ other Form of Equity Issues

At present, access to international capital markets through equity issues like GDRs, ADRs, etc., is permitted on a case by case basis by the Government and clearance is obtained from the RBI under FERA. While timing of the issue is crucial for the success of the issues, the approval process itself involves avoidable delay. The Committee is of the view that since all such issues are handled by merchant/investment bankers taking into account all factors including the rating of the corporate/country, prior approval by Government/ RBI is not necessary. Moreover, most of the international capital markets are regulated by securities regulators for investor protection and minimising systemic risk. The Committee therefore recommends that all restrictions on accessing international capital markets by resident corporates by way of GDRs/ ADRs/ other equity issues be removed subject to reporting such transactions not later than 30 days of the close of the issue.

I.A.4. External Commercial Borrowings (ECBs)

In order to keep the external debt of the country within sustainable limits, the Committee accepts that an overall ceiling on debt, albeit a flexible one, is necessary. The Committee is also aware that in order to implement the ceiling, the process of prior approval of such loans with a principle of queuing is unavoidable. The system of prior approvals should ensure that relatively smaller borrowers are not crowded out by a few very large borrowers. As in the case of equity issues, debt issues are syndicated/managed by international investment banks and the terms of issue, timing of borrowing, etc., are best left to the perception of the manager. The Committee recommends that in Phase 1, loans with average maturity of 10 years and above may be kept

outside the ceiling for ECB. In the subsequent phases, the average maturity of loans for which ceiling on ECBs should not be applicable may be reduced to 7 years and above. The Committee recommends that all restrictions on end use of ECB should be removed for all ECBs.

I.A.5. Foreign Currency Convertible Bonds (FCCBs)/Floating Rate Notes (FRNs)

The Committee recommends that the policy governing ECBs should be applicable to FCCBs/FRNs, etc., and the ceiling on ECB should include those debt issues with average maturity below the periods recommended viz., 10 years in the first phase and 7 years thereafter.

I.A.6. Loans from Non Residents

The Committee has elsewhere (Paragraph IV.A.3) recommended that resident individuals could be allowed to avail of loans from non residents up to an amount of US $ 250,000 (with increase in subsequent phases) in Phase I on repatriation basis with payment of interest at LIBOR. Analogously, the Committee recommends that corporates/businesses may be freely allowed to avail of loans from non residents up to US $ 250,000 (with increase in subsequent phases) in Phase I on repatriation basis with payment of interest at LIBOR on similar lines as available to resident individuals.

I.A.7. Joint Ventures/Wholly Owned Subsidiaries(JV/WOS) Abroad

With the globalisation of the Indian economy, Indian enterprise should be encouraged to invest in joint ventures/wholly owned subsidiarles (JVs/ WOSs) abroad. At present, proposals involving Indian investment not exceeding US $ 4 million fulfilling conditions relating to past export turnover accompanied by an undertaking for repatriation are cleared by RBI under the Fast Track Route within a period of 21 days. All other proposals which do not qualify for the Fast Track Route are cleared by a Special Committee constituted for this purpose by the RBI. An announcement was made in the recent Budget that funds in Exchange Earners Foreign Currency (EEFC) account can be used for making investment in overseas JVs/WOSs up to a limit of US $ 15 million without reference to the RBI. The limits mentioned above include remittance from India, capitalisation of export proceeds towards equity and giving loans/corporate guarantees to/on behalf of the Indian JVs/WOSs.

The Committee is of the view that in order that Indian industry is able to exploit opportunities on a global scale, there should be a substantial step up in the limit for investment by Indian industry in overseas businesses.

The Committee recommends that overseas investment up to US $ 50 million could be cleared at the level of the ADs based on transparent and comprehensive guidelines set out by the RBI. Projects involving investment of over US $ 50 million may go through a screening to be done by the Special Committee. The Committee recommends that the existing requirement of repatriation of the amount of the investment by way of dividend, technical know-how fee, etc., within a period of five years may be removed. Furthermore, JVs/WOSs could be allowed to be set up by all parties and not restricted only to exporters/exchange earners.

I.A.8. Project Exports

Indian project exporters are required to approach RBI for prior approval for a variety of purposes while executing projects abroad such as executing corporate guarantee at the bid or post award stage instead of providing bank guarantee, advance payment of commission instead of pro rata payment, inter-project transfer of funds, etc. The Committee recommends that requirement of RBI approval for various purposes while executing projects abroad should be dispensed with, subject to project exporters reporting the transactions to the RBI.

I.A.9. Establishment of Offices Abroad

Indian corporate entities may open offices/branches abroad without the need for prior approval from RBI. The published balance sheet of the company should reflect the operations of these branches/offices separately. The Committee recommends that the necessary amendments towards this end in the legislation be made expeditiously. Capital expenditure towards opening of the

offices and current expenditure for maintenance could be subject to suitable overall value limits to be allowed by ADs.

I.A.10. EEFC accounts for Exporters/Exchange Earners

Under the present exchange control restrictions, exporters/exchange earners are allowed to retain their foreign exchange earnings not exceeding 25 per cent of such remittances. In the case of 100 per cent export oriented units or EPZ units, etc., amounts up to 50 per cent of the remittance can be credited to EEFC accounts. RBI permits individual exporters having good track records to credit a higher percentage of inward remittances i.e., in excess of 25 per cent/50 per cent as the case may be, to EEFC accounts to meet their foreign exchange requirements for imports. As long as the exchange earnings are retained in accounts in India to be used flexibly by the exchange earner/ exporter for all current/permitted capital transactions, the Committee recommends 100 per cent retention of exchange earnings in EEFC accounts for all exporters/exchange earners. The Committee recommends complete flexibility in the operation of these accounts including having cheque writing facility. It is essential to put in place a system of contemporaneous reporting to the RBI of the operations in the EEFC accounts. At a later phase of CAC, the restriction on maintaining EEFC accounts in India could be removed and exporters/exchange earners could be allowed to maintain such accounts with banks abroad. One of the members (Shri AN. Rajwade) was of the view that 100 per cent retention of earnings by exporters/exchange earners could be allowed only after the Phase I preconditions are met fully.

I.B. Corporates - Non Residents (including OCBs)

I.B.1. Foreign Direct Investment (FDI)

The Committee recognises that FDI is an engine of growth. In the context of a move towards CAC the Committee recommends that no prior RBI approval should be necessary for foreign direct investment/disinvestment. The Committee recommends that to encourage foreign direct investment, the guidelines for investment/disinvestment should be made transparent without complicated administrative clearances and without any requirement of any form of RBI intervention. Towards this end, the Committee recommends that investors should be provided comprehensive and transparent guidelines for foreign direct investment in India.

I.B.2. Portfolio Investment in India through Stock Exchanges in Shares/Debentures

Currently, foreign equity holding in a company through the portfolio investment route is available for approved NRIs, OCBs & FIIs and should not exceed 24 per cent (can be increased to 30 per cent at the option of the company) of the equity of the company. This limit is monitored through a system of reporting by designated ADs and when such portfolio investments are moving towards the limit, a brake is applied. The sub-limits of holding by any individual F11, NRI or OCB are also monitored through this system. The Committee recommends that the portfolio investment route could be made available to all non residents through designated ADs without the need for prior approval of RBI. The designated ADs would continue to report to the RBI. The comprehensive and transparent guidelines referred to under I.B.1 above could also cover portfolio investment.

I.B.3. Disinvestment

Approval of disinvestment by the RBI could be dispensed with and there should only be reporting by the ADs. The Committee recommends that the guidelines on foreign direct investment and portfolio investment should also cover guidelines for disinvestment.

II. BANKS

II. A. ***Banks-Residents***

II.A. 1. Loans and Borrowings from Overseas Banks and Correspondents Including Overdrafts in Nostro Accounts

At present each bank is permitted to borrow up to US $ 10 million without any restriction on the use of such funds in India or its repayment. With a view to providing the banking system with

greater opportunities to access/intermediate funds from abroad and bring about integration between overseas and domestic markets, the Committee recommends that banks may be allowed to borrow, both short-term (upto one year) and long-term (over one year), from the overseas markets to the extent of 50 per cent of their unimpaired Tier I capital in Phase I (with increase in subsequent phases) with a sub-limit of one-third of the overall limit for short term borrowings. In Phase II the overall limit may be increased to 75 per cent and in Phase III to 100 per cent of the unimpaired Tier I capital. While the prudential norms regarding open position and gap limits will also govern such borrowings, there should be no restrictions on the end-use and repayment of funds.

II.A.2 Investments in Overseas Markets

The Committee notes that Section 25 of the Banking Regulation Act, 1949 restricts the deployment of assets by way of loans or investments outside India to 25 per cent of a bank's demand and time liabilities. The Committee is of the view that other than this legal restriction, no restrictions need be placed on deployment of banks' funds outside India either by way of investments or loans. Investments may be made in overseas money markets, mutual funds and foreign securities. The ceiling under Section 25 would include investment in overseas markets made from foreign currency accounts maintained in their books in India. The bank's management may formulate a policy in this regard keeping in view the credit risk and prudential regulations relating to currency exposure and maturity mismatches. The policy should enunciate in detail the. systems in place for managing various types of risks including credit risk, market risk, settlement risk, etc., so that the bank's management is aware of the likely loss that will devolve on the bank in a worst case scenario. As at present the open position and gap limit fixed by bank's management may be approved by RBI. Capital adequacy guidelines for cash and derivative instruments may be reviewed in keeping with international standards.

II.A.3. Fund Based/Non Fund Based Facilities to Indian Joint Ventures and Wholly Owned Subsidiaries Abroad

The Committee has proposed considerable liberalisation of the approval process for setting up JVs/WOSs and is of the view that banks in India should be free to assist such ventures/ subsidi aries on the basis of their commercial judgment subject to only the restriction imposed under Section 25 of the Banking Regulation Act, 1949 as stated under paragraph II.A.2.

II.A.4. Buyers Credit/Acceptance for Financing Importer/their Bankers for Buying Goods and Services from India (including Financing of Overseas Projects)

Consistent with measures to provide sufficient flexibility to banks to intermediate forex flows, the Committee recommends that banks should be free to exercise their commercial judgment in providing buyers' credit/ acceptance facilities to importers/their banks for facilitating exports of goods and services from India (including financing of project exports). Banks should be free to extend such credit without approval from any authority subject only to the provisions of Section 25 of the Banking Regulation Act, 1949.

II.A.5. Accept Deposits and Extend Loans Denominated in Foreign Currencies from/to Individuals (only Rupee Settlement)

The Committee's proposal is analogous to the recommendation at paragraph I.A.1 viz., permitting corporates to issue/invest in foreign currency denominated assets where the settlement takes place in rupees. The Committee recommends that banks may be permitted to accept deposits from residents denominated in foreign currency as also to make advances to residents by way of foreign currency denominated loans for any purpose for which the banks normally give rupee loans. While no ceiling need be fixed for lending or for deposits, the currency/maturity mismatches will be taken into account for overall open position/gap limits.

II.A.6 Forfaiting

At present RBI has accorded approval only to EXIM Bank for forfaiting. The Committee recommends that all AD s should be freely permitted to undertake forfaiting.

II.B. Banks - Non Residents

II.B.1. Rupee Accounts of non resident banks

The Committee recommends a cautious approach in allowing non-resident banks to open accounts in India and invest/borrow in these accounts for arbitraging between markets. In Phase I, while the existing restrictions on opening/operating on such accounts to support merchant based activities may continue, the Committee recommends that the existing restrictions on forward cover to non resident banks could be removed and forward cover provided to the extent of the balances in these accounts. Furthermore, the present limit of Rs. 150 lakhs on overdrafts in such accounts could be increased commensurate with the business and investment facilities may also be provided to non resident banks in such accounts. In Phase III, non resident banks may be allowed to freely open rupee accounts with banks in India without any restrictions on their operations.

III. NON BANKS

III.A. Non Banks - Residents

III.A.1. SEBI registered Indian Investors(including Mutual Funds) Investments Overseas

In order to diversify the investment opportunities for residents, the Committee recommends that SEBI approved investors in India (including mutual funds) could be allowed to set up funds part/whole of which can be invested in overseas markets. Such funds could be open for subscription by all residents and may be subject to an overall ceiling of US $ 500 million in Phase I with higher overall ceilings of US $ 1 billion for Phase II and US $ 2 billion for Phase III. The overall ceiling should be so operated that a few large funds do not pre-empt the overall amount. Individual fund clearances from the exchange control should be only for purposes of implementing the overall ceiling.

III.A.2. All India Financial Institutions (FIs)

At present long term borrowings by FIs have to be cleared by the Government. External commercial borrowings by FIs are also subject to the ceiling for ECB. The Committee recommends that the existing process may continue. To facilitate efficient funds management, the Committee recommends that the All India FIs may be allowed, without prior clearance from Government/RBI, to avail of overseas short term borrowings subject to certain limits and also be permitted to invest in short term instruments in overseas markets to the extent of liabilities maturing within one month in Phase II, three months in Phase II and six months in Phase III.

III.B. Non Banks - Non Residents

III.B.I. FIIs

(a) Portfolio Investment

Currently, approved FIIs are permitted portfolio investment provided such investment in any one company for all FIIs, NRIs and OCBs taken together does not exceed 24 per cent, the limit can be increased to 30 per cent at the option of the company. Consistent with the Committee's recommendation at I.B.2 above, the Committee recommends that the portfolio investment route could be made available freely to all non residents (including FIIs) through designated ADs without the requirement of prior approval from RBI, subject to reporting by the ADs.

(b) Primary Market Investment/Private Placement

At present FIIs who want to make private placement or enter the primary market are allowed to do so on a case by case approval by RB I subject to the 24 per cent limit for overall foreign equity holding (including NRIs, OCBs) in any company and specific limit of 15 per cent of each issue in case of private placement. Consistent with the Committee's recommendation for portfolio investment, the Committee recommends that prior RBI approval for FIIs' private placement/primary market investment may be dispensed with subject to reporting by the company.

(c) Disinvestment

The Committee recognises that although there is CAC on inflows by FIIs, prior approval from RBI is required for portfolio disinvestment where such disinvestment is not on the basis of the quoted prices for listed shares. The Committee recommends that disinvestment may be undertaken on the basis of comprehensive and transparent disinvestment guidelines referred to earlier subject to reporting by ADs and the requirement of exchange control approval for disinvestment should be dispensed with.

(d) Investment in Debt Instruments

FIIs in general can invest in equity and debt in the ratio of 70:30. In 1996-97, approved FlIs were allowed to set up funds to be invested exclusively in debt instruments listed on the stock exchange. Recently, approved debt funds of FIIs have also been permitted to invest in Government dated securities. The total of such investments is, however, subject to the overall ceiling for ECB and therefore specific approvals are given for such investments, not exceeding certain limits. Moreover, there are restrictions placed on investments in Treasury bills.- The Committee recommends that all maturity restrictions on debt instruments including Treasury bills be removed and furthermore that while FII investment in- rupee debt instruments could be subject to an overall ceiling, such a ceiling should be distinct and separate from the ECB ceiling.

IV. INDIVIDUALS

IV.A. Individuals - Residents

IV.A.1. Foreign Currency Denominated Deposits with Banks/ Corporates in India (only Rupee Settlement)

As indicated under I.A. 1 and II.A.5, in order to familiarise residents with having foreign currency denominated assets/liabilities, the Committee recommends the introduction. of foreign currency denominated deposits with banks and corporates and obtaining foreign currency denominated loans from banks. Since the settlement takes place in rupees, the Committee is of the view that no limit on such deposits is necessary. The facility would enable residents to take a view on the future movement of currencies vis-a-vis interest rate s

IV.A.2 All Other Financial Capital Transfers including for Opening, Current/Chequeable Accounts

The Committee recommends that in Phase 1, individual residents be permitted to invest in assets in financial markets abroad up to US $ 25,000 per annum (with higher limit's in subsequent phases), thus providing them the freedom of an additional avenue- for their personal savings. This will send a salutary signal regarding the country's commitment to CAC. One of the members of the Committee, Shri A.V. Rajwade, was not in favour of permitting financial outflows by resident individuals, resident corporates (Paragraph I.A.2) and non resident individuals out of their non repatriable assets (Paragraph IV.B. 1) until the preconditions set out for the first phase of CAC are met. Furthermore, he stressed that significant improvements need to be effected in the collection of data to allow a proper assesment of market conditions. Another member, Dr. S.S. Bhalla, held a contrary view and in his assessment the macro economic situation was unprecedently strong. In fact he felt that as the country is likely to continue to experience large capital inflows better macro and exchange rate management would be facilitated if individual residents were allowed outflows with significantly larger limits. Taking into account the divergent viewpoints the Committee recommends that such outflows by resident individuals should be permitted, up to US $ 25,000 per annum in Phase I and with the progressive entrenchment of preconditions/signposts recommended by it, these limits could be gradually increased to US $ 50,000 per annum in Phase II and to US $ 100,000 in Phase III.

IV.A.3 Loans from Non Residents

At present, individual residents are permitted to obtain loans from non resident relatives for personal or business purposes on an interest free non repatriation basis. Such loans cannot be used for purposes of investments by the resident. In the context of CAC, such conditions are too

restrictive and the Committee recommends that resident individuals should be free to obtain loans up to US $ 250,000 in Phase I (with increase in subsequent phases) from non resident individuals on repatriation basis at LIBOR without any restriction on the use of funds and without any prior approval from RBI.

IV.B. Individuals : Non Residents

IV.B.1. Capital Transfers from Non Repatriable Assets held in India (including NRO & NRNRRD Accounts)

Currently, non residents are not allowed any capital transfers out of their assets in India other than out of investments made by them on repatriation basis. The Committee considered the question of permitting non resident individuals to effect capital transfers out of their non repatriable assets in India. Consistent with the view taken by it in regard to capital outflows for resident individuals (Paragraph IV.A.2) the Committee recommends that capital outflows up to identical annual limits may be allowed out of non repatriable assets of non residents.

At present, under the Non Resident Non Repatriable Rupee Deposit Account (NRNRRD) scheme the principal is non repatriable, but with the introduction of current account convertibility interest is freely repatriable. The continuation of such a scheme is incongruous with CAC and the Committee recommends this scheme should be terminated in Phase 1. The funds under the existing NRNRRD scheme would get merged with other non repatriable assets on maturity. In order to give an incentive to NRNRRD. account holders, the Committee recommends that in case the maturity proceeds of the NRNRRD accounts are placed in a special three year NRE account (without facility of premature withdrawal) the non resident may be allowed to repatriate the full amount of such deposits on maturity.

IV.B.2. Foreign Direct Investment (FDI) in India(other than in Real Estate)

As in the case of FDI by non resident corporates, FDI by non resident individuals should be without prior RBI approval but subject only to reporting by ADs. The Committee is of the view that in the matter of FDI no distinction need be made between non resident Indians and other non residents. It, therefore, recommends that all direct investments/disinvestments by non resident individuals may be governed by the comprehensive and transparent guidelines on foreign investment (direct and portfolio) and may be freed of all restrictions from exchange control, subject to reporting through ADs.

IV.B.3. Portfolio Investment in India through Stock Exchanges

The recommendations made by the Committee in regard to portfolio investments in India by non resident OCBs (Paragraph I.B.2) and FlIs (Paragraph III.B.1) should be applicable to non resident individuals as well and be governed by the comprehensive guidelines referred to elsewhere.

IV.B.4. Disinvestment

Consistent with the recommendations made that all foreign investments/ disinvestments in India be freed from exchange control, the Committee recommends that disinvestment by non resident individuals need not be subject to approval by RBI/exchange control and can be freely allowed in terms of the comprehensive guidelines referred to above.

V. FINANCIAL MARKETS

The role of the financial markets in the context of CAC has been elaborated in Chapter 111. Well developed financial markets are essential to provide efficient transmission mechanisms for monetary and exchange rate policies and to even out varying market sentiment enabling the arbitrageurs to play their full role in stabilising the volatility arising out of intern al/extern al shocks. Development of deep and liquid financial markets also enable the development of the derivatives market based on the underlying cash market. Towards developing financial markets, the Committee recommends the following specific measures:

V.1. Foreign Exchange Market

(a) Forward Markets

The Committee recommends that in Phase I, all participants in the spot market should be permitted to operate in the forward market; FIIs, non residents and non resident banks having rupee assets may be allowed forward cover (with right of cancelling and rebooking) to the extent of their assets in India. This measure will facilitate two-way expectations to emerge in the market, reducing the need for RBI intervention. Allowing banks in India to make two-way quotes in rupees to overseas branches/banks/ correspondents will signal a step towards CAC. Those having economic exposures may be allowed to participate in the forward market. Restrictions on participation in spot/forward markets, i.e., in terms of underlying actual or economic exposure may be removed in Phase III.

(b) Authorised Dealers

Currently, only banks are allowed to operate as full-fledged ADs. In order to have larger number of market makers who actively give two way quotes and correct the present skewed market, the Committee recommends that All India FIs which comply with well defined criteria and fulfill prescribed prudential/regulatory requirements should be allowed to participate in the forex market as full-fledged ADs even in Phase I. In Phase III, other non bank entities fulfilling criteria similar to those prescribed for FIs could be permitted to become full-fledged ADs.

(c) Products

For long, the forward contract was the only hedging instrument available to cover exchange risk. Even this product is available in the Indian market only for periods up to six months. The monetary and credit policy of April 15, 1997 has announced several measures to facilitate development of the money market and long-term forward market. In view of this and concomitant with other measures for evolving a smooth yield curve, there is scope for introduction of rupee based derivatives. The Committee, recognising the fact that the market will evolve a variety of hedging products, recommends that proper risk management systems should be in place before allowing ADs to start trading in derivatives. Simultaneously, capital requirements for market risk for derivatives on the lines of internationally accepted principles should be introduced by the RBI. In this connection, the recommendations made by the Expert Group on Foreign Exchange Markets (Chairman: Shri O.P.Sodhani) may be reviewed and implemented. Currently, corporates are allowed to use derivatives for hedging their currency/interest rate exposures through ADs in India and are not allowed to access overseas markets directly. The Committee recommends that in Phase 11, corporates may be allowed to access overseas markets directly for derivatives without routing such transactions through ADs in India. Reporting requirement should, however, continue.

The Committee is of the view that the time is ripe for introduction of futures in currencies and interest rates to facilitate various users to have access to a wide spectrum of cost efficient hedge mechanism. Alongside the introduction of futures, the Committee is of the view that it may be worthwhile to institute a system of trading in futures which is more transparent and cost efficient than the existing system of trading in forex markets. An ideal system of trading in futures would be one which permits greater transparency by displaying on the screen the demand and supply at various rates to all participants at any given moment, but at the same time, preserving the anonymity of the counterparties. A trader who intends to enter the market enters his quote/quantum after having a look at the ongoing display of quotes. The computer then proceeds to match the quotes and orders and finalises the deal. Such a system is employed by the National Stock Exchange for equity/ debt trading. A trading system of this kind needs the support of an efficient clearing and payment settlement mechanism. The Committee, therefore, recommends that futures trading should be introduced on a screen-based system with back-up support of an efficient settlement system.

V.2. *Money Market*

The money market, in its existing form, suffers from a considerable degree of segmentation. The banks, FIs and mutual funds are subjected to different norms regarding borrowing and lending. In the interest of developing greater depth and liquidity in money markets, the Committee

recommends that such segmentation should be given up simultaneous with introduction of uniform reserve requirement prescriptions for banks and non banks. The financial institutions and non bank entities may be permitted entry in the money market subject to exacting prudential regulations. The RBI should issue prudential guidelines in regard to asset liability mismatches in rupee books of banks and non banks. Various market regulators should jointly examine the feasibility of introducing transparent and cost efficient trading systems. As a further measure of development of the money market, all interest rates should be totally deregulated, minimum period restrictions removed and restriction on entry of participants should be totally removed. Participants in the money market at the wholesale and retail level should be distinguished only by the size of transactions.

V.3 Government Securities Markets

The Committee is of the view that in India, the development of a deep and liquid securities market across all maturities is a *sine qua non for* development of a consistent yield curve. Without development of a well defined rupee yield curve, with sufficient liquidity across maturities, the development of derivatives markets in forex and rupees would be constrained. Several measures have been announced in the monetary and credit policy of April 15, 1997 for development of the money, forex and securities markets. The Committee's recommendations for development of the securities market as indicated in the tabulated list of measures are based on (i) increasing role of primary dealers and satellite dealers, (ii) the RBI withdrawing from the primary market in stages with active presence in the secondary market, (iii) setting up of an Office of the Public Debt (OPD) by Government which will eventually assume full responsibility for the management of public debt including timing and amount of primary issue of all Government securities, (iv) the RBI providing a Liquidity Adjustment Facility to Primary Dealers (PDs) through repos/reverse repos. The Liquidity Adjustment Facility would provide for a corridor within which market rates would be able to move without undue volatility and would facilitate formation of a consistent yield curve, (v) strong and exclusive fiscal incentives for dedicated gilt funds to encourage effective retailing of government securities, (vi) totally automated real time gross settlement through the DVP system for government securities, (vii) allowing FlIs in the Treasury bill market and (viii) introduction of futures in all Government securities.

V.4 Development of the Gold Market

It is essential to liberalise the policy on gold while simultaneously taking steps to develop a transparent and well regulated gold market with integrated links with other financial markets to ensure a successful move towards CAC. The main ingredients of the change in policy on gold could be :

(i) Removal of restrictions on imports/exports of gold, which *inter alia* would diminish hoarding by ready availability of gold in India.

(ii) Development of go)d related products/financial instruments.

(iii) Development of markets in physical as well as financial gold in India which could be made use of by both residents and non-residents.

(iv) Encouragement for the active role of banks and other non bank financial entities in the gold market.

The Committee recognises that the recommendations imply a major change in the policy in relation to gold and that full operative details would need to be worked out for implementation of these recommendations. In this context, the Committee is of the view that it would be useful to study the gold financing schemes and measures for fostering markets in Italy, Turkey and Malaysia.

The Committee recommends that in Phase I banks and financial institutions fulfilling well-defined criteria may be allowed to operate freely both in the domestic and the international markets in gold. Sale of gold by banks and financial institutions should be allowed freely to all residents. The Committee also recommends that all banks may be allowed to offer gold-linked deposits and loans on the lines of foreign currency linked rupee deposits and loans for residents recommended

in Paragraph II.A.5. Banks fulfilling certain well-defined criteria may be allowed to mobilise household gold for providing working capital gold loans to jewellery manufacturers as also traders. Banks may also be encouraged to grant loans against gold denominated deposits.

In Phase II, steps should be taken by Government of India and RBI for developing a well-regulated market in India for gold and gold derivatives including forward trading. Both residents and non residents may be allowed to operate in this market, subject to adherence to certain well-defined guidelines.

V.5 Participation in International Commodity Markets

At present residents are not permitted to participate in International Commodity Exchanges. In the context of globalisation, it is necessary to provide residents the same facility as that enjoyed by non residents. Participation in Commodity Exchanges helps participants to hedge their price risk as also provide a mechanism for "price discovery". Allowing such facilities to residents will reduce the volatility of prices.

Concluding Observations

4.9 The Committee underscores the critical importance of monitoring information on various types of capital flows and stocks. The establishment of a comprehensive database encompassing regular reporting of accurate information on capital transactions by ADs as well as by other entities dealing in foreign exchange for capital transactions should be accorded the highest priority by the RBI and in this context an expeditious revamping of the statistical information system should be undertaken.

4.10 While CAC to some extent privatises decisions relating to foreign assets, in order to ensure tax compliance, it is necessary for India to institute arrangements with other countries for sharing tax information on a multilateral basis, akin to the agreement negotiated by the OECD countries.

4.11 Taking into account the sizeable adjustments in terms of the preconditions which would be required in various sectors, principally the fisc and the financial sector, the Committee recommends a phased approach to CAC in India. With a view to implementing the opening up of the capital account without deleterious consequences and erosion of credibility because of any backtracking on the timing and sequencing of measures set out in this Chapter, the Committee recommends that the RBI should ensure ongoing monitoring of policies undertaken to entrench the preconditions/signposts and also ensure that measures on the phased move towards CAC are carefully implemented. The phased programme outlined here could be accelerated or decelerated depending on the performance vis-a-vis the preconditions/ signposts.

4.12 The Committee recognises that even after the third phase is completed, capital controls on a number of items would continue to be necessary. The Committee recommends that at the end of the three year phasing, a stock taking of the progress on the preconditions/signpo sts as well as the impact of the measures outlined by the Committee should be undertaken. CAC is a continuous process and further measures could be undertaken in the light of the experience gained.

Chapter 5

Recommendations of the Committee

The recommendations of the Committee are summarised below :

Issues in Capital Account Convertibility

1. The Committee is of the view that there are several benefits of a more open capital account : the availability of a larger capital stock to supplement domestic resources and thereby higher growth, reduction in the cost of capital and improved access to international financial markets

(Paragraph 1.22). Capital Account Convertibility (CAC) allows residents to hold an internationally diversified portfolio which reduces the vulnerability of income streams and wealth to domestic real and financial stocks, lower funding costs for borrowers and prospects of higher yields for savers (Paragraph 1.23). An associated gain from CAC is the dynamic gains from financial integration. Allocative efficiency improves as a result and this can stimulate innovation and improve productivity (Paragraph 1.24). CAC provides the impetus for domestic tax regimes to rationalise and converge to international tax structures. This removes inducements for domestic agents towards evasion and capital flight. The Committee emphasises that capital controls turn progressively ineffective, costly and even distortive (Paragraph 1.19 and Paragraph 1.25).

2. The Committee recognises that the institution of financial sector reforms in India brought into the open weaknesses which had been in the system for a long time. The introduction of CAC would require more proactive policy action as an open capital account could bring these weaknesses under sharper focus. CAC would impose a strong discipline upon the financial system and would expedite the early rectification of infirmities in the system and lead to widening/deepening of markets to enable the spreading/distribution of risks (Paragraph 1.27).

The International Experience

3. The Committee's survey of the international experience with CAC revealed that countries which initiated the move to CAC on the basis of strong fundamentals were able to modulate the pace of instituting CAC without undertaking large and dramatic shifts in the stance of macro economic policies. Furthermore, these countries were less vulnerable to backtracking and the reimposition of controls. Countries with weak initial conditions were constrained to adopt drastic macro economic policies to facilitate the move to CAC. Some of these countries had to face interruptions and reintroduce capital controls in. the evolution of CAC (Paragraph 2.108).

4. The Committee noted that most countries considered a strong balance of payments position as a necessary precondition for the move to CAC and universally built up reserves. The Committee's survey of the country experiences shows that strengthening of the financial system emerged as the most important precondition for CAC. Fiscal consolidation is another important precondition for CAC among all countries. An important concomitant in the process of CAC is the conduct of an appropriate exchange rate policy (Paragraphs 2.109, 2. 110 and 2. 111).

5. In the specifics of capital account liberalisation, in the countries studied by the Committee, restriction on inflows and related outflows by non residents and residents were removed first, followed by relaxation of restrictions on outflows by residents. Among residents, corporates and non banks usually received preferential treatment, followed by banks and individuals. Most countries maintained or were required to impose some controls on capital inflows during the transition to CAC (Paragraph 2.112).

Preconditions/Signposts for CAC

6. Based on an assessment of macro economic conditions, the Committee is of the considered view that the time is now apposite to initiate a move towards CAC. The Committee, however, recognises that the initial conditions do contain certain weaknesses and the entrenchment of preconditions can be achieved in the Indian context only over a period of time. The establishment of preconditions need to be viewed as processes rather than as one time indicators (Paragraph 3.2). The Committee therefore recommends that the implementation of CAC be spread over a three year period 1997-98, 1998-99 and 1999-2000. The Committee stresses that implementation of measures towards CAC should be sequenced along with the authorities making an assessment of the progress towards the attainment of the preconditions/ signposts stipulated for the relevant year and depending on this assessment the implementation of measures could be accelerated or decelerated (Paragraph 3.4).

7. Fiscal consolidation, a mandated inflation target and strengthening of the financial system should be regarded as crucial preconditions/signposts for CAC in India. In addition, a few important macro economic indicators should also be assessed on an on-going basis. These are

: the conduct of exchange rate policy, the balance of payments and the adequacy of foreign exchange reserves (Paragraph 3.6).

Fiscal Consolidation

8. The Committee recommends a reduction in the GFD/GDP ratio from a budgeted 4.5 per cent in 1997-98 to 3.5 per cent in 1999-2000. The reduction in the Centre's gross fiscal deficit should be accompanied by a reduction in the States' deficit as also a reduction in the quasi-fiscal deficit (Paragraph 3.11).

9. The practice of financing the amortisation of Government market loans out of fresh borrowings is clearly unsustainable and this practice would inevitably result in a crisis situation. The Tenth Finance Commission has recommended the institution of a Consolidated Sinking Fund (CSF) for the public debt and the Committee while strongly endorsing this recommendation, stresses that the institution of a CSF is an important ingredient in the achieving of the precondition on fiscal consolidation (Paragraph 3. 10).

10. Monetary management is often clouded by the monetary authorities' concern about the Government's borrowing programme and therefore, the Committee recommends that steps should be initiated to separate the debt .management policy from monetary management and to this effect the Government should set up its own Office of 'Public Debt. The RBI should -totally eschew from participating in the primary is-sues of Government borrowing (Paragraph 1.12).

11 Transparent and internationally comparable procedures for fiscal accounting should be adopted so as not to blur the true magnitude of the GFD/GDP ratio as also the constituents of the budget as a whole. The Committee recommends that the Government of India should consider an early introduction of a systems. of fiscal transparency on the lines of the New Zealand Fiscal Responsibility Act (Paragraph 3.13).

Mandated Inflation Rate

12. In the context of the move towards CAC effective measures should be taken, to evolve a more specific commitment on the inflation rate. The Committee recommends that there should be an early empowering of the RBI, on the inflation mandate. There should be a medium-term inflation mandate approved by Parliament and only Parliament should alter that mandate. Once -the- mandate is given, the RBI should be given freedom to use the instruments at. its command- to attain the. medium-term inflation target. Intensification or withdrawl of public intervention in price formation or a shock in the real sectors could warrant a review of the mandate but there should be clear and transparent guidelines on the circumstances under which the mandate could be changed (Paragraph 3.18). The Committee recommends that the mandated rate of inflation for the three yew, period. 1997-98 to 1999-2000 should be an average of 3 - 5 per cent. Such a mandate would necessarily need to provide for greater independence for the RB1 (Paragraph 3.19).

Consolidation in the Financial Sector

13. The Committee recommends that interest rates should be fully deregulated in 1997-98 and there should be total transparency to ensure that there are no formal interest rate controls (Paragraph 3.22).

14. The strengthening of the financial system is the most important precondition to the move to CAC. Noting the systemic dangers of some of the weak banks growing at rates faster than the system, the Committee recommends that the weak banks should be converted into what are called 'narrow banks'. The incremental resources of such banks should be restricted only to investments in Government securities and in extreme cases of weakness not only should such banks not be allowed to increase their advances but there would need to be a severe restraint on their liability growth. Such measures are unavoidable if the financial system is to be safeguarded during the move towards CAC (Paragraph 3.23).

15. The Committee recommends the following sequencing and time frame for signposts which

should be attained in relation to CRR and NPAs, as part of a progressive move towards CAC (Paragraph 3.24).

	Present Level	1997-98	1998-99	1999-2000
i) Gross NPAs of the banking sector (as a percentage of total advances)	13.7* (as of March 1997)	12.0	9.0	5.0
ii) Average effective CRR for the banking system	9.3 (as of April 1997)	8.0	6.0	3.0

*   Tentative estimate

16. The Committee recommends that the financial institutions should also be made to function with a targeted mandate to reduce the quantum of NPAs within a time-bound programme (Paragraph 3.25).

Exchange Rate Policy

17. The RBI should have a Monitoring Exchange Rate Band of +/- 5.0 per cent around the neutral Real Effective Exchange Rate (REER). The RBI should ordinarily intervene as and when the REER is outside the band. The RBI should ordinarily not intervene when the REER is within the band. The RB I could, however, use its judgment to intervene even within the band to obviate speculative forces and unwarranted volatility. The Committee further recommends that the RBI should undertake a periodic review of the neutral REER which could be changed as warranted by fundamentals (Paragraph 3.28).

18. The Committee stresses that credibility of the exchange rate policy would be vital in the context of CAC and to this extent there must be transparency in exchange rate policy: (i) the neutral REER i.e., the base period should be announced, (ii) the REER Monitoring Band should be declared, (iii) the REER should be published on a weekly basis with the same time lag as the publication of the reserves and (iv) changes in the neutral REER should be made public (Paragraph 3.29).

19. The Committee recommends that as part of exchange rate management greater attention should be focussed on ensuring that the forward exchange markets reflect the interest rate differentials (Paragraph 3.31).

Balance of Payments

20. The Committee recognises that in view of the growing degree of integration of the Indian economy, the size of the current account deficit (CAD) which can be sustained without encountering external constraint is a function of the degree of openness of the economy which can be defined in terms of the ratio of current receipts (CR) to GDP (Paragraph 3.35). Accordingly, the Committee recommends that, as a broad rule of thumb, over the three year period 1997-98 to 1999-2000, external sector policies should be designed to ensure a rising trend in the CR/GDP ratio from the present level of 15 per cent and the endeavour should be to reduce the debt service ratio gradually from 25 per cent to 20 per cent. The CAD/GDP ratio would need to be consistent with the above parameters (Paragraph 3.36).

Adequacy of Reserves

21. In the context of a move to CAC, capital flows would have a more significant effect on the balance of payments and conventional indicators in terms of import cover does not provide a good indicator of the adequacy of reserves. As a broad guideline, the Committee recommends that the following four indicators be used in the Indian context for evaluating the adequacy of reserves:

(i) Reserves should not be less than six months of imports; this ratio is higher than earlier norms as it would take into account the uncertainties and volatility in capital flows which can arise in the context of a move to CAC. Under this formulation, the foreign exchange reserves would, at present need to be about US $ 22 billion.

(ii) Reserves should not be less than three months of imports plus 50 per cent of debt service payments plus one month's exports and imports to take into account the possibilities of leads and lags. On this basis the present requirement would be US $ 24 billion. When more accurate data on leads and lags are available, the requirement for resources could be adjusted appropriately.

(iii) The short term debt and portfolio stock which is equivalent to 70 per cent of the level of reserves should be lowered to 60 per cent by using a formulation that incremental short term debt and portfolio liabilities should be accompanied by equivalent increases in reserves which would ensure that this ratio would decline to the desired extent. On this basis the reserves would need to rise from the present level of US $ 26 billion to US $ 31 billion.

(iv) The net foreign exchange assets to currency ratio (NFA/Currency ratio) should be prescribed by law at not less than 40 per cent . The present ratio is 70 per cent and the objective should be to maintain it around the present ratio. The implication would be that at the present time the stipulation under the proposed ratio of a minimum of 40 per cent would be around US $ 15 billion; under the desired ratio of 70 per cent, the requirement would be a little over US $ 26 billion.

(Paragraph 3.42)

Strengthening of the Financial system

22. The Committee recommends that a uniform regulatory system needs to be put in place for banks and non banks particularly FIs in relation to prudential norms, market participation, reserve requirements and the interest rate regime (Paragraph 3.45).

23. In the context of a move towards CAC, the Committee recommends that reserve requirements on banks' non resident liabilities and overseas borrowings should be at least on par with those on domestic liabilities. Furthermore, as one of the instruments for moderating capital inflows, the RBI should use the instrument of CRR to impose higher reserve requirement on non resident liabilities including overseas borrowings (Paragraph 3.46).

24. The Committee is of the view that risk management is a critical area, to which banks and non banks (including FIs) must bestow immediate attention. Towards this, the Committee recommends that :

(i) RBI should prescribe prudential norms for rupee mismatches,

(ii) banks should move to 100 per cent mark-to-market valuation of investments,

(iii) banks should adopt best practices of risk management suggested by the Expert Group on Forex markets (Chairman Shri O.P. Sodhani),

(iv) banks should follow international accounting and disclosure norms,

(v) capital prescriptions should be stipulated for market risk.

(Paragraph 3.47)

25. A successful move to CAC requires an effective supervisory regime which needs to be able to pick up warning signals and weaker entities need to be monitored more closely and frequently (Paragraph 3.48).

26. As risks faced by the financial sector are much higher in developing countries, the Committee recommends that the RBI should consider the imposition of even more stringent capital

adequacy standards than the Basle norms and income recognition and asset classification norms should be tightened expeditiously. There could also be steeper capital requirements for banks with higher level of NPAs (Paragraph 3.49).

27. The Committee is of the view that much more needs to be done to enable public sector banks to operate with a greater degree of autonomy to cope with the rapidly changing environment. The Committee recommends that the more efficient public sector banks need to be allowed, nay actively encouraged, to break away from the pack and their activities should not be hemmed in by concerns for the weak banks. The Committee recommends that the FIs should also be given a greater degree of operational freedom within the framework of strict prudential norms. While issues of autonomy are often posed as one of the regulator/owner giving freedom to the entities, there is also the issue of entities taking on their rightful autonomy. The Boards should be so constituted that they effectively operate as autonomous units. The Committee emphasises that autonomy is never given, it is always earned (Paragraph 3.50).

28. The Committee recommends that a comprehensive banking legislation and an enforcement machinery be put in place not only to reduce the quantum of NPAs but also to ensure that such a framework serves as a deterrent for future defaulters. In the context of CAC, a comprehensive review of all banking and finance related enactments needs to be taken up, which have engendered inflexibilities/rigidities in the system (Paragraph 3.51).

29. The Committee is of the view that without a greater degree of technology absorption, the market participants will be ill-equipped to build strong risk management systems and management information systems. Upgradation of technology can pave the way for an efficient payment and settlement mechanism which will strengthen the financial system considerably (Paragraph 3.52).

30. The Committee underscores the need for strong initiatives on the part of market participants to upgrade their human resource skills for enabling Indian financial entities to compete meaningfully with their counterparts abroad. In order that they attract the best talent and expertise, individual banks and FIs should have freedom to determine their personnel policies including recruitment and wage policies without being constrained by any rigidities (Paragraph 3.53).

CAC and Gold

31. In the context of CAC there is strong case for liberalising the overall policy regime on gold. The Committee is of the view that the policy on gold is, to some extent in the nature of a precondition for a successful move to CAC (Paragraph 3.57).

Timing and Sequencing of measures

32. The Committee recommends that alongside further measures of liberalisation of 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 ban on certain outflows and the system needs to develop confidence that some capital outflows, far from being destabilising, would be conducive to the overall efficiency of deployment of resources (Paragraph 4.2).

33. The Committee recognises that while the timing and sequencing of CAC proposed can be undertaken under the existing laws and regulations relating to foreign exchange, they would be facilitated by the proposed changes in the legislative framework governing foreign exchange transactions (Paragraph 4.3)

34. The timing and sequencing of measures for liberalisation of capital outflows and inflows are set out in a tabular form in Chapter 4 classified in relation to various economic agents viz., corporates, banks, non banks and individuals. A three year road map is outlined with Phase I (1997-98), Phase II (1998-99) and Phase III (1999-2000). Concomitant measures for the development and integration of the foreign exchange, money and securities markets are also set out. Some of the important measures are :

(i) Direct investment in ventures abroad by Indian corporates should be allowed up to US $ 50 million at the level of authorised dealers in terms of transparent guidelines by RBI and beyond US $ 50 million through the Special Committee. The restrictions on repatriation of dividend etc., within a time period should be removed. Ventures abroad should not be confined to exporters/ exchange earners.

(ii) Corporates should be allowed to freely open offices abroad for promoting their businesses.

(iii) ECB ceiling should not be applicable for loans with average maturity of 10 years and above which in Phase II could be reduced to 7 years and above. Restriction on end use of ECB for rupee expenditure should be removed.

(iv) RBI approval for various purposes while executing projects should be dispensed with subject to guidelines and reporting.

(v) Exporters/exchange earners may be allowed 100 per cent retention of earnings in EEFC accounts with complete flexibility in operation of the accounts for current and permitted capital transactions and allowed cheque writing facility in these accounts.

(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. Direct/portfolio investment may be open to all non residents on par with NRIs and FIIs.

(vii) Banks may be allowed to borrow from overseas markets and deploy their 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. Deployment of funds outside India should be permitted subject to the adherence to Section 25 of the BR Act and prudential norms relating to open position and gap limits.

(viii) SEBI registered Indian investors may be allowed to set up funds for investments overseas subject to overall limit of US $ 500 million in Phase I, US $ 1 billion in Phase II and US $ 2 billion in Phase III.

(ix) Individuals may be allowed to invest in assets in financial markets abroad to the extent of US $ 25,000 in Phase I, 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.

(x) Residents may be allowed to have foreign currency denominated deposits with corporates and banks (only rupee settlement).

(xi) Residents may be allowed to obtain loans from non residents US $ 250,000 on repatriation basis with interest at LIBOR with no restrictions on use of funds.

(xii) The non resident non repatriable rupee deposit scheme should be discontinued in Phase I. Maturity proceeds if kept in a special NRE account for 3 years with no early withdrawal facility should be allowed for full repatriation.

(xiii) All participants in spot markets should be allowed participation in forward markets; FIIs, non residents and non resident banks may be allowed forward cover to the extent of their assets in India.

(xiv) All India FIs fulfilling requisite criteria should be allowed to become full-fledged ADs.

(xv) Currency futures, may be introduced with screen based trading and efficient

settlement systems..

(xvi) Participation in money markets may be. widened, market segmentation removed and interest rates deregulated.

(xvii) RBI should withdraw from primary market in Government securities, role of Primary and Satellite Dealers should be increased, fiscal incentives should be provided for individuals investing in Government securities and the Government should set up its own office of public debt.

(xviii) Banks and FIs should be allowed to participate in gold markets in India and abroad and deal in gold products.

(Paragraph 4.4 and, the tabulated list of measures).

35. The Committee underscores the critical importance of monitoring information on various types of capital flows and stocks. In this context an expeditious revamping of the statistical information system should be undertaken (Paragraph 4.9).

36. While CAC to some extent privatises decisions relating to foreign assets, in order to ensure tax compliance, it is necessary for India to institute arrangements with other countries for sharing tax information on a multilateral basis, akin to the agreement negotiated by the OECD countries (Paragraph 4.10).

37. The RBI should ensure ongoing monitoring of policies undertaken to entrench the preconditions/signposts and also ensure that measures on the phased move towards CAC are carefully implemented. The phased programme outlined here could. be accelerated or decelerated depending on the performance vis-a-vis the preconditions/signposts .(Paragraph 4.11).

38. The Committee recommends that at the end of the three year phasing a stock taking of the progress on the preconditions/signposts as well as the impact of the measures outlined by the Committee should be undertaken. CAC is a continuous process and further measures could be undertaken in the light of the experience gained (Paragraph 4.12).

Annexures

Annexure I

Reserve Bank of India
Central Office
Mumbai 400 001

Memorandum

1. With a view to examining the various issues relating to capital account convertibility, Reserve Bank of India appoints a Committee on Capital Account Convertibility.

2. The Committee consists of the following :

1)	Shri S.S.Tarapore	Chairman
2)	Dr. Surjit S.Bhalla	Member
3)	Shri M.G.Bhide	Member
4)	Dr. Kirit Parikh	Member
5)	Shri A.V.Rajwade	Member

3. The terms of reference of the Committee will be as follows :

(i) To review the international experience in relation to capital account convertibility and to indicate the preconditions for introduction of full capital account convertibility.

(ii) To recommend the measures that should be taken to achieve full capital account convertibility.

(iii) To specify the sequence and time frame in which such measures are to be taken.

(iv) To suggest domestic policy measures and changes in institutional framework, consistent with the specified sequencing, and

(v) To make such other recommendations as the Committee may deem relevant to the subject.

4. The Committee will adopt its own work procedures and meet as often as necessary.

5. The Committee is expected to submit its Report by May 30, 1997.

6. The Secretariat for the Committee will be provided by the Reserve Bank of India.

(C.Rangarajan)
Governor
28.2.1997

Annexure II

List of Organisations with whom the Committee had discussions or received material as also a list of persons who provided help to the Committee:

List of Organisations

1. Associated Chambers of Commerce and Industry of India (ASSOCHAM)
2. Confederation of Indian Industry (CII)
3. Federation of Indian Chambers of Commerce and Industry (FICCI)
4. PHD Chamber of Commerce and Industry
5. Indian Merchants' Chamber
6. Federation of Indian Export Organisations (FIEO).
7. Indian Banks Association (IBA)
8. Foreign Exchange Dealers' Association of India (FEDAI).
9. Bombay Chartered Accountants' Society
10. Bombay Chamber of Commerce and Industry
11. Industrial Development Bank of India (IDBI)
12. Industrial Credit and Investment Corporation (ICICI)
13. Export- Import Bank of India (EXIM Bank)
14. Bank Indonesia
15. Bank of Thailand
16. Banco Central de Chile
17. Ministry of Finance, Buenos Aires, Argentina
18. Bank of Mexico
19. Bank Negara, Malaysia
20. Bank of Korea
21. Reserve Bank of New Zealand
22. Central Bank of the Philippines
23. South African Reserve Bank

List of Persons:

1. M.R.Sivaraman, Executive Director, International Monetary Fund.
2. R. Kannan, International Monetary Fund
3. David Goldsbrough, International Monetary Fund
4. Suman Bery, The World Bank
5. John Williamson, The World Bank
6. N. Ganesh Kumar, University of Southern California, Los Angeles.

7. G.Giridhar Prabhu, Achal Industries
8. M.V Subbiah, Murugappa Group
9. Ajay Shah, Indira Gandhi Institute of Developmental Research
10 Susan Thomas, Indira Gandhi Institute of Developmental Research

Reserve Bank of India

1. V Subrahmanyam, Executive Director
2. A. Vasudevan, Executive Director
3. C. Harikumar, Executive Director
4. Khizer Ahmed
5. A. K. Batra
6. B. Maheshwaran
7. Benu Schneider
8. Urjit Patel

List of Persons:

Department of External Investments and Operations

9. H. Bhattacharya
10. G. Mahalingam
11. Raj i v Ranjan
12. Vanitha K Venugopal
13. R. Mani
14. R. Srinivas Rao
15. G. V. Naik
16. J. S. Jathan
17. R.S. Vaidya

Department of Economic Analysis & Policy

18. S.K. Pattanaik.
19. L. Laxmanan
20. David L. Sinate
21. Sumit B asu
22. S. Sugandhi
23. Ambika Padmanabhan
24. L.F..Fernandes

Exchange Control Department

25. K. G. Chaudhari
26. K.C.Nair
27. K. Ramasubramanian
28. K.K. Rawal
29. G. Padmanabhan
30. F.M. Chinikamwala
31. D.G. Kolhatkar

Annexure III.1

IMF Members not having
Restriction on Payments for
Capital Ttansactions

Developed countries

1. Australia
2. Austria

3. Belgium and Luxembourg
4. Canada
5. Denmark
6. Finland
7. France
8. Germany
9. Hong Kong
10. Ireland
11. Italy
12. Netherland
13. New Zealand
14. Norway
15. Portugal
16. Saudi Arabia
17. Spain
18. Sweden
19. Switzerland
20. United Kingdom
21. United States

Developing Countries

1. Antigua and Barbuda
2. Argentina
3. Bahrain
4. Bolivia
5. Brunei Darussalam
6. Costa Rica
7. Djibouti
8. Ecuador
9. El Salvador
10. Estonia
11. Gambia
12. Guatemala
13. Honduras
14. Indonesia
15. Jamaica
16. Kiribati
17. Kuwait
18. Latvia
19. Lebanon
20. Lithuania
21. Malaysia
22. Maldives
23. Marshall Island
24. Mauritius
25. Micronesia,Fed. States of
26. Niger
27. Oman
28. Panama
29. Peru
30. Qatar
31. San Marino
32. Seychelles
33. Singapore
34. Trinidad And Tobago
35. United Arab Emirates
36. Vanuatu

Source : International Monetary Fund

Annexure III.2

Capital Controls in Developing Countries

Category	Number of Countries Maintaining Controls
Any form of capital control	119
Comprehensive controls	67
On outflows	67
On inflows	17
Foreign direct investments	107
Of non residents	84
Of residents	35
Profit repatriation and capital liquidation	34
Taxes on capital transactions	9
Non resident-controlled enterprises	6
Portfolio investments	61
Of non residents	30
Of residents	33
Security issuance by non residents	15
Security issuance abroad by residents	6
Debt-to-equity conversion	2
Financial transactions	78
Of non residents	41
Of residents	66
Trade-related financial transactions	7
Deposit requirements for borrowing from abroad by residents	2
Deposit accounts	83
Of non residents in foreign exchange'	37
Of non residents in local currency	52
Of residents abroad	29
Of residents in foreign currency with domestic banks	23
Other capital transfers	70
Personal capital transfers	34
Blocked accounts	24
Real estate transactions	
Of non residents	23
Of residents	30

Source: Quirk, Peter J., Owen Evans, et al " Capital Account Convertibility, Review of Experience and Implications for IMF. Policies", Occasional Paper 13 1, IMF, Washington D.C. , October 1995.

Annexure III.3

Comparator Country Performance

	Real GDP Growth (per cent)					
	1990	**1991**	**1992**	**1993**	**1994**	**1995**
Argentina	0.1	8.9	8.7	6.0	7.4	-4.6
Chile	3.3	7.3	10.7	6.6	4.2	8.5
Indonesia	7.2	7.0	6.5	6.5	7.5	8.1
Korea	9.5	9.1	5.1	5.8	8.6	9.0
Malaysia	9.7	8.7	7.8	8.3	8.7	9.5
Mexico	4.5	3.6	2.8	0.7	3.5	-6.9
New Zealand	-0.8	-1.3	Neg	6.0	3.4	6.2
Philippines	3.0	-0.5	0.3	2.1	4.4	4.8
Thailand	11.6	8.4	7.9	8.2	8.5	15.4

South Africa	-0.3	-1.0	-2.2	1.3	2.7	3.3
India	5.7	0.5	4.6	4.5	6.3	7.2

Neg : Negligible.

Investment/GDP (Per cent)						
	1990	**1991**	**1992**	**1993**	**1994**	**1995**
Argentina	14.0	14.6	16.7	18.2	19.9	18.3
Chile	26.3	24.5	26.8	28.8	26.8	27.4
Indonesia	36.1	35.5	35.9	33.2	34.3	41.8
Korea	36.9	38.9	36.6	35.1	36.1	37.1
Malaysia	31.3	35.9	33.5	35.0	38.5	40.7
Mexico	22.8	23.4	24.4	23.2	23.5	19.4
New Zealand	19.9	16.8	18.6	21.1	22.3	21.9
Philippines	24.2	20.2	21.3	24.0	24.0	22.3
Thailand	41.1	42.2	39.6	39.9	40.1	42.2
South Africa	17.6	16.9	15.9	15.7	17.7	19.3
India	27.7	23.4	24.0	23.6	26.0	27.4

Inflation, CPI (Percent)						
	1990	**1991**	**1992**	**1993**	**1994**	**1995**
Argentina	2314.0	171.7	24.9	10.6	4.2	3.4
Chil	26.0	21.8	15.4	12.7	11.4	8.2
Indonesia	7.8	9.4	7.5	9.7	8.5	9.4
Korea	8.6	9.3	6.2	4.8	6.3	4.5
Malaysia	2.6	4.4	4.8	3.5	3.7	5.3
Mexico	26.7	22.7	15.5	9.8	7.0	35.0
New Zealand	6.1	2.6	1.0	1.3	1.7	3.8
Philippines	14.1	18.7	8.9	7.6	9.1	8.1
Thailand	6.0	5.7	4.1	3.4	5.1	5.7
South Africa	14.4	15.3	13.9	9.7	9.0	8.7
India	9.0	13.9	11.8	6.4	10.2	10.2

CAD/GDP (Percent)						
	1990	**1991**	**1992**	**1993**	**1994**	**1995**
Argentina	3.2	-0.3	-2.9	-2.9	-3.3	-0.9
Chil	-1.8	0.3	- 1.6	-4.6	-1.2	0.2
Indonesia	-2.8	-3.7	-2.2	-1.3	-1.6	-3.4
Korea	-0.7	-2.8	-1.3	0.3	-1.0	-1.8
Malaysia	-2.0	-8.9	-3.7	-4.4	-5.9	-8.3
Mexico	-3.0	-5.1	-7.3	-6.4	-7.8	-0.3
New Zealand	-7.2	-3.5	-3.4	-2.5	-4.6	-6.3
Philippines	-6. 1	-2.3	-1.9	-5.5	-4.4	-2.7
Thailand	-8.5	-7.7	-5.7	-5.6	-5.9	-8.1.
South Africa	1.9	-2.0	1.2	1.5	-0.5	-2.6
India	-3.2	-0.4	-1.8	-0.4	-1.1	-1.6

Current Receipts/GDP (Per cent)						
	1990	**1991**	**1992**	**1993**	**1994**	**1995**
Argentina	265.6	8.9	7.4	6.9	7.8	10.2
Chile	35.8	34.7	31.2	27.8	29.4	30.3
Indonesia	28.4	28.8	30.1	26.8	26.7	31.3
Korea	31.1	29.5	30.2	30.2	31.3	34.3
Malaysia	81.2	84.3	80.5	84.9	93.6	97.4@
Mexico	8.1	19.9	18.4	18.4	20.8	39.0
New Zealand	28.8	29.5	31.0	32.1	32.1	31.7

Philippines	31.0	38.7	34.3	36.1	39.1	45.9
Thailand	36.9	38.7	38.9	40.2	42.2	45.2
South Africa	26.5	24.9	23.8	24.5	24.6	25.2
India	8.7	11.1	11.1	12.5	13.3	14.8

@ Excludes Transfer Receipts

Reserves* ($ Bn.)						
	1990	**1991**	**1992**	**1993**	**1994**	**1995**
Argentina	4.6	6.0	10.0	13.8	14.3	14.3
Chile	6. 1	7.0	9.2	9.6	13.1	14.1
Indonesia	7.5	9.3	10.4	11.3	12.1	13.7
Korea	14.8	13.7	17.1	20.2	25.6	32.7
Malaysia	9.8	10.9	17.2	27.2	25.4	23.8
Mexico	9.9	17.7	18.9	25.1	6.3	16.8
New Zealand	4.1	3.0	3.1	3.3	3.7	4.4
Philippines	0.9	3.2	4.4	4.7	6.0	6.4
Thailand	13.3	17.5	20.4	24.5	29.3	36.0
South Africa	1.0	0.9	1.0	1.0	1.7	2.8
India	2.3	5.7	6.5	15.2	20.8	17.1

*Total Reserves minus Gold.

Reserves */Imports (Months)						
	1990	**1991**	**1992**	**1993**	**1994**	**1995**
Argentina	13.5	8.7	8.1	9.9	8.0	8.5
Chile	9.5	10.4	10.9	10.4	13.3	10.7
Indonesia	4.1	4.3	4.6	4.8	4.6	4.0
Korea	2.5	2.0	2.5	2.9	3.0	2.9
Malaysia	4.0	3.6	5.2	7.2	5.1	3.7
Mexico	3.8	5.6	4.7	6.1	1.2	4.4
New Zealand	5.2	4.2	4.0	4.2	3.8	3.8
Philippines	0.8	3.0	3.4	3.0	3.2	2.7
Thailand	4.8	5.6	6.0	6.4	6.5	5.9
South Africa	0.7	0.6	0.6	0.6	0.9	1.1
India	1.0	3.3	3.3	7.3	7.4	4.9

*Total Reserves minus Gold

Exchange Rates {App. (+)/Dep. (-)} (Period Average)						
	1990	**1991**	**1992**	**1993**	**1994**	**1995**
Argentina #	-1051.9	-95.6	-3.9	-0.8	-0.0	-0.1
Chile *	-14.2	- 14.5	-3.8	- 11.5	-3.9	5.5
Indonesia @	-4.1	-5.8	-4.1	-2.8	-3.5	-4.1
Korea @	-5.4	-3.6	-6.4	-2.8	-0.1	4.0
Malaysia #	0.1	-1.7	7.4	-1.0	-2.0	4.6
Mexico @	-14.3	-7.3	-2.6	-0.7	-8.3	-90.2
New Zealand @	0.6	2.7	7.1	-0.5	-9.8	-10.6
Philippines @	-11.8	-13.0	7.2	-6.3	2.6	2.7
Thailand #	0.5	0.3	0.5	0.3	0.7	0.9
South Africa *	-1.2	6.2	3.3	12.7	8.0	2.1
India @	-7.9	-29.9	-14.0	-17.7	-2.9	-3.4

Official Rate; @ Market Rate; * Principal Rate;

Debt Service Ratio (Per cent)					
	1990	**1991**	**1992**	**1993**	**1994**
Argentina	41.1	36.4	32.3	36.8	31.8
Chile	26.4	23.2	21.0	23.1	19.2
Indonesia	31.5	34.0	31.6	33.8	30.0
Korea	10.7	7.1	7.6	9.2	6.8
Malaysia	10.3	7.7	6.6	7.8	7.7
Mexico	25.9	29.6	44.3	42.3	33.9
New Zealand#	NA	NA	NA	NA	NA
Philippines	27.0	23.0	24.4	25.5	18.5
Thailand	16.9	13.0	13.7	18.5	15.6
South Africa	10.7	9.5	15.3	.10.3	10.7
India	35.3	30.2	28.6	26.9	27.5

Not included in World Debt Tables.

GFD/GDP (Per cent)						
	1990	**1991**	**1992**	**1993**	**1994**	**1995**
Argentina	-0.3	-0.5	-0.0	-0.6	-0.7	NA
Chile	0.8	1.5	2.2	1.9	1.6	2.5
Indonesia	0.4	0.4	-0.4	0.6	0.0	0.0
Korea	-0.7	- 1.6	-0.5	0.6	0.3	-0.2
Malaysia	-4.8	-4.4	-4.2	-5.3	2.4	0.9
Mexico	-2.8	-0.2	1.5	0.4	-0.8	-0.7
New Zealand	4.0	1.9	-2.2	0.1	0.8	0.1
Philippines	-3.5	-2.1	-1.2	-1.5	1.1	0.5
Thailand	4.5	4.7	2.8	2.1	1.9	3.0
South Africa	-2.5	-4.1	-7.9	-6.0	-5.7	-5.5
India@	-8.3	-5.9	-5.7	-7.4	-6.1	-5.5

@ Refers to Central Government Only. N.A. : Not Available

Sources: World Debt Tables 1996.
International Financial Statistics Year Book 1996, IMF.
International Financial Statistics, February 1997, IMF.
Economic Survey, GOI, 1996-97
Annual Report, RBI, 1995-96.
Status Report on India's External Debt, 1997.

Annexure III.4

Reserve Adequacy Indicators

	Year	Reserves ($ million)	Reserves to Imports (in months)	Reserves to Imports and Debt Service Payments (in months)	Short term debt and portfolio Stocks/ Reserves (per cent)	NFEA to currency (per cent)	Reserves to Broad Money (per cent)
Argentina	**1991**	6005	8.7	5.2	232.9	-117.7	30.0
	1992	9990	8.1	6.0	170.3	33.0	31.9
	1993	13791	9.9	7.1	94.9	78.2	30.3
	1994	14327	8.0	6.1	89.4	57.0	26.8
	1995	14288	8.5	NA	NA	22.9	27.5
Chile	**1991**	7041	10.4	7.9	39.4	291.0	51.9
	1992	9168	10.9	8.6	45.0	350.6	56.9
	1993	9640	10.4	8.3	55.8	363.9	54.1

	1994	13088	13.3	10.7	54.6	500.8	68.5
	1995	14140	10.7	NA	NA	558.0	55.6
Indonesia	**1991**	9258	4.3	3.0	160.1	184.9	18.2
	1992	10449	4.6	3.1	178.8	243.8	17.8
	1993	11263	4.8	3.2	181.6	NA	NA
	1994	12133	4.6	3.1	191.6	NA	NA
	1995	13708	4.0	NA	NA	NA	NA
Korea	**1991**	13701	2.0	1.9	88.9	104.7	12.0
	1992	17121	2.5	2.3	93.1	142.6	13.9
	1993	20228	2.9	2.6	110.0	146.5	14.5
	1994	25639	3.0	2.8	103.2	157.0	15.5
	1995	32678	2.9	NA	NA	149.0	16.4
Malaysia	**1991**	10886	3.6	3.3	24.3	200.4	33.4
	1992	17228	5.2	4.8	26.7	278.6	37.9
	1993	27249	7.2	6.6	42.6	410.5	47.9
	1994	25423	5.1	4.7	47.9	388.5	40.4
	1995	23774	3.7	NA	NA	333.9	NA
Mexico	**1991**	17726	5.6	4.1	151.3	73.7	21.7
	1992	18942	4.7	3.3	184.1	82.0	19.4
	1993	25110	6. 1	4.3	206.7	112.7	22.6
	1994	6278	1.2	0.9	967.6	-21.0	5.0
	1995	16847	4.4	NA	NA	-21.6	19.2
New Zealand	**1991**	2950	4.2	NA	NA	-385.2	9.2
	1992	3079	4.0	NA	NA	-800.2	9.9
	1993	3337	4.2	NA	NA	-605.3	9.7
	1994	3709	3.8	NA	NA	-860.2	9.5
	1995	4410	3.8	NA	NA	-941.2	9.4
Philippines	**1991**	3246	3.0	2.2	160.1	-26.4	18.5
	1992	4403	3.4	2.7	132.8	46.8	23.0
	1993	4676	3.0	2.4	143.3	128.9	20.4
	1994	6017	3.2	2.7	146.1	131.6	20.6
	1995	6372	2.7	NA	NA	106.7	17.1
South Africa	**1991**	899	0.6	NA	NA	-48.7	NA
	1992	992	0.6	NA	NA	-111.0	1.5
	1993	1020	0.6	NA	NA	-157.0	1.7
	1994	1685	0.9	NA	NA	-168.5	2.5
	1995	2820	1.1	NA	NA	-125.1	-5.9
Thailand	**1991**	17517	5.6	4.9	85.7	277.1	24.4
	1992	20359	6.0	5.2	84.7	249.2	24.4
	1993	24473	6.4	5.3	103.7	217.6	24.7
	1994	29332	6.5	5.5	116.9	60.5	26.1
	1995	35982	5.9	NA	NA	1.9	27.1
India	**1991**	5721	3.3	2.3	132.9	14.4	4.9
	1992	6452	3.3	2.5	110.8	29.6	5.3
	1993	15156	7.3	5.4	52.5	31.8	12.6
	1994	20816	7.4	5.6	58.5	60.2	15.0
	1995	17126	4.9	3.8	82.9	71.4	10.5

Note : Broad Money is measured by M3 in case of India and M2 for all other countries.
NA: Not Available
NFEA: Net Foreign Exchange Assets.
Imports are given in c.i.f. basis.
Reserves exclude gold.
Portfolio Stock is calculated by adding up flow figures. In case of India it is calulated by converting the outstanding stock figures in Rupees into US dollars at end March exchange rate.

Source : International Financial Statistics Yearbook 1996 and IFS, April 1.997, IMF.
World Debt Tables 1996, The World Bank.
Economic Survey, 1996-97, GOI.
Status Report on India's External Debt, GOI, 1997.
Annual Report, RBI, 1995-96.

Annexure III.5

Indicators of the Structure of the Banking Industry

	Bank share in financial Intermediation* 1994	Share of state-owned banks @	Non-interest operating costs	Net interest margins
			As a % of total assets#	
India	80	87	2.6	2.9
Hongkong	-	0	1.5	2.2
Korea	38	13	1.7	2.1
Singapore	71	0	1.4	1.6
Taiwan	80	57	1.3	2.0
Indonesia	91	48	2.4	3.3
Malaysia	64	8	1.6	3.0
Thailand	75	7	1.9	3.7
Argentina	98	36	8.5	9.2
Brazil	97	48	6.o	6.8**
Chile	62	14	3.0	6.1
Colombia	86	23	7.3	8.3
Mexico	87	28	3.9	5.1
Venezuela	92	30	5.7	8.1
Memorandum :				
United States	23	0	3.7	3.7
Japan	79	0	0.8	1.1
Germany	77	50***	1.1	1.4

Note : Operating costs and net interest margins are shown before loan loss provisions

* Assets of banks as a percentage of the assets of banks and non bank financial institutions.

@ Percentage share of assets. For India, 1993. For Argentina, June 1996.

\# Average of 1990-94

** 1992-94

*** Not strictly comparable

Source : Goldstein Morris and Philip Turner, "Banking crises in Emerging Economics: Origins and Policy Options", BIS Economic Papers, No.46, October 1996.

Annexure III.6

Indicators of Profitability and Concentration in the Banking Industry

	Average rate of return on assets*	Five largest banks' share of deposits or assets @
India	-0.2	47.3
Hong Kong	1.7#	39.7**
Korea	0.6	38.1
Singapore	1.1	39.0
Taiwan	0.7	55.9
Indonesia	0.7	-
Malaysia	1.3	34.8
Thailand	1.3	59.6
Argentina	1.4	37.5
Brazil	0.1	54.9
Chile	1.1	46.7
Colombia	2.3	24.5
Maxico	1.3	61.9
Venezuela	1.4	57.2

Russian Federation	-	29.0
Israel	0.4	85-90
South Africa	0.8	82.0
Memorandum :		
United States	0.8	13.8
Japan	0.1	27.3
Germany	0.2	16.7

* Average 1990-94; for Argentina, Hong Kong and South Africa, 1991-94 and for India, 1991-95
@ In 1994: for Germany and India, 1995 and for Argentina and Singapore, May 1996
\# Locally incorporated licensed banks only
** Total deposits include both domestic and foreign currency deposits.

Source: Goldstein Morris and Philip Turner, "Banking crises in Emerging Economies : Origins and Policy Options", BIS Economic Papers, No.46, October 1996

Annexure III.7

Loan Loss Reserves and Non-Performing Loans

	Loan loss reserves* (A)	Non-performing loans @ (B)	Coverage ratio i.e. A/B
	as a percentage of total loans		
India	-	19.5#	-
Hong Kong	2.2@	3.1	0.71
Korea	1.5	1.0	1.50
Singapore	-	-	1.20
Taiwan	1.1	2.6	0.42
Indonesia	2.6	11.2	0.23
Malaysia	9.6	8.2	1.17
Thailand	1.7	7.6	0.22
Argentina	10.2@	10.5	0.97
Brazil	1.6	5.9	0.27
Chile	3.5	1.0	3.50
Colombia	1.9	2.5	0.76
Mexico	3.1**	14.8	0.21
Venezuela	7.0	17.7	0.40
Memorandum :			
United States	2.7	1.6	1.69
Japan	1.0	3.3	0.30

Note : These figures may not be strictly comparable.
* Average 1990-94
@ Average 1994-95
\# Relates only to public sector banks
** Average 1992-94

Source : Goldstein, Morris and Philip Turner, "Banking crises in Emerging Economics: Origins and Policy Options", BIS Economic Paners,. No.46,October 1996.

Annexure III.8

Argentina: Summary of the Regulations on Capital Account and other Financial Transactions

Liberalisation Measures	Year
(1)	(2)

1. Operations in Securities	
a) Controls on Capital Market securities	
1) Purchase in the country by non residents	1991
2) Sale or issue by non residents	1991
3) Purchase abroad by residents	1991
4) Sale or issue abroad by residents	1991
b) Controls on money market instruments	
1) Purchase in the country by non residents	1991
2) Sale or issue by non residents	1991
3) Purchase abroad by residents	1991
4) Sale or issue abroad by residents	1991
c) Controls on collective investments securities	
1) Purchase in the country by non residents	1991
2) Sale or issue by non residents	1991
3) Purchase abroad by residents	1991
4) Sale or issue abroad by residents	1991
2. Controls on derivatives and other instruments	
a. Purchase in the local market by non residents	1991
b. Sale or issue by non residents	1991
c. Purchase abroad by residents	1991
d. Sale or issue abroad by residents	1991
3. Controls on credit operations	
a. Commercial credits	
1) by residents to non residents	1991
2) residents from non residents	1991
b. Financial credits	
1) by residents to non residents	1991
2) residents from non residents	1991
c. Guarantees, sureties and financial back-up facilities	
1) by residents to non residents	1991
2) residents from non residents	1991
4. Controls on direct investment	
a. Outward direct investment	1991

b. Inward direct investment	1991
5. Control on liquidation of direct investment	1991
6. Control on real estate	
a. Purchase abroad by residents	1991
b. Purchase locally by non residents	1991
c. Sale locally by non residents	1991
7. Provisions specific to commercial banks and other credits institutions: controls on :	
a. Borrowing abroad	1991
b. Maintenance of account abroad	1991
c. Lending to non residents (loans, financial or commercial credits)	1991
d. Lending locally in foreign exchange	1991
e. Purchase of locally issue securities denominated in foreign exchange	1991
f. Other controls : differential treatment of non resident deposit account or deposit accounts in foreign exchange	
1) Reserve requirements	1991
2) Liquid asset requirements	1991
3) Interest rate controls	1991
4) Investment regulation	1991
5) Credit controls	1991
6) Open foreign exchange position limits	1991
8. Provision specific to institutional investors @	
a. Limits (max.) on portfolio invested abroad	
b. Limits (min.) on portfolio invested locally	
c. Currency matching regulations on assets/ liabilities composition	
9. Other restrictions imposed by Securities Laws	1991

@ There is a specific provision for Pension Funds Investments.

Source : Ministry of Finance, Buenos Aires, Argentina.

Annexure III.9

A. Korea : Sequencing of Capital Account Transactions.

CATEGORY	AT PRESENT	1995	1996-97	1998-99
Overseas Direct Investment	Subject to approval	Partially liberalised	Liberalised	
Stock Investment by Non residents	12 per cent	15 per cent	Ceiling raised	Ceiling raised or abolished
Overseas Portfolio Investment by Firms, (individuals)	W300 million; (W100 million)	W1 billion (W500 million)	Liberalised	
Overseas Deposit by Firms; (indv)	Partially allowed; (not allowed)	$1 million; ($30 thousand)	Ceiling raised	Liberalised,; (ceiling raised)
Overseas Real estate inv.(indv)	Restricted	Restrictions eased	Restrictions eased	Liberalised; (ceiling raised)
Domestic Issuance by Non residents	Not allowed	Issuance of equities liberalised	Won-denomi-nated bonds liberalised	Liberalised
Overseas Issuance by Residents	Partially allowed	Restrictions eased	Equity-linked bond liberalised	Liberalised
Commercial Loans (for facilities import)	Not allowed (with the exception of some public enterprises)	SMEs, high-tech firms, etc.	Liberalised for SMEs and partially allowed to all other firms	Liberalised for all firms
Spot Financing	Restrictions applied to usage	Restrictions eased	Liberalised	

B. Korea Sequencing of Foreign Exchange Market Reforms

CATEGORY	AT PRESENT	1995	1996-97	1998-99
Exchange Rate System	plus or minus 1.5 per cent	Review enlarging the band	Review plan to transition into a floating rate system	
Position system	Restrictions	the ceiling on Spot O/S raised	the ceiling on composite O/S, O/B and Spot O/S raised	Further raised or liberalised
Underlying Documentation System	Restrictions	Restrictions eased	Exempted	
FX Concentration System	Liberalised (registration requirement for amounts exceeding $50,000)	Liberalised (registration requirement abolished)		
External Credit Collection Requirement	$20,000	$30,000	the ceiling raised	the ceiling raised

Source: Bank of Korea