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.