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; FlIs, 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).