Report of the

Committee on

Fuller Capital Account Convertibility.

भारतीय रिज़र्व बैंक

RESERVE BANK OF INDIA

www.rbi.org.in

July 31, 2006
Shravana 9, 1928(Saka)

The Governor,
Reserve Bank of India
Mumbai

Dear Sir,

We submit herewith the Report of the Committee on Fuller Capital Account Convertibility.

Yours faithfully,

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Chairman

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LIST OF ABBREVIATIONS

AD	Authorised Dealer
AML	Anti-Money Laundering
AS	Accounting Standard
BE	Budget Estimate
BoP	Balance of Payment
BR	Banking Regulation
CAC	Capital Account Convertibility
CAD	Current Account Deficit
CAR	Capital Adequacy Ratio
CBLO	Collateralised Borrowing and Lending Obligation
CCIL	Clearing Corporation of India Ltd.
CD	Certificate of Deposit
CME	Capital Market Exposure
CP	Commercial Paper
CR	Current Receipts
CRAR	Capital to Risk Weighted Assets Ratio
CRR	Cash Reserve Ratio
DGA	Duration Gap Analysis
DSR	Debt Service Ratio

EC	European Community
ECB	External Commercial Borrowing
EEFC	Exchange Earners’ Foreign Currency
EMEs	Emerging Market Economies
FATF	Financial Action Task Force
FCAC	Fuller Capital Account Convertibility
FCNR(B)	Foreign Currency Non-Resident (Banks)
FDI	Foreign Direct Investment
FEMA	Foreign Exchange Management Act
FII	Foreign Institutional Investor
FIMMDA	Fixed Income Money Market and Derivatives Association
FRA	Forward Rate Agreement
FRBM	Fiscal Responsibility and Budget Management Act
FSI	Financial Soundness Indicators
GDP	Gross Domestic Product
GETF	Gold Exchange Traded Funds
G-Sec	Government Security
HRD	Human Resource Development
HTM	Held to Maturity
IAS	International Accounting Standard
ICAAP	Internal Capital Adequacy Assessment Process

ICAI	Institute of Chartered Accountants of India
IMF	International Monetary Fund
IRAC	Income Recognition, Asset Classification and Provisioning
IRF	Interest Rate Futures
IRR	Interest Rate Risk
IRS	Interest Rate Swaps
IT	Information Technology
KYC	Know Your Customer
MIBOR	Mumbai Inter-bank Offer Rate
MIFOR	Mumbai Inter-bank Forward Offer Rate
MSS	Market Stabilisation Scheme
MVE	Market Value of Equity
NDF	Non-deliverable Forward
NEER	Nominal Effective Exchange Rate
NFA	Net Foreign Exchange Assets
NII	Net Interest Income
NPA	Non-performing Advances
NR	Non-residents
NRE	Non-residents (External)
NRERA	Non-resident (External) Rupee Account
NRI	Non-resident Indian

NRO	Non-resident Ordinary
OMO	Open Market Operations
OTC	Over the Counter
PDs	Primary Dealers
PN	Participatory Note
PSBR	Public Sector Borrowing Requirement
RBI	Reserve Bank of India
RE	Revised Estimate
REER	Real Effective Exchange Rate
RFC	Resident Foreign Currency
RFC(D)	Resident Foreign Currency (Domestic)
RM	Reserve Money
SBI	State Bank of India
SCRA	Securities Contract and Regulations Act
SEBI	Securities and Exchange Board of India
SLR	Statutory Liquidity Ratio
SME	Small and Medium Enterprises
SPV	Special Purpose Vehicle
STRIPS	Separate Trading of Registered Interest and Principal of Securities
TAS	Transaction Appropriateness Standards

TFC	Twelfth Finance Commission
TGA	Traditional Gap Analysis
TOM	Tomorrow
WPI	Wholesale Price Index

CHAPTER 1

INTRODUCTION

The Prime Minister, Dr. Manmohan Singh in a speech at the Reserve Bank of India, Mumbai, on March 18, 2006 referred to the need to revisit the subject of capital account convertibility. To quote:

> "Given the changes that have taken place over the last two decades, there is merit in moving towards fuller capital account convertibility within a transparent framework…I will therefore request the Finance Minister and the Reserve Bank to revisit the subject and come out with a roadmap based on current realities".

1.2 Dr. Y.V. Reddy, Governor, Reserve Bank of India (RBI), in consultation with the Government of India, appointed, on March 20, 2006, a Committee to set out the Roadmap Towards Fuller Capital Account Convertibility consisting of the following:

(i)	Shri S.S. Tarapore	Chairman
(ii)	Dr. Surjit S. Bhalla	Member
(iii)	Shri M.G. Bhide	Member
(iv)	Dr. R.H. Patil	Member
(v)	Shri A.V. Rajwade	Member
(vi)	Dr. Ajit Ranade	Member

Shri K. Kanagasabapathy, Consultant, Monetary Policy Department, RBI was the Secretary of the Committee, who together with Smt. Meena Hemchandra, Chief General Manager, Department of External Investments and Operations, Dr. R.K. Pattnaik, Adviser, Department of Economic Analysis and Policy and Shri M. Rajeshwar Rao, General Manager, Foreign Exchange Department formed the Secretariat.

The terms of reference of the Committee were:

(i) To review the experience of various measures of capital account liberalisation in India,

(ii) To examine implications of fuller capital account convertibility on monetary and exchange rate management, financial markets and financial system,

(iii) To study the implications of dollarisation in India of domestic assets and liabilities and internationalisation of the Indian rupee,

(iv) To provide a comprehensive medium-term operational framework, with sequencing and timing, for fuller capital account convertibility taking into account the above implications and progress in revenue and fiscal deficit of both centre and states,

(v) To survey regulatory framework in countries which have advanced towards fuller capital account convertibility,

(vi) To suggest appropriate policy measures and prudential safeguards to ensure monetary and financial stability, and

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

The Committee commenced its work from May 1, 2006 and was expected to submit its report by July 31, 2006. The Memorandum appointing the Committee is at Annex IA.

1.3 Governor, Dr. Y.V. Reddy as part of his Annual Policy Statement for the year 2006-07 on April 18, 2006 said:

> "While a gradual approach to liberalisation of capital account in India has paid dividends so far, continuation of the gradual process may warrant that some hard and basic decisions are taken in regard to macro-economic management, in particular monetary, external and financial sector management".

1.4 Governor, Dr. Y.V. Reddy addressed the Committee at its first meeting on May 6, 2006. Deputy Governors, Dr. Rakesh Mohan, Shri V. Leeladhar, Smt. Shyamala Gopinath and Smt. Usha Thorat also addressed the Committee at subsequent meetings. The Committee is deeply appreciative of insights provided by the top management of the RBI. The Committee also had the opportunity of discussions with Smt. K.J. Udeshi, Chairperson, Banking Codes and Standards Board of India (who, till recently was Deputy Governor, RBI) and Shri S. Narayanan, who was earlier India's Ambassador to the World Trade Organisation. Shri Anand Sinha, Executive Director provided valuable help to the Committee on banking and foreign exchange regulations.

1.5 A number of RBI officials provided support to the Committee including: Shri Himadri Bhattacharya, Chief General Manager-in-Charge, Department of External Investments and Operations, Dr. Michael Debabrata Patra,

Adviser-in-Charge and Dr. Mohua Roy, Director (Monetary Policy Department), Shri Prashant Saran, Chief General Manager-in-Charge, Shri P. Vijaya Bhaskar, Chief General Manager and Shri K. Damodaran, General Manager (Department of Banking Operations and Development), Shri Chandan Sinha, Chief General Manager and Dr. Mridul K. Saggar, Director (Financial Markets Department), Shri G. Mahalingam, Chief General Manager and Shri T. Rabi Sankar, Deputy General Manager (Internal Debt Management Department), Dr. Janak Raj, Adviser, Department of Economic Analysis and Policy and Shri Vinay Baijal, Chief Executive Officer, Banking Codes and Standards Board of India. The Committee is deeply indebted to all these officials for their help.

Other persons and organisations which provided material are set out in Annex IB.

1.6 Dr. Benu Schneider, Chief of International Finance, Department of Economic and Social Affairs, United Nations and Dr. A. Prasad, Adviser to Executive Director for India at the International Monetary Fund helped the Committee with various papers and notings.

1.7 The Committee wishes to place on record that the four-member Secretariat led by Shri K. Kanagasabapathy and including Dr. R.K. Pattnaik and Shri M. Rajeshwar Rao and Smt. Meena Hemchandra put in painstaking efforts to meet the exacting requirements of the Committee's work and their performance reflected a touch of class. These four officials fully participated in the Committee's deliberations and provided exemplary support to the Committee. In particular, Shri K. Kanagasabapathy, as Secretary of the Committee played a pivotal role in co-ordinating the work of the Committee and in the preparation of the Report. The Committee is appreciative of the administrative support of the Department of External Investments and Operations.

The three members of the secretarial staff, *viz*., Shri R.N. Iyer, Private Secretary, Smt. Hazel G. Quadros, Private Secretary and Smt. Sudha P. Shetty, Stenographer worked under pressure with great diligence and dedication, well beyond the call of duty.

1.8 The Committee had 12 formal meetings and a number of informal meetings.

1.9 The Report is set out in nine chapters: Chapter 2 provides an overview of fuller capital account convertibility (FCAC) and the Committee's approach. Chapter 3 attempts to assess the progress since 1997 towards capital account convertibility. Chapter 4 draws attention to the concomitants for a move to fuller capital account convertibility and Chapter 5 discusses the interaction of monetary policy and exchange rate policy. The development of financial markets is discussed in Chapter 6 while issues of regulation/supervision are outlined in Chapter 7. Chapter 8 sets out the roadmap for fuller capital account convertibility in India with specific focus on the timing and sequencing of measures. A summary of observations/recommendations of the Committee is contained in Chapter 9.

CHAPTER 2

OVERVIEW OF FULLER CAPITAL ACCOUNT CONVERTIBILITY AND THE COMMITTEE'S APPROACH

Meaning of Capital Account Convertibility

2.1 Currency convertibility refers to the freedom to convert the domestic currency into other internationally accepted currencies and *vice versa.* Convertibility in that sense is the obverse of controls or restrictions on currency transactions. While current account convertibility refers to freedom in respect of 'payments and transfers for current international transactions', capital account convertibility (CAC) would mean freedom of currency conversion in relation to capital transactions in terms of inflows and outflows. Article VIII of the International Monetary Fund (IMF) puts an obligation on a member to avoid imposing restrictions on the making of payments and transfers for current international transactions. Members may cooperate for the purpose of making the exchange control regulations of members more effective. Article VI (3), however, allows members to exercise such controls as are necessary to regulate international capital movements, but not so as to restrict payments for current transactions or which would unduly delay transfers of funds in settlement of commitments.

2.2 The cross-country experience with capital account liberalisation suggests that countries, including those which have an open capital account, do retain some regulations influencing inward and outward capital flows. The 2005 IMF *Annual Report on Exchange Arrangement and Exchange Restrictions* shows that while there is a general tendency among countries to lift controls on capital movement, most countries retain a variety of capital controls with specific provisions relating to banks and credit institutions and institutional investors (Table 2.1). Even in the European Community (EC), which otherwise allows unrestricted movement of capital, the EC Treaty provides for certain restrictions.

2.3 The path to fuller capital account convertibility (FCAC) is becoming unidirectional towards greater capital account convertibility. For the purpose of this Committee, the working definition of CAC would be as follows:

> CAC refers to the freedom to convert local financial assets into foreign financial assets and *vice versa*. 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.

Changing International and Emerging Market Perspectives

2.4 There is some literature which supports a free capital account in the context of global integration, both in trade and finance, for enhancing growth and welfare. The perspective on CAC has, however, undergone some change following the experiences of emerging market economies (EMEs) in Asia and Latin America which went through currency and banking crises in the 1990s. A few countries backtracked and re-imposed some capital controls as part of crisis resolution. While there are economic, social and human costs of crisis, it has also been argued that extensive presence of capital controls, when an economy opens up the current account, creates distortions, making them either ineffective or unsustainable. The costs and benefits or risks and gains from capital account liberalisation or controls are still being debated among both academics and policy makers. The IMF, which had mooted the idea of changing its Charter to include capital account liberalisation in its mandate, shelved this proposal.

2.5 These developments have led to considerable caution being exercised by EMEs in opening up the capital account. The link between capital account liberalisation and growth is yet to be firmly established by empirical research. Nevertheless, the mainstream view holds that capital account liberalisation can be beneficial when countries move in tandem with a strong macroeconomic policy framework, sound financial system and markets, supported by prudential regulatory and supervisory policies.

Objectives and Significance of Fuller Capital Account Convertibility (FCAC) in the Indian Context

2.6 Following a gradualist approach, the 1997 Committee recommended a set of measures and their phasing and sequencing. India has cautiously opened up its capital account since the early 1990s and the state of capital controls in India today can be considered as the most liberalised it has ever been in its history since the late 1950s. Nevertheless, several capital controls continue to persist. In this context, FCAC would signify the additional measures which could be taken in furtherance of CAC and in that sense, 'Fuller Capital Account Convertibility' would not necessarily mean zero capital regulation. In this context, the analogy to *de jure* current account convertibility is pertinent. *De jure* current account convertibility recognises that there would be reasonable limits for certain transactions, with 'reasonableness' being perceived by the user.

2.7 FCAC is not an end in itself, but should be treated only as a means to realise the potential of the economy to the maximum possible extent at the least cost. Given the huge investment needs of the country and that domestic savings alone will not be adequate to meet this aim, inflows of foreign capital become imperative.

2.8 The inflow of foreign equity capital can be in the form of portfolio flows or foreign direct investment (FDI). FDI tends to be also associated with non-financial aspects, such as transfer of technology, infusion of management and supply chain practices, etc. In that sense, it has greater impact on growth. To what extent FDI is attracted is also determined by complementary policies and environment. For example, China has had remarkable success in attracting large FDI because of enabling policies like no sectoral limits, decentralised decision making at the levels of provisional and local governments and flexible labour laws in special economic zones. By contrast, in India, policies for portfolio or Foreign Institutional Investor (FII) flows are much more liberal, but the same cannot be said for FDI. Attracting foreign capital inflows also depend on the transparency and freedom for exit of non-resident inflows and easing of capital controls on outflows by residents. The objectives of FCAC in this context are: (i) to facilitate economic growth through higher investment by minimising the cost of both equity

and debt capital; (ii) to improve the efficiency of the financial sector through greater competition, thereby minimising intermediation costs and (iii) to provide opportunities for diversification of investments by residents.

Some Lessons from the Currency Crises in Emerging Market Economics

2.9 The risks of FCAC arise mainly from inadequate preparedness before liberalisation in terms of domestic and external sector policy consolidation, strengthening of prudential regulation and development of financial markets, including infrastructure, for orderly functioning of these markets.

2.10 In the above context, the East Asian experience and that of some other EMEs is of relevance:

(i) The East Asian currency crisis began in Thailand in late June 1997 and afflicted other countries such as Malaysia, Indonesia, South Korea and the Philippines and lasted up to the last quarter of 1998. The major macroeconomic causes for the crisis were identified as: current account imbalances with concomitant savings-investment imbalance, overvalued exchange rates, high dependence upon potentially short-term capital flows. These macroeconomic factors were exacerbated by microeconomic imprudence such as maturity mismatches, currency mismatches, moral hazard behaviour of lenders and borrowers and excessive leveraging.

(ii) The Mexican crisis in 1994–95 was caused by weaknesses in Mexico's economic position from an overvalued exchange rate, and current account deficit at 6.5 per cent of Gross Domestic Product (GDP) in 1993, financed largely by short-term capital inflows.

(iii) Brazil was suffering from both fiscal and balance of payments weaknesses and was affected in the aftermath of the East Asian crisis in early 1998 when inflows of private foreign capital suddenly dried up. After the Russian crisis in 1998, capital flows to Brazil came to a halt.

(iv) In 1998, Russia faced a serious foreign exchange crisis due to concerns about its fiscal situation and had to introduce a series of

emergency measures, including re-intensification of capital controls and the announcement of a debt moratorium. Russia has lifted the last remaining restrictions on the rouble on July 1, 2006 clearing the way for making its currency fully convertible. The rouble's exchange rate will continue to be linked to a bi-currency basket and will be managed by the central bank.

(v) Argentina embarked on a currency board arrangement pegged to US dollar from April 1991 up to January 2002 which coupled with Argentina's persistent inability to reduce its high public and external debts, caused a recession-turned-depression during 1998-2001. This led Argentina to abandon the peg in January 2002, first devaluing and later floating its currency.

(vi) Difficulties in meeting huge requirements for public sector borrowing in 1993 and early 1994, led to Turkey's currency crisis in 1994. As a result, output fell by 6 per cent, inflation rose to three-digit levels, the central bank lost half of its reserves, and the exchange rate depreciated by more than 50 per cent. Turkey faced a series of crisis again beginning 2000 due to a combination of economic and non-economic factors.

2.11 From the various currency crises experienced in the past fifteen years, certain lessons emerge, which are summarised below:

(i) Most currency crises arise out of prolonged overvalued exchange rates, leading to unsustainable current account deficits. As the pressure on the exchange rate mounts, there is rising volatility of flows as well as of the exchange rate itself. An excessive appreciation of the exchange rate causes exporting industries to become unviable, and imports to become much more competitive, causing the current account deficit to worsen.

(ii) Even countries that had apparently comfortable fiscal positions, have experienced currency crises and rapid deterioration of the exchange rate. In many other economies, large unsustainable levels of external and domestic debt directly led to currency crises.

Hence, a transparent fiscal consolidation is necessary and desirable, to reduce the risk of currency crisis.

(iii) Short-term debt flows react quickly and adversely during currency crises. Receivables are typically postponed, and payables accelerated, aggravating the balance of payments position.

(iv) Domestic financial institutions, in particular banks, need to be strong and resilient. The quality and proactive nature of market regulation is also critical to the success of efficient functioning of financial markets during times of currency crises.

(v) Imposition of safeguards in the form of moderate controls on capital flows may be necessary in some cases.

(vi) The quality of balance sheets in terms of risk exposure needs to be monitored.

(vii) While the impossibility of the trinity (fixed exchange rate, open capital account and independent monetary policy) may be a theoretical construct, in practice, it is possible to approach situations, which are close enough, through a combination of prudential policies.

(viii) Opening up of foreign investment in domestic debt market needs to be pursued with caution as also the issuance of foreign currency linked domestic bonds.

Country macroeconomic data are set out in Annex II.

Committee's Approach to FCAC and Related Issues

2.12 The status of capital account convertibility in India for various non-residents is as follows: for foreign corporates, and foreign institutions, there is a reasonable amount of convertibility; for non-resident Indians (NRIs) there is approximately an equal amount of convertibility, but one accompanied by severe procedural and regulatory impediments. For non-resident individuals, other than NRIs, there is near-zero convertibility. Movement towards FCAC implies that all non-residents (corporates and individuals) should be treated equally. This would mean the removal of the tax benefits presently accorded to NRIs via special bank deposit schemes for NRIs, *viz*., Non-Resident External Rupee Account

[NR(E)RA] and Foreign Currency Non-Resident (Banks) Scheme [FCNR(B)]. The Committee recommends that the present tax benefit for these special deposit schemes for NRIs, [NR(E)RA and FCNR(B)], should be reviewed by the government. The existing concessions date back to an era when Indian tax rates were much higher; now they are comparable to the rest of the world. Moreover, in the interim years, India has entered into Double Taxation Avoidance (DTA) agreements with various countries which permit taxes levied in one country to be allowed as a tax credit in the other. These changes warrant a review of the current tax provisions. Non-residents, other than NRIs, should be allowed to open FCNR(B) and NR(E)RA accounts without tax benefits, subject to Know Your Customer (KYC) and Financial Action Task Force (FATF) norms. In the case of the present NRI schemes for various types of investments, other than deposits, there are a number of procedural impediments and these should be examined by the Government and the RBI.

2.13 In practice, the distinction between current and capital account transactions is not always clear-cut. There are transactions which straddle the current and capital account. Illustratively, payments for imports are a current account item but to the extent these are on credit terms, a capital liability emerges and with increase in trade payments, trade finance would balloon and the resultant vulnerability should carefully be kept in view in moving forward to FCAC. Contrarily, extending credit to exports is tantamount to capital outflows.

2.14 As regards residents, the capital restrictions are clearly more stringent than for non-residents. Furthermore, resident corporates face a relatively more liberal regime than resident individuals. Till recently, resident individuals faced a virtual ban on capital outflow but a small relaxation has been undertaken in the recent period. There is justification for some liberalisation in the rules governing resident individuals investing abroad for the purpose of asset diversification. The experience thus far shows that there has not been much difficulty with the present order of limits for such outflows. It would be desirable to consider a gradual liberalisation for resident corporates/business entities, banks, non-banks and individuals. The issue of liberalisation of capital outflows for individuals is a strong confidence building measure, but such opening up has to be well calibrated

as there are fears of waves of outflows. The general experience is that as the capital account is liberalised for resident outflows, the net inflows do not decrease, provided the macroeconomic framework is stable.

2.15 As India progressively moves on the path of FCAC, the issue of investments being channelled through a particular country so as to obtain tax benefits would come to the fore as investments through other channels get discriminated against. Such discriminatory tax treaties are not consistent with an increasing liberalisation of the capital account as distortions inevitably emerge, possibly raising the cost of capital to the host country. With global integration of capital markets, tax policies should be harmonised. It would, therefore, be desirable that the government undertakes a review of tax policies and tax treaties.

2.16 In terms of the concomitants to FCAC, some sustainable macroeconomic indicators need to be considered. While a precise prioritisation of these indicators would be difficult, the policy for macroeconomic stability widens in scope in an open economy with domestic and external market liberalisation. The conventional focus on price stability and counter-cyclical monetary and fiscal policies needs to be modulated to address the issue of financial stability consistent with the objectives of FCAC.

2.17 A hierarchy of preferences may need to be set out on capital inflows. In terms of type of flows, allowing greater flexibility for rupee denominated debt which would be preferable to foreign currency debt, medium and long term debt in preference to short-term debt, and direct investment to portfolio flows. There are reports of large flows of private equity capital, all of which may not be captured in the data (this issue needs to be reviewed by the RBI). There is a need to monitor the amount of short term borrowings and banking capital, both of which have been shown to be problematic during the crisis in East Asia and in other EMEs.

2.18 Greater focus may be needed on regulatory and supervisory issues in banking to strengthen the entire risk management framework. Preference should be given to control volatility in cross-border capital flows in prudential policy measures. Given the importance that the commercial banks occupy in the Indian

financial system, the banking system should be the focal point for appropriate prudential policy measures. In the absence of strong risk management policies and treasury management skills, banks may be prone to excessive risk taking. Strong prudential policies will help banks in minimising financial risks and possible losses. These prudential measures should be applicable to both balance sheet items as also off-balance sheet items.

2.19 Management of normal flows may have to be distinguished from emergence of vulnerable situations of large inflows as also sudden cessation of inflows. Potential for large outflows also cannot be precluded under conditions of uncertainty. Major shifts in sentiments, leverage, and liquidity problems could cause major financial panics rendering shocks to the entire financial system.

Broad Framework for Timing, Phasing and Sequencing of Measures

2.20 On a review of existing controls, a broad time frame of a five year period in three phases, 2006-07 (Phase I), 2007-08 and 2008-09 (Phase II) and 2009-10 and 2010-11 (Phase III) has been considered appropriate by the Committee. This enables the authorities to undertake a stock taking after each Phase before moving on to the next Phase. The roadmap should be considered as a broad time-path for measures and the pace of actual implementation would no doubt be determined by the authorities' assessment of overall macroeconomic developments as also specific problems as they unfold. There is a need to break out of the "control" mindset and the substantive items subject to capital controls should be separated from the procedural issues. This will enable a better monitoring of the capital controls and enable a more meaningful calibration of the liberalisation process. (This is detailed in Chapter 8).

Table 2.1: Summary of Features of Controls on Capital Transactions in IMF Member Countries

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(Total number of countries: 184)

	Features of Controls on Capital Transactions		**Total no. of Countries with this feature**
1.	Capital Market Securities	-	126
2.	Money Market Transactions	-	103
3.	Collective Investment Securities	-	97
4.	Derivatives and Other Instruments	-	83
5.	Commercial Credits	-	98
6.	Financial Credits	-	109
7.	Guarantees, Sureties and Financial Backup Facilities	-	87
8.	Direct Investment	-	143
9.	Liquidation of Direct Investment	-	54
10.	Real Estate Transactions	-	135
11.	Personal Capital Transactions	-	97
	Provisions specific to		
(a)	Commercial Banks and Other Credit Institutions	-	157
(b)	Institutional Investors	-	91

Note: India figures under all these items

Source: IMF, Annual Report on Exchange Arrangements and Exchange Restrictions, 2005

CHAPTER 3

REVIEW OF CAPITAL ACCOUNT LIBERALISATION IN INDIA SINCE 1997

3.1 The position in relation to the capital account in India in 1997 was that of an economy which had taken the early steps in capital account liberalisation. From 1991 onwards the regulatory framework for inflows was significantly liberalised particularly for FDI and portfolio flows (largely FIIs). Capital account convertibility had all along been available for non-residents; there were, however, severe procedural hurdles and a maze of approvals required for both inflows and outflows by non-residents. Within non-residents there has, for three decades, been a separate category, *viz.*, non-resident Indians (NRIs) that are provided special schemes for investments which are not available to other non-residents.

3.2 In the case of residents, the capital account was tightly controlled. For resident corporates, inflows were permitted which were contextually (in 1997) somewhat liberal but subject to a complex set of approvals and procedures. For outflows from the corporate sector, some very limited facilities were provided but, again, those were subject to several approval requirements and procedural hurdles. Banks had very limited facilities for borrowing abroad although they were allowed to raise resources abroad outside the very restricted limits for purposes of financing exports and raising of deposits under the NR(E)RA and FCNR(B) Schemes. For resident individuals, however, there was a total ban on capital outflows.

3.3 The Committee on Capital Account Convertibility (CAC) in its Report (May 1997) had set out detailed preconditions/signposts for moving towards capital account convertibility and also set out the timing and sequencing of measures. In any meaningful assessment of the liberalisation of the capital account since 1997, it is necessary to undertake the assessment against the backdrop of certain vital parameters. First, the 1997 Committee's framework related to the three year period ending in March 2000 while the present assessment is being undertaken six years after the last year in the Committee's time frame for measures. Secondly, the Indian macroeconomic situation as also the international

economy have undergone significant changes since 1997. Thirdly, there have been large capital inflows into India in recent years and much of the authorities' efforts have been directed towards handling these large capital flows in terms of the domestic monetary expansion and evolving of suitable neutralisation policies. As the 1997 CAC Report stressed, capital account convertibility has to be viewed as an ongoing process with the gradual entrenchment of the preconditions/signposts and the implementation of measures. Against this backdrop, an attempt is made in this Chapter to briefly assess the progress on meeting the preconditions and a broad-brush evaluation is attempted on the implementation of measures since 1997.

Progress on Preconditions/Signposts

3.4 The 1997 Committee's recommendations on preconditions/signposts and the situation in 2006 need to be assessed taking into account certain important differences in the actual approach and the recommendations of the Committee. Subject to this proviso an attempt is made to juxtapose the 1997 Committee's set of preconditions and the present position.

Preconditions/Signposts

(Per cent)

	Item	**Recommendation of 1997 Committee for 1999-2000**	**Position in 2005-06**
1.	Gross Fiscal Deficit of the Centre as a percentage of GDP	3.5	4.1
2.	Inflation Rate	3.0 – 5.0* (average for 3 years)	4.6 (average for 3 years)
3.	Financial Sector		
	(i) Gross NPAs as a percentage of total advances@	5.0	5.2 (2004-05)
	(ii) Average effective CRR for the banking system	3.0	5.0

* The inflation rate was to be mandated.

@ The monitoring system has moved over to a net NPA approach which was 8.1 per cent in 1996-97 and 2.0 per cent in 2004-05

CRR: Cash Reserve Ratio

3.5 While significant efforts have been made at fiscal consolidation and greater fiscal transparency introduced as required under the *Fiscal Responsibility and Budget Management Act (FRBM), 2003* and *FRBM Rules (2004)*, it is clear that fiscal consolidation has fallen short of the expectations of the 1997 Committee in terms of the Centre's gross fiscal deficit as percentage of GDP. The domestic liabilities of the Centre as a percentage of GDP which was 45.4 per cent in 1996-97 increased to 60.3 per cent in 2005-06. The gross interest payments as a percentage of revenue receipts which was 47.1 per cent in 1996-97 has come down to 37.3 per cent in 2005-06 partly due to the perceptible reduction in interest rates as also changes in the system of Centre –States transfers which impinge on the gross interest payments of the Centre. The shortfall in the extent of fiscal consolidation envisaged by the 1997 Committee for 1999-2000 has not been attained even by 2005-06. Again, the 1997 Committee's recommendation of a Consolidated Sinking Fund to ensure smooth repayment of borrowings has not been implemented and any alternative mechanism has not been devised. As such, repayments continue to be financed by fresh borrowing.

3.6 As against the 1997 Committee's recommendation of a formal inflation mandate, such a system has not been put in place. Nonetheless, the three year average rate of inflation (wholesale price index) for the period ended March 2006 was 4.6 per cent, which is within the 1997 Committee's recommended range. The relatively low inflation rate in India in the recent period has also to be viewed in the context of relatively low international inflation rates and improved Indian macroeconomic performance in recent years. Globalisation induced productivity and competition have had a major influence in reducing inflation rates.

3.7 While the 1997 Committee's objective on the gross NPAs of the banking sector, by 1999-2000, has been attained by 2004-2005, the authorities have not reduced the CRR to 3.0 per cent. The concerns of the 1997 Committee on the need to strengthen the financial system in the context of liberalisation continues to be a matter which needs to be addressed.

3.8 The 1997 Committee had recommended that there should be a more transparent exchange rate policy with a Monitoring Band of $\pm$ 5.0 per cent around

the neutral real effective exchange rate (REER) and that the RBI should ordinarily not intervene within the band. The RBI has not accepted this recommendation.

3.9 The 1997 Committee indicated that with the then Current Receipts(CR)/GDP ratio of 15 per cent, the economy could sustain a Current Account Deficit/GDP ratio at 2.0 per cent. The 1997 Committee envisaged that the authorities should endeavour through external sector policies to increase the CR/GDP ratio such that the debt service ratio (DSR) comes down from 25 per cent to 20 per cent. The CR/GDP ratio in 2005-06 was 24.5 per cent. The debt service ratio for 2005-06 is placed at 10.2 per cent (including repayments under the India Millennium Deposit Scheme); the debt service ratio for 2004-05 was only 6.2 per cent. Clearly, there have been significant improvements in the external sector, much beyond that envisioned by the 1997 Committee Report.

Liberalisation of the Capital Account Since 1997

3.10 The action taken on the 1997 Committee Report is set out in Annex III provided by the RBI. This does bring out that by and large the RBI has taken action on a number of recommendations but the extent of implementation has been somewhat muted on some of the proposed measures (e.g., outflows by resident individuals and overseas borrowing by banks), while for some other measures, the RBI has proceeded far beyond the Committee's recommendations (e.g. outflows by resident corporates). RBI has, however, taken a number of additional measures outside the 1997 Committee's recommendations.

3.11 Capital inflows were fairly liberalised by the time of the 1997 Committee Report and the essential recommendations of the Committee were to remove or reduce the procedural impediments. While some of these procedural problems have been largely attended to, certain difficulties remain. Following the 1997 Committee Report, powers have been delegated by the RBI to the Authorised Dealers (ADs). In some cases this has merely shifted the controls and worsened the procedural impediments.

3.12 In the case of resident corporates, financial capital transfers abroad have been permitted within a limit of 25 per cent of their networth. In 2003-04 a total

amount of US$ 11.13 million has been remitted abroad; later data are not available.

3.13 Investment overseas by Indian companies/registered partnership firms upto 200 per cent of their networth is permitted. The outflows in 2005-06 are reported at US$ 3.1 billion.

3.14 Loans and borrowings by resident banks from overseas banks and correspondents is limited to 25 per cent of unimpaired Tier I Capital; these limits amount to US$ 2.7 billion as of March 31, 2006. The extent of such borrowing is not readily available. The 1997 Committee recommended significantly higher limits.

3.15 Resident individuals are permitted to remit abroad upto US$ 25,000 per year. The Committee was provided a total figure of remittance under this facility for 2004 and 2005 amounting to US$ 28.3 million and an additional US$ 1.9 million for immovable property. Resident individuals are also permitted to invest without limit in overseas companies listed on a recognised stock exchange and which have a shareholding of at least 10 per cent in an Indian company listed on a recognised stock exchange in India as well as in rated bonds/fixed income securities (IV.A.2). For portfolio investments by resident individuals upto November 2005 a total amount of remittance of US$ 13.7 million has been furnished to the Committee. The bulk of these remittances were in 2004-05, while such remittances became a trickle in 2005-06. It is not clear whether this is a case of data infirmities and/or some procedural hitches.

3.16 NRIs holding non-repatriable assets [including Non-resident Ordinary (NRO) Accounts] are permitted to repatriate upto US$ one million per calendar year out of balances held in NRO Accounts/sales proceeds of assets/assets acquired by way of inheritance. This is a major relaxation but the Committee was unable to obtain data on outflows under this scheme.

3.17 In the case of External Commercial Borrowing (ECB), there is an overall annual limit on ECB authorisations, which is currently US$ 18 billion. Issues of queuing, to ensure that small borrowers are not crowded out, do not appear to

have been addressed. Furthermore, ECB upto US$ 500 million per year can be availed of under the automatic route.

3.18 On the issue of forward contracts in the foreign exchange market the 1997 Committee had recommended that participation should be allowed without any underlying exposure. The hedging of economic exposures was also recommended but not permitted. The basic principle underlying the 1997 Committee's recommendation has not been accepted by the RBI.

3.19 The core of the capital account liberalisation measures proposed by the 1997 Committee were essentially in relation to residents. While resident corporates have been provided fairly liberal limits, the liberalisation for resident individuals has been hesitant and in some cases inoperative because of procedural impediments.

3.20 To the extent the RBI regulates the outflows by resident individuals and corporates under a myriad of schemes it must make special efforts to collect information as such flows could be expected to rise in a regime of a relatively more liberalised capital account.

3.21 The present Committee's observation is that in a tightly regulated regime, with a myriad of specific schemes and controls, the monitoring was related to these individual schemes. While there has, no doubt, been a fair amount of liberalisation, the basic framework of the control system has remained unchanged. The RBI has liberalised the framework on an *ad hoc* basis and the liberalised framework continues to be a prisoner of the erstwhile strict control system. Progressively, as capital account liberalisation gathers pace it is imperative that there should be a rationalisation/simplification of the regulatory system and procedures in a manner wherein there can be a viable and meaningful monitoring of the capital flows. The Committee recommends that there should be an early rationalisation/consolidation of the various facilities. Furthermore, it is observed that with the formal adoption of current account convertibility in 1994 and the subsequent gradual liberalisation of the capital account, some inconsistencies in the policy framework have emerged and the Committee recommends that these issues should be comprehensively examined by the RBI.

CHAPTER 4

CONCOMITANTS FOR A MOVE TO FULLER CAPITAL ACCOUNT CONVERTIBILITY

4.1 This Chapter reviews some key macro-economic indicators since 1996-97 and against this backdrop, certain steps are set out to enable a move to FCAC. Policies for macroeconomic stability in an open economy environment need greater attention. The fiscal-monetary policies, exchange rate management, prudential, regulatory and supervisory safeguards and measures for development of financial markets all assume importance (some of these issues are discussed in subsequent Chapters). The implementation of these measures and the pace of liberalisation are a simultaneous process.

Macroeconomic Indicators

4.2 Table 4.1 sets out select macroeconomic indicators comparing the position as of 1996-97 and 2005-06. The real sector, monetary and external sectors show improvement while the fisc continues to be of concern. The level of foreign exchange reserves is at an all time high and the net foreign exchange assets (NFA) are well in excess of the reserve money (RM) and are equivalent to one fourth of the money supply. Unlike some countries, which have accumulated their foreign exchange reserves through current account surpluses, the build up of the Indian forex reserves has largely been the result of capital inflows. (Table 4.2)

Table 4.1: Select Macroeconomic Indicators

	1996-97	2005-06
I. Real Sector		
Real Growth Rate (percentage) during the year	7.8 7.5 (Three year average ended 1996-97)	8.4 8.1 (Three year average ended 2005-06)
Rate of Growth of Industrial Production (percentage)	6.1	8.1
II. Monetary Sector		
Inflation Rate (measured in terms of WPI) Year on year	5.4 9.0 (Three year average ended 1996-97)	4.1 4.6 (Three year average ended 2005-06)
Reserve Money Outstanding Percentage change during the year	Rs. 1,99,985 crore 2.8 13.3 (Three year average ended 1996-97)	Rs. 5,73,066 crore 17.2 15.8 (Three year average ended 2005-06)
M_3 Outstanding Percentage change during the year	Rs. 6,96,012 crore 16.2 17.4 (Three year average ended 1996-97)	Rs. 27,29,535 crore 21.2 16.7 (Three year average ended 2005-06)
III. Fiscal Sector		
Gross Fiscal Deficit as percentage of GDP		
- Centre	4.9	4.1 (RE)
- States	2.7	3.1 (BE)
- Combined	6.4	7.7 (BE)
Revenue Deficit as percentage of GDP		
- Centre	2.4	2.6 (RE)
- States	1.2	0.7 (BE)
- Combined	3.6	3.4 (BE)
Domestic liabilities as percentage of GDP		
- Centre	45.4	60.3 (RE)
- States	21.0	32.7 (BE)
- Combined	55.7	78.9 (BE)
IV. External Sector		
Current Receipts as a percentage to GDP	14.3	24.5
Current Account Deficit as a percentage of GDP	-1.2	-1.3
External Debt as a percentage of Current Receipts	169.6	64.0
Total External Debt Outstanding (US$ million)	93,470	125,181
Foreign Exchange Reserves (US$ billion)	26.4	151.6
Net foreign exchange assets/Currency Ratio (percentage)	69.1	156.3
NFA/RM Ratio (percentage)	47.4	117.4
NFA/M3 Ratio (percentage)	13.6	24.7
Average US-Rupee $ Exchange Rate	35.5	44.3
REER (6-currency trade based) 1993-94=100	101.0	106.7

RE: Revised Estimates; BE: Budget Estimates

Source: Reserve Bank of India

Table 4.2: Sources of Accretion to Foreign Exchange Reserves Since April 1, 1997

(US$ billion)

	Items		1997-98 to 2005-06
A	**Reserves Outstanding as on end March 1997**		**26.4**
B	Current Account Balance		-9.1
C	Capital Account (1 to 6)		130.2
	1 Foreign Investment	(I + ii)	73.6
		(i) Direct	30.6
		(ii) Portfolio	43.0
	2 Banking Capital	(I + ii)	24.5
		(i) NRI Deposits	17.1
		(ii) Other @	7.4
	3 External Assistance		1.5
	4 External Commercial Borrowings		13.4
	5 Short Term £		7.2
	6 Others #		10.0
D	Valuation Changes		4.1
	Total (A+B+C+D)		**151.6**

@: Comprises foreign assets of banks, foreign liabilities of banks (other than NRI deposits) and movements in balances of foreign central banks and international institutions maintained with the RBI.

£: Does not include supplier's credit of less than 180 days.

#: Comprises mainly the leads and lags in export receipts (difference between the customs data and the banking channel data).

Source: Reserve Bank of India

Concomitants for a Move to Fuller Capital Account Convertibility

4.3 The 1997 Committee had set out certain preconditions/signposts for liberalising the capital account and the actual outcomes *vis-à-vis* the preconditions in a sense determined the pace of capital account liberalisation. While a certain extent of capital account liberalisation has taken place, since 1997, it would be necessary to set out a broad framework for chalking out the sequencing and timing of further capital account liberalisation. The key concomitants discussed below are not in any order of priority.

Fiscal Consolidation

4.4 The Fiscal Responsibility and Budget Management (FRBM) Legislation was enacted in 2003 and the Rules were notified in 2004. Steps are required to be taken to reduce the fiscal and revenue deficits and the revenue deficit was to be eliminated by March 31, 2008 and adequate surpluses were to be built up thereafter. The target for reducing the Centre's fiscal deficit to 3 per cent of GDP

and elimination of the revenue deficit has been extended by the Central Government to March 31, 2009.

4.5 The Twelfth Finance Commission (TFC) recommended that the revenue deficits of the States should be eliminated by 2008-09 and that the fiscal deficits of the States should be reduced to 3 per cent of GDP.

4.6 The Committee notes that apart from market borrowings, at the general government level, there are several other liabilities of government – both explicit and implicit - such as small savings and unfunded pension liabilities which are large but not easily quantifiable. As the interest rate conditions and climate for investment and growth are dependent upon the totality of such resource dependence, generation of revenue surplus to meet repayment of the marketable debt should be viewed but as a first step towards fiscal prudence and consolidation. A large fiscal deficit makes a country vulnerable. In an FCAC regime, the adverse effects of an increasing fiscal deficit and a ballooning internal debt would be transmitted much faster and, therefore, it is necessary to moderate the public sector borrowing requirement and also contain the total stock of liabilities.

4.7 The system of meeting government's financing needs is set out in terms of *net* borrowing, i.e., the *gross* borrowing minus repayments. This masks the repayment issue totally as no arrangement is made for the repayment. Over the years, the practice has been that the government determines its *net* borrowing requirement and the repayment is merely added to derive the *gross* borrowing requirement. Till the early 1990s, the difference between the gross and the net borrowing was marginal and with high investment prescriptions for banks/institutions it was reasonable to assume that the repayments would automatically be met out of fresh issuances of government securities. This approach of financing repayments out of fresh borrowings poses the danger of a vicious cycle of higher market borrowings at a relatively higher cost, chasing higher repayments. While repayment obligations financed through gross borrowings would not affect the gross fiscal deficit for the particular year of borrowings, the concomitant interest burden would fuel the revenue deficit as well as the gross fiscal deficit in subsequent years. This development would not only

result in higher accumulation of debt but also further aggravate the problem of debt sustainability.

4.8 Over one-third of the Centre's *gross* borrowing in 2006-07 of Rs.1,79,716 crore would go towards repayment. Over the years, on account of higher repayments, the gross borrowings of the Centre have increased significantly. For example, *gross* market borrowings relative to GDP are estimated at 4.5 per cent in 2006-07 as compared with 2.6 per cent in 1996-97. With the progressive move to market determined interest rates on government securities and the dilution of the captive market, there is no certainty that repayments would smoothly and automatically be met out of fresh borrowings without a pressure on real interest rates. Progressively, therefore, it is the *gross* borrowing programme and not the *net* borrowing programme which has to be related to the absorptive capacity of the market as also in gauging potential borrowing costs of the government. With the practice of meeting repayments out of fresh borrowing there has been a ballooning of the government's internal debt. The combined domestic liabilities of the Centre and States rose from about 56 per cent of GDP in 1996-97 to an estimated 79 per cent of GDP in 2005-06. The large *gross* borrowing of the government has consequential effects of crowding out private sector requirements, particularly, long-term requirements for infrastructure and other investments. More importantly, it has the adverse effect of raising interest rates; this would, in turn, hurt investment, output and employment. At the present time, the comfortable liquidity in the system, following large capital inflows, has resulted in interest rates being moderate. Once these capital flows slow down or reverse, the large *gross* borrowing programme of the government would force interest rates up to undesirably high levels. To obviate such high interest rates, it would be imperative to make arrangements for repayment of loans progressively out of the revenue surplus, while ensuring that the overall fiscal deficit is contained within the parameters laid down by the FRBM/TFC. By 2010-11 the Centre should endeavour to build a revenue surplus of 1.0 per cent of GDP which would amount to an estimated Rs.62,197 crore in 2010-11 (assuming a nominal GDP growth of 12 per cent). The repayment schedule of the Centre's market borrowing (as at the end of March 2006) for 2010-11 amounts to Rs.62,586 crore. The Committee recommends that a substantial part of the revenue surplus of the Centre should be

earmarked for meeting the repayment liability under the Centre's market borrowing programme, thereby reducing the *gross* borrowing requirement.

4.9 While the government has brought an element of transparency in fiscal operation, quasi-fiscal deficits still remain. The Committee recommends that as part of better fiscal management, the Central Government and the States should graduate from the present system of computing the fiscal deficit to a measure of the *Public Sector Borrowing Requirement (PSBR)*. The PSBR is a more accurate assessment of the fisc's resource dependence on the economy. Rough indications point to the probability of the PSBR being about 3 per cent of GDP above the fiscal deficit. While an official figure on the PSBR is not available, once a policy decision is taken to move over to a PSBR measure, steps can be taken to effectively implement a systematic compilation of this information and its regular monitoring. The RBI should attempt a preliminary assessment of the PSBR and put it in the public domain which would then facilitate the adoption of the PSBR as a clearer indicator of the public sector deficit.

4.10 There have been some initial moves to functionally separate public debt management from monetary policy operations; the two functions, however, continue to be within the RBI. For an effective functional separation enabling more efficient debt management as also monetary management, the Committee recommends that the Office of Public Debt should be set up to function independently outside the RBI.

Monetary Policy Objectives

4.11 In the context of a progressively liberalised capital account, inflation rates in India need to converge towards internationally acceptable lower levels. Furthermore, interest rates in India would broadly need to realign and reflect inflation differentials. There is a strong social objective in an unswerving policy on inflation control as inflation hurts the weakest segments the most.

4.12 Issues relating to transparency in setting monetary policy objectives and the need to develop effective tools of monetary policy have come to the forefront especially in the context of progressive liberalisation of the capital account. In recent years, there have been significant changes in the formulation and

monitoring of fiscal policy with increased transparency of operation. Monetary policy transparency is the obverse of fiscal transparency. The operation of monetary policy and instruments and issues of strengthening the policy tools are discussed in Chapter 6 along with issues relating to exchange rate management.

4.13 In the rapidly changing international environment and the drawing up of a roadmap towards fuller capital account convertibility, the issue of greater autonomy for monetary policy needs to be revisited. This issue has been raised earlier by more than one committee.

4.14 The Committee recommends that, consistent with overall economic policy, the RBI and Government should jointly set out the objectives of monetary policy for a specific period and this should be put in the public domain. Once the monetary policy objectives are set out, the RBI should have unfettered instrument independence to attain the monetary policy objectives. Given the lagged impact of monetary policy action, the monetary policy objectives should have a medium-term perspective. The Committee recommends that the proposed system of setting objectives should be initiated from the year 2007-08. Strengthening the institutional framework for setting monetary policy objectives is important in the context of FCAC.

4.15 The RBI has instituted a *Technical Advisory Committee on Monetary Policy.* While this is a useful first step, the Committee recommends that a formal Monetary Policy Committee should be the next step in strengthening the institutional framework. At some appropriate stage, a summary of the minutes of the Monetary Policy Committee should be put in the public domain with a suitable lag.

Strengthening of the Banking System

4.16 In any significant move towards liberalising the capital account, the state of health of the banking system would be of concern. As the economy moves to a more open external environment, it would be necessary to restructure the banking system and put in place appropriate safeguards.

4.17 India has a set of diversified financial institutions like commercial banks (private and public, foreign and domestic), non-banking financial institutions, urban and rural cooperatives, regional rural banks, micro-finance institutions and an informal money lending sector and each of these groups of institutions have varying strengths. It bears recalling the old adage that a financial system is as strong as its weakest link. These institutions cater to varied needs and are subject to different sets of regulations. Over three-fourths of the business of the financial sector is accounted for by the commercial banks and three-fourths of the commercial banks business is accounted for by public sector banks. The competitive efficiency of institutions needs to be promoted, in the context of liberalisation and FCAC. Initiatives have been taken to develop various segments of financial markets – foreign exchange, money and government securities – and strengthen the financial system and improve efficiency.

4.18 In the light of greater deregulation of the pre-emptions in the banking system, which is likely to increase on the path to a FCAC regime, and with the growing significance of the banking system in the economy, the size of the commercial assets of the banking system is expected to increase. Consequently, the capital requirements of banks in India would increase. Furthermore, in the context of Basel II, capital adequacy requirements would be more risk sensitive and exacting than at present and consequently, banks' appetite for shouldering risks will be reflected in the capital requirements. The present minimum 9 per cent capital adequacy ratio (CAR) may need to be reviewed for banks which have an international presence, on the basis of the risks assumed by them both in the domestic as well as international jurisdictions. The prudential measures would need to be calibrated, simplified and rationalised as the banks are able to manage various types of risks. In addition, capacity-building in the domestic banks would be an imperative to enable them to meet the enhanced needs of a financial system with a liberalised capital account. Inputs towards this, in the form of human resource development, information technology, accessing expert advice for formulating policy on potentially complicated issues such as risk management, financial conglomerates, bundling of services, upgradation of accounting systems in line with international standards such as International Accounting Standard

(IAS) 39, would be critical in the area of capacity-building (issues relating to regulation/supervision are detailed in Chapter 7).

4.19 While it is sometimes argued that commercial banks should be classified as international, national, and regional, it is not feasible to use such classification as some of the smaller banks may be more competitive than larger banks. Some of the smaller banks which specialise in certain areas of business or regions may have a comparative advantage over larger banks by virtue of their core competence. As such, emphasis on consolidation to mean larger banks, merely by mergers, may not lead to strengthening of the banking system. In other words, there is no immutable relationship between size and efficiency of operation.

4.20 About three-fourths of the banking system is covered by the public sector. This, by itself, should not be a constraint but the legislative framework is a major handicap and there are embedded disabilities for consolidation and governance. First, within the public sector, the legislative framework for the State Bank of India (SBI) Group is different from the nationalised banks. The major constraint is majority ownership by the Government/RBI in the public sector banks. The capital requirements of banks will go up in the context of Basel II, since they have to maintain capital for certain risks which do not attract a capital requirement under Basel I. In an FCAC context, the banks would be exposed to greater level of risks than at present and hence the capital requirement would go up even further. There is a dilemma here which has to be squared off in the ensuing period: the government is unable or unwilling to provide large additional capital injection into the public sector banks; at the same time, the government has so far not agreed to a reduction in the Government/RBI majority holding in public sector banks. The danger is that there could be a weak resolution in that various types of hybrid loan capital would be used to meet the capital adequacy requirements of banks. The Committee cautions that regulatory forbearance in the case of public sector banks would greatly weaken the system and as such should be avoided.

4.21 In the absence of injection of capital in public sector banks and the reluctance of government to give up majority ownership, public sector banks' share of business would shrink. Either way, there would be a weakening of the Indian financial system. In this context, the issue of majority Government/RBI

ownership of public sector banks would come to the fore. The problem needs to be examined separately for the SBI Group and the nationalised banks. All public sector banks should not be on a 'one size fits all' approach. The stronger public sector banks need to be given greater autonomy and the powers and accountability of bank boards of the stronger banks need to be enhanced. Thought also needs to be given to encouraging well-capitalised new private sector banks to be set up preferably with institutional backing. The banking system has only limited time up to 2009 when intense competition from foreign banks is expected and, therefore, urgent action is warranted.

4.22 In this regard, the Committee notes that the RBI proposes to transfer its stake in SBI to the Government of India. If this transfer materialises, the share of nationalised banks in the banking system, will increase from around 50 per cent to around 75 per cent. The SBI, at present, has a greater degree of functional autonomy than the nationalised banks and bringing it under the category of nationalised banks would be a retrograde step. The shareholding of the RBI in SBI, currently 59.7 per cent, is close to the statutory minimum of 55 per cent and the bank may need to raise further capital in the near future to sustain its normal growth and business requirements. This is expected to place a further burden on the government, if it became the majority shareholder in SBI.

4.23 With a view to further enhance the efficiency and stability of the banking system to the best global standards, a two-track and gradualist approach was adopted by the RBI in March 2005. One track was consolidation of the domestic banking system in both public and private sectors. The second track was gradual enhancement of the presence of foreign banks in a synchronised manner. The second phase, which will commence in April 2009 after a review of the experience gained and after due consultation with all the stakeholders in the banking sector, would consider allowing a greater role for foreign banks. There has been, however, hardly any progress on the first track with regard to consolidation in the public and private sector banks.

4.24 At present, the Indian banking system is fragmented with as many as 85 commercial banks. Going forward, the Indian banking system will be exposed to greater competition. In the context of the greater uncertainties which call for

greater focus on the risk management capabilities of banks, it would also be appropriate to envisage the need for development of stronger and professionally run domestic banks which will enable them to compete effectively. A weak and fragmented banking sector cannot co-exist with a system opened to global influences. In addition, with the likely gradual enhancement of presence of foreign banks after 2009, the banking system would be exposed to intense competition from large global banks. In this regard it has been the policy of the RBI not to actively pursue consolidation but to play the role of a facilitator. While respecting this approach of the RBI, the Committee considers that consolidation in the banking sector is an important concomitant to FCAC and hence the Committee recommends that the RBI should formulate its prudential policies in a manner which will favour consolidation in the banking sector. The Committee also recommends that the RBI should facilitate emergence of strong and professionally managed banks and not only large banks. The initial target may be, as recommended by the Committee on Banking Sector Reforms (Narasimham II), to create 4 or 5 large banks with international presence which are equipped with the state of the art skills in banking, risk management and information technology (IT).

4.25 In this regard, it will also be relevant to address the issue of governance. Commercial banks are at present governed by the following six statutes in addition to the Banking Regulation Act, 1949, *viz.,* Banking Companies (Acquisition & Transfer of Undertaking) Act, 1970, Banking Companies (Acquisition & Transfer of Undertaking) Act, 1980, State Bank of India Act 1955, State Bank of India (Subsidiary Banks) Act, 1959, Industrial Development Bank (Transfer of Undertaking and Repeal) Act, 2003 and the Companies Act, 1956. These statutes have embedded provisions which hinder good governance and consolidation. The Committee recommends that one of the first initiatives which the RBI should initiate to promote easier market driven consolidation within the banking sector is to move necessary legislative amendments to the above statutes to ensure that all commercial banks are registered under a single Act, *viz.*, Companies Act and regulated under the Banking Regulation Act and the voting rights of investors should be in accordance with the provisions of the Companies

Act. Early enactment of the proposed amendments of the Banking Regulation Act is imperative.

4.26 On the strengthening of the banking system, the Committee has the following recommendations:

(i) All commercial banks should be subject to a single Banking Legislation and separate legislative frameworks for groups of public sector banks should be abrogated. All banks, including public sector banks, should be incorporated under the Companies Act; this would provide a level playing field.

(ii) The minimum share of Government/RBI in the capital of public sector banks should be reduced from 51 per cent (55 per cent for SBI) to 33 per cent as recommended by the Narasimham Committee on Banking Sector Reforms (1998). There are, admittedly, certain social objectives in the very nature of public sector banking and a reduction in the Government/RBI holding to 33 per cent would not alter the positive aspects in the public sector character of these banks.

(iii) With regard to the proposed transfer of ownership of SBI from the RBI to government, the Committee recommends that given the imperative need for strengthening the capital of banks in the context of Basel II and FCAC, this transfer should be put on hold. This way the increased capital requirement for a sizeable segment of the banking sector would be met for the ensuing period. The Committee, however, stresses that the giving up of majority ownership of public sector banks should be worked out both for nationalised banks and the SBI.

(iv) In the first round of setting up new private sector banks, those private sector banks which had institutional backing have turned out to be the successful banks. The authorities should actively encourage similar initiative by institutions to set up new private sector banks.

(v) Until amendments are made to the relevant statutes to promote consolidation in the banking system and address the capital

requirements of the public sector banks, the RBI should evolve policies to allow, on a case by case basis, industrial houses to have a stake in Indian banks or promote new banks. The policy may also encourage non-banking finance companies to convert into banks. After exploring these avenues until 2009, foreign banks may be allowed to enhance their presence in the banking system.

(vi) Issues of corporate governance in banks, powers of the Boards of public sector banks, remuneration issues, hiring of personnel with requisite skills in specialised functions and succession planning need early attention.

(vii) The voting rights of the investors should be in accordance with the provisions of the Companies Act.

(viii) Following the model of the comprehensive exercise undertaken on Transparency, a number of Groups/Committees could be set up for examining each set of issues under the overall guidance/coordination of a High Level Government – RBI Committee to ensure concerted and early action to expeditiously prepare the financial system to meet the challenges in the coming years in the context of Basel II and the move to FCAC. As part of this comprehensive exercise, the proposed Committee should revisit the issue of investments by foreign banks in Indian banking. In this Committee's view, this has relevance in the context of issues relating to bank recapitalisation, governance, induction of technology and weak banks.

External Sector Indicators

4.27 Recent developments in the balance of payment (BoP) indicate continuing resilience of the external sector even as the Indian economy is entering an expansionary phase of the business cycle. There has been an emergence of a current account deficit (CAD) in 2004-05 and 2005-06 after surpluses in the preceding three years (2001-04). For a developing country like India, imports of raw materials, intermediates, capital goods, technology and services hold the key to scaling up growth in the medium-term. It is important to recognise that current BoP has significantly improved over 1990-91.

Current Account Deficit

4.28 Since the crisis of 1990-91, during which a CAD of 3 per cent of GDP turned out to be unsustainable, the appropriate level of the CAD for India has been the subject of considerable deliberation. The appropriate level of the CAD is a dynamic concept and cannot be fixed in time, or cast in stone.

4.29 The openness is based on the increase in the current receipts to GDP ratio to 24.5 per cent in 2005-06, which is substantially higher than the ratio of 8.0 per cent in 1990-91. Current receipts in 2005-06 pay for 95 per cent of current payments, up from 72 per cent in 1990-91.

4.30 Acceleration in the growth of current earnings economises on the need to seek access to international financial markets and strengthens the ability to run a higher CAD (and achieve higher growth) without encountering a financing constraint. Stepping up the growth of current receipts is essential for sustaining a higher CAD.

4.31 Viability of the CAD is a function of the availability of normal capital flows, as opposed to exceptional financing. Net capital flows have regularly exceeded the CAD requirements by a fair measure, enabling large accretions to the reserves. During 2005-06, the CAD has been comfortably financed by net capital flows with over US$ 15 billion added to the foreign exchange reserves. Compositional shifts in favour of foreign investment have actually strengthened the economy's absorptive capacity. The share of non-debt creating flows in net capital flows has, in fact, risen from 1 per cent in 1990-91 to nearly 50 per cent in 2004-05. The operating ‘viability’ criterion for determining the access to capital flows is the ability to service external liabilities as embodied in a low ratio of debt service payments to current receipts. The debt service ratio (DSR) has fallen to as low as 10.2 per cent in 2005-06 and the ratio of the external debt stock to GDP was a modest 15.8 per cent. The DSR could safely be in the range of 10-15 per cent.

4.32 If the ratio of current account deficit to GDP is regarded as the target variable, the ratio of current receipts to GDP can be regarded as the instrument variable. Accordingly, a sustainable current account deficit is dependent on the current receipts to GDP ratio. A rising current receipts to GDP ratio will enable a higher current account deficit which would enable a higher investment ratio. Given the present CR/GDP ratio of 24.5 per cent, the CR/CP ratio of 95 per cent and a debt service ratio in the range of 10-15 per cent, a CAD/GDP ratio of 3 per cent could be comfortably financed. Should the CAD/GDP ratio rise substantially over 3 per cent there would be a need for policy action.

Adequacy of Reserves

4.33 The adequacy of reserves is regarded as an important parameter in gauging an economy's ability to absorb external shocks. With the changing profile of capital flows, the traditional approach of assessing reserve adequacy in terms of import cover has been broadened to take into account risk profiles of various types of external shocks to which the economy is vulnerable. In the more recent period, assessment of reserve adequacy has been influenced by the introduction of new measures that are particularly relevant for emerging market countries like India. One such measure requires that the foreign currency assets should exceed scheduled amortisation of foreign currency debt (assuming no rollovers) during the following year. The other one is based on a "Liquidity at Risk" rule that takes into account the foreseeable risks that a country could face under a range of possible outcomes for relevant financial variables such as exchange rates, commodity prices, credit spreads and the like. The RBI has been pursuing a policy of maintaining an adequate level of foreign exchange reserves to meet import requirements, unforeseen contingencies and liquidity risks associated with different types of capital flows. Adequacy of reserves in the context of consumption and investment smoothing requirements in the event of a shock is assessed in relation to trade needs which cover import payments as well as the broader measure of all current external payments. Liquidity indicators of reserve adequacy are monitored in terms of the preparedness to meet short-term liabilities and to fulfill the need for maintaining orderly conditions in the foreign exchange market in the event of mismatches between supply and demand. Thus, reserves are also required to be adequate in terms of short-term debt obligations and

portfolio investments. Broader measures of solvency are assessed in terms of the ratio of reserves to total external debt and to the external liabilities, the latter encompassing direct and portfolio investments and bank claims in addition to gross external debt. Money-based indicators of reserve adequacy help to indicate vulnerability of economic activity to any possibility of massive capital outflows. Finally, reserve adequacy is also gauged in terms of macro indicators, i.e., the ratio of India's reserves to GDP.

4.34 In terms of trade-related reserve adequacy indicators, India's foreign exchange reserves at about 11.6 months of imports at end-March 2006 are comfortable. India's ratio of reserves to short-term debt is also comfortable. The level of reserves well exceed India's overall external debt. In terms of total external liabilities, which include portfolio liabilities, India's reserves cover over one half of the external liabilities. In the context of large non-debt flows in recent years, greater attention is required to the concept of reserve adequacy in relation to external liabilities.

4.35 While the reserves are comfortable in relation to various parameters, the Committee has some concerns about the coverage of data on short-term debt, including suppliers' credit. Again there are concerns whether the flow of private equity capital are fully captured in the data (on FDI). The Committee suggests that the RBI should undertake an in-depth examination of the coverage and accuracy of these data.

CHAPTER 5

INTERACTION OF MONETARY POLICY AND EXCHANGE RATE POLICY

5.1 Till the 1990s, the reserve money creation process predominantly originated from the RBI's financing of government and the instruments of monetary control were essentially reserve requirements, interest rate controls and direct credit controls. Against the backdrop of tight capital controls, exchange rate policy was governed by the preoccupation of conserving foreign exchange and maintaining India's competitiveness in international markets. In other words, there was only limited interaction between monetary policy and exchange rate policy. With the gradual relaxation of controls in the domestic financial sector beginning in the early 1990s, there has been a move away from reserve requirements, interest rate controls and other direct controls and increasing reliance on market related instruments.

5.2 With the gradual opening up of the external sector, and the relaxation of capital account controls, there has been an upsurge of capital inflows. The reliance of government on the RBI credit is now reduced and virtually the entire reserve money is externally generated. The preoccupation of monetary policy is to a large extent on managing capital flows while ensuring monetary and financial stability and meeting the real sector's requirements for credit. The progressive integration of India into the global economy exposes the real sectors to the vicissitudes of the international economy.

5.3 As the Indian economy moves to FCAC, albeit at a measured pace, monetary policy and exchange rate policy will be increasingly inter-twined. It is in this context that the conflict of the impossible trinity – independent monetary policy, open capital account and a managed exchange rate comes out in the open. Technically, all poles of the trinity cannot be simultaneously attained, but the approach of the Indian authorities, quite rightly, has been to work towards optimising intermediate solutions.

5.4 Given the Indian policy makers' distinct preference for monetary stability and growth of the economy and the gradual opening up of the capital account, the performance of Indian monetary policy, exchange rate policy and gradual capital account liberalisation has yielded satisfactory results. The move to fuller capital account convertibility would need to derive synergies between the quest for monetary stability and an appropriate exchange rate regime which would be supportive of the growth objectives.

Monetary Policy Instruments and Operations

5.5 The sterilisation and open market operations (OMO) and interventions in the forex markets have to be so calibrated along with domestic monetary instruments so as to be consistent with the monetary policy objectives.

5.6 In the emerging scenario of greater integration of domestic and international markets, interest rate policy comes to the fore. In this context, a few observations would be apposite. First, while interest rate policy has to take into account various factors, both domestic and international, the RBI would need to progressively give somewhat more weightage than hitherto to international real interest rates. Indian real interest rates would need to be better aligned with international real interest rates. Secondly, while skillful open market operations (OMO) need to be developed for modulating liquidity conditions, OMO could also be used to correct any serious misalignments perceived by the authorities between short-term and long-term interest rates. Thirdly, while there is some advantage in a rule based interest rate policy, there are dangers in that monetary policy could become a prisoner of rigid rules.

5.7 Large and sudden capital inflows and outflows can be destabilising to the economy and hence, the economy can face the problem of boom and bust. The Indian authorities have had to rethink the kind of interest rate signals which are given to the system. Till the late 1990s, the signalling rates of the RBI were altered by as large an amount as 1 to 2 percentage points. With the increased opening up of the economy and the development of financial markets, the RBI has recognised that large changes in interest rates would be disruptive. Accordingly, the extent of interest rate changes by the RBI, in the more recent period, have

generally each been of the order of 0.25 percentage point. A major objective of monetary policy is containing inflationary expectations and to attain this objective, monetary policy action needs to be undertaken well before the economy reaches the upper turning point of the cycle. If the measures are delayed, small incremental changes are ineffective and moreover could be destabilising, particularly if monetary tightening is undertaken during the downturn of the cycle. With transparency in setting objectives (discussed in the previous Chapter), there would be improved credibility if the RBI had greater independence in optimising the use of instruments and operating procedures.

5.8. The RBI has rightly de-emphasised reserve requirements and interest rate controls as key instruments of monetary policy. Given the nascent state of development of market based monetary policy instruments and the size of capital flows, it would be necessary to continue to actively use the instrument of reserve requirements. It would be necessary for the RBI to have flexibility to alter the Statutory Liquidity Ratio (SLR) below 25 per cent when felt necessary. In this context, it is imperative that legislative amendments relating to the SLR stipulation are put through expeditiously.

5.9. The RBI has in recent years developed the Liquidity Adjustment Facility (LAF) as an effective instrument. The LAF at present provides for a one percentage point spread within the corridor for overnight call money. The LAF is meant to be a short-term discretionary instrument for smooth equilibrating of liquidity in the system and, therefore, the repo and reverse repo interest rates are key signalling rates in the system. Since 2002-03, however, LAF has become a passive facility for CRR/SLR management of banks within the books of the RBI. The LAF should be essentially an instrument of equilibrating very short-term liquidity. The Committee recommends that, over time, the RBI should build up its stocks of government securities so as to undertake effective outright OMO. The Committee recognises that this is easier said than done. Nonetheless, the RBI should use every window of opportunity to build up its stock of government securities.

5.10 The interest cost of sterilisation to the Government and the RBI in 2005-06 is reported to be in the broad range of Rs.4,000 crore (though reduced somewhat

by corresponding earnings on the forex reserves). While the costs of sterilisation are often highlighted, the costs of non-intervention and non-sterilisation are not easily quantifiable as the costs are in terms of lower growth, lower employment, loss of competitiveness of India, lower corporate profitability and lower government revenues; these costs could be much more than the visible costs of sterilisation.

5.11 While appreciating the RBI's dilemma of a shortage of instruments, the Committee recommends the following:

(i) The way the LAF is operated, it is used by banks like a current account on which they are remunerated. The RBI needs greater freedom in operating the LAF. Under the present system of fixed rate repo/reverse repo auctions, these rates become a major policy announcement and this restricts the degree of freedom the RBI needs in its day-to-day operations. The RBI should activate variable rate repo/reverse repo auctions or repo/reverse repo operations on a real time basis.

(ii) Apart from overnight LAF operations the RBI should consider somewhat longer-term LAF facilities, say, for a fortnight or a month.

(iii) To the extent the RBI assesses the excess liquidity to be more than transient, it should also use the CRR and SLR. Where there is a large increase in liquidity and credit expansion way above the trend line, bank profitability is higher and the banks can be legitimately expected to bear a part of the burden of containing the deleterious expansion of liquidity. The Committee recognises that the CRR cannot be as effective as in earlier years as banks are anyway maintaining large balances for settlement operations. Nonetheless, it can be a supportive instrument and the entire burden should not be on the LAF and the Market Stabilisation Scheme (MSS).

(iv) To the extent the capital inflows are exceptionally high and the economy is inundated with excess liquidity, arising out of FII inflows, the authorities may consider, in very exceptional circumstances, the imposition of an unremunerated reserve

requirement on fresh FII inflows. This would need to be imposed under the FEMA Rules for FIIs. Under such a dispensation, FIIs would be required to retain a stipulated percentage of the inflows with the bank and the bank in turn would be required to transfer these balances to the RBI. The impounded balance would be released to FIIs after a stipulated period. The Committee recommends that measures of such a nature should be exceptional, to be used only in extreme situations wherein the liquidity arising out of extremely large and volatile FII inflows reaches unmanageable proportions. Furthermore, such a measure, to be effective, should be used as a temporary measure only for a few months.

Exchange Rate Management

5.12 Exchange rate management, in the context of a liberalised capital account, calls for skillful operations by the central bank as there could be large capital inflows resulting in appreciation of the exchange rate and a loss of India's international competitiveness; equally, large capital outflows could result in sharp depreciation of the currency which could be dislocative to the economy. The articulation of the exchange rate policy gives the Committee some concern. The Indian exchange rate regime is classified by the IMF as a "managed float with no predetermined path for the exchange rate". The authorities have centered the articulation of the exchange rate policy on managing *volatility*. The Committee is of the view that apart from volatility what is more important is the *level* of the exchange rate. Movements of the Indian rupee *vis-à-vis* different currencies would show sharp directional differences as these currencies could move in different directions. While these cannot be controlled, sharp appreciation or depreciation of the exchange rate in real effective terms can have adverse impacts on the economy.

5.13 The RBI in its Bulletin for December 2005 has undertaken a revision of indices on the nominal effective exchange rate (NEER) and the REER. The base year and country composition of the 6-country and 36-country indices have been altered. While appreciating the limitation of the REER index in the context of a

rapid growth of services, the Committee recommends that work needs to be undertaken by the RBI to refine the REER index by incorporation of services to the extent possible. Furthermore, for periods where there are large import duty adjustments, these should be built into the construction of the REER. According to the RBI, these indices are constructed "as part of its communication policy and to aid researchers and analysts". The Committee would, however, stress that the REER should also be a valuable input into the formulation of the RBI's exchange rate policy.

5.14 The 1997 Committee recommended 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."

The present Committee endorses the recommendations of the 1997 Committee.

5.15 The Committee recommends that, as an operative rule, if the CAD persists beyond 3 per cent of GDP (referred as an outer sustainable limit, at the present time) the exchange rate policy should be reviewed.

CHAPTER 6

DEVELOPMENT OF FINANCIAL MARKETS

6.1 When there is progressive integration of the domestic economy with the global economy in a FCAC regime, the interaction of domestic markets with global markets results in enhanced cross-border capital flows with benefits of diversification and additional capital. But, it also adds to credit and market risks. The nature of the cross-border financial flows are largely determined by the stage of development of different segments of financial markets, the skill and competency levels and maturity and robustness of the regulatory and payment and settlement systems.

6.2 All financial inflows across the border have to be first handled by the foreign exchange markets and later by other segments of the financial system comprising equity market, money markets and debt markets comprising both government securities and corporate debt markets. As regards outflows, they may originate from different segments of the financial system but will finally flow through the foreign exchange markets. The quality of response of different segments of the financial markets to handle financial flows will depend on whether financial markets are sufficiently broad-based in terms of number of participants, instruments and other necessary infrastructure to process large transactions of inflows and outflows.

6.3 In a well integrated financial system close linkages develop between the money market, the Government Securities (G-sec) market, the corporate bond market, the securitised debt market, the forex market and the derivatives market. Volatility in any one of the market segments gets transmitted to other market segments, although the magnitude of the impact will depend upon the extent of integration. Interest rates prevailing in different market segments would reflect their risk-reward relationships. Exchange rates and interest rates are interlinked. In an efficient market, the forward margin on the exchange rate should normally be equal to the interest differential between the two currencies. As regards the interest rate linkages between the G-sec market and the corporate bond market,

any changes in interest rate in one market should lead to corresponding changes in the rate structure of the other markets if markets are well developed and efficient. For example, the yield curves for AAA rated corporate bonds and G-sec should reflect a healthy difference (although not necessarily remaining parallel) along different maturities. If the gap/differential between the two yield curves varies excessively for different maturities it is likely because either or both of these markets are not well-developed.

6.4 Any country intending to introduce FCAC needs to ensure that different market segments are not only well developed but also that they are well integrated. Otherwise, shocks to one or more market segments would not get transmitted to other segments efficiently so that the entire financial system is able to absorb the shocks with minimal damage. Broadly, there are three main dimensions of a well developed financial system. These are: (i) vibrancy and strength of the physical infrastructure of markets as reflected by the IT systems, communication networks, business continuity and disaster management capabilities, (ii) the skill and competency levels of people who man the offices of financial intermediaries like commercial and investment banks, institutions that manage trading platforms and clearing and settlement arrangements and market intermediaries like brokerage houses, etc. and (iii) quality of regulatory and supervisory arrangements.

Equity Market

6.5 Indian equity market consists of primary and secondary segments, both of which have evolved to world class standards in terms of trading technology, disclosure standards and price discovery processes. Infrastructure in terms of depository, clearing corporation and anonymous electronic order matching, coupled with products ranging from cash and derivatives, both on stocks and indices, provide for an integrated framework for all participants. Participants are both retail and institutional, while foreign participants are restricted to the latter. Retail participation is significant including through mutual funds and exchange traded funds. Mutual funds have seen their funds under management increase steadily. Foreign institutional holding has risen to about 10 to 15 per cent of the market capitalisation, which itself is now approaching 100 per cent of GDP. In

terms of trading intensity and liquidity, Indian stock exchanges are among the world's best.

Money Market

Overnight market

6.6 There has been a pronounced policy induced shift in overnight money market in recent years from uncollateralised call money market to collateralised segments. By August 2005, all non-bank entities except primary dealers have been phased out of the call/notice money market, making the call/notice money market a pure inter-bank market. Also, in 2003, the Clearing Corporation of India Ltd. (CCIL) developed a new product, *viz*., Collateralised Borrowing and Lending Obligations (CBLO). This market is very active, with participation from banks, financial institutions, insurance companies, non-government provident funds and some corporates. CCIL provides an order matching anonymous trading screen for its CBLO product and it is transparent and on a real time basis. This has helped in making the money market efficient and rates for different products in this market get influenced by the CBLO rates which are available transparently on real time basis. A similar screen for the call/notice money market and this screen has been developed by CCIL.

6.7 Although CBLO is a highly versatile product and meets the objectives of a repo deal, some market players still find repo to be a useful instrument and there is, therefore, a need to develop a repo order matching screen for increasing level of transparency and providing real time rate information to the entire market. The repo facility is yet to be effectively opened up to corporates and other players to manage their liquidity through repo operations. Since entities, other than banks, Primary Dealers (PDs) and mutual funds cannot enter into repo transactions with a maturity of less than one week, this market has not yet taken off. Again, corporate bonds are not eligible for repo purposes.

Term money market

6.8 One of the major gaps in the structure of the money market is the absence of a term money market and, therefore, a money market yield curve. There are no reliable interest rate quotes for fortnight/one month/three months/six months/nine

months/364 day duration transactions despite availability of Treasury Bills of varying maturities. Until this segment of the market develops, it will be difficult to develop proper/meaningful linkages between the forex and domestic currency markets. The derivative market is also at a disadvantage when meaningful term money market benchmarks do not exist. Despite several efforts made, the term money market has not developed due to poor treasury skills as also lack of incentives to borrow or lend term money in certain segments of the banking sector. This is a hurdle in the development of not only the term market but also other important segments of the financial markets, *viz.,* forex, G-sec, corporate bond markets as also the derivative markets. Human Resources Development (HRD) policies/practices followed by a large part of the banking sector have to be significantly changed so that suitable staff is recruited and posted on a long-term basis and allowed to develop high quality skills/expertise in treasury operations including foreign exchange dealings.

Certificates of Deposit (CD) & Commercial Paper (CP) Markets

6.9 There has been a significant growth in the CD market in recent years and CPs also remain a popular instrument in the money market. The fact that CDs can be traded makes them attractive for investors like mutual funds, which seek liquid investments.

6.10 The CP market is also expanding over time. More importantly, the nature of the CP market has changed significantly in recent times. Leasing and Finance Companies accounted for nearly three-fourths of the total outstanding as at end-March 2006, while there has been a secular decline in the amount of CPs being issued by 'Manufacturing and other companies'.

Rupee Interest Rate Derivatives

6.11 Presently, Forward Rate Agreements (FRAs), Interest Rate Swaps (IRS) and interest rate futures are permitted in the Indian money market. The volumes of swaps FRAs have increased substantially both in terms of outstanding notional principal amounts and the number of contracts. Some foreign banks, private sector banks, PDs and large corporates are the major participants. Though certain steps have been taken to shore up the monitoring and regulatory aspects of risks

related to derivatives, there are certain other areas requiring immediate strengthening. Interest rate futures, though permitted, have not become popular.

6.12 Since FCAC would mean that market participants would be increasingly enabled to take on or transfer risk across markets, further expansion of hedging instruments such as interest rate futures are necessary. For effective risk management of G-Sec portfolios, participants will also need access to a liquid interest rate futures market, and eventually to an interest rate options market, which in turn would increase liquidity in the G-Sec market.

6.13 In the interest rate swap market, apart from increase in volumes, the market also witnessed emergence of interest rate benchmarks like Mumbai Inter-Bank Offer Rate (MIBOR), the Mumbai Inter-Bank Forward Offer Rate (MIFOR) (which is a combination of the MIBOR and forward premium) and other multiple benchmarks which essentially had linkages to the movement in overseas interest rates.

6.14 While an interest rate futures market nominally exists, there are no transactions, mainly because banks can use it only for hedging exposures. Since they are all long in fixed interest securities, there is lack of counterparty on the other side. First, banks should be allowed to trade in interest rate futures, subject to prudential market risk management. In principle, if they can trade in interest rate swaps, the logical extension is that they should be allowed to trade in futures as well. Secondly, FIIs in the debt market should also be permitted in all the derivatives markets.

6.15 With the large market for Over the Counter (OTC) swaps, which is expected to grow fast with more open markets, a safe and efficient settlement system for such swaps is necessary. A netting legislation needs to be in place to ensure legality of such a clearing and settlement system. The proposed Payment and Settlement Bill does incorporate provisions in this regard.

6.16 As interest rate derivatives grow, an area which requires urgent attention relate to accounting and disclosures. The current standards in respect of these are not comprehensive enough, do not prescribe mandatory uniform accounting

policies, and in some respects are not aligned to international standards. Institute of Chartered Accountants of India (ICAI) is in the process of evolving an Indian standard for this purpose in line with IAS 39, the relevant international standard.

6.17 There is a general concern about the complexity with which the swaps/ options are being structured and marketed to corporates. Many complex products involve multiple benchmarks and writing of options by corporates. An issue is whether these products are appropriate as hedging instruments and whether the risks are understood by the corporates and/or made known to them by the banks.

6.18 The Committee's recommendations relating to development of the money market are as follows:

(i) Policy initiatives should be taken to facilitate development of different financial markets to encourage capital inflows. During this process, prudential regulations on inflows of foreign capital, segment-wise would be desirable.

(ii) In cases where the regulatory purview extends beyond one regulator, one of the regulators should be designated as the lead regulator so that necessary coordination is ensured.

(iii) Suitable regulatory changes need to be progressively introduced to enable more players to have access to the repo market.

(iv) The CBLO and repo markets could be expanded in scope to cover corporate debt instruments.

(v) Considerable staff-skill up-gradation programmes in banks have to be undertaken to develop the inter-bank term money market. Staff compensation levels have to be different depending on the area of activity.

(vi) Since CP and CD are short-term instruments, any unlimited opening up could have implications for short-term flows. Limits from prudential angle may have to be considered even in an environment of FCAC.

(vii) There is a need to set up a dedicated cell within the RBI for tighter monitoring of all derivatives. This would be specially important as demand for derivatives could increase manifold to meet larger hedging requirements in the context of FCAC.

(viii) Banks should have well laid down 'appropriateness policy' before complex structured derivatives are marketed to their clients.

(ix) Efforts may be made to activate the market in interest rate futures to all participants including foreign investors. Permitted derivatives should include interest rate options, initially OTC and subsequently exchange traded.

(x) Enactment of the Payment and Settlement legislation, followed by a swap clearing arrangement, with provisions for netting will need to be completed before opening up swap markets.

(xi) Development of accounting standards for derivatives in line with international standards should be a priority.

(xii) Liberalised and open markets require strong regulation. It is also necessary to have transparency with respect to market related information such as the volumes transacted, etc. Towards this end Fixed Income Money Market and Derivatives Association (FIMMDA) may be suitably empowered to act as a self regulatory organisation to develop market ethics, trading standards and also undertake regulation of participants besides disseminating information.

Government Securities Market

6.19 While the outstanding stock of government securities of both the Central and State Governments has grown to the size of more than Rs.12 lakh crore, this market is yet to emerge as a deep and liquid market across different maturities so that the market is able to throw up a meaningful yield curve. Markets in financial derivatives will emerge effectively only if the yield curve can be accessed based on actual traded prices in a wide range of maturities. Most of the trading now is concentrated on Central Government stocks and that too in the ten-year maturity which accounts for, on an average, 50 per cent of the daily trading volume. Lack of liquidity in most of the other stocks is attributable *inter alia,* to the Held to Maturity (HTM) facility available to the banks.

6.20 Participant base in the G-Sec markets in India is currently dominated by mandated holders like banks, insurance companies and retirement funds. To improve depth and liquidity of the G-Sec market, particularly in an environment of freer capital flows, as well as to improve price discovery, it is necessary that the non-mandated investor base, in particular, the retail investor base expands. The retail segment could be encouraged through direct retail investment in G-secs or via gilt mutual funds and suitable incentives provided for such investments.

6.21 The high SLR level is one of the major constraints restricting the incentive for banks to reshuffle their investment portfolio in response to changing market conditions. The eventual objective should be to do away with any stipulations for statutory/regulatory preemptions; but this would be contingent on the fisc

achieving a significant improvement thereby enabling a moderation in the size of the gross borrowing programme of the government.

6.22 For a deep and liquid market in G-secs, a process of consolidation should be taken up to reduce the number of floating stocks so that each series has at least Rs 25,000 crore of stock in the market. The RBI has adopted a process of passive consolidation by resorting to reissues. But, the difficulty with this process is that it is very slow in building up liquid stocks. Hence, a more rapid consolidation should be considered.

6.23 The present FII limit for investment of US $ 2 billion in G-secs (Centre and States) as a percentage of total gross issuances of Centre and States for 2005-06 amounts to only 4.8 per cent. The Committee suggests that rather than an *ad hoc* fixation of ceiling, the ceiling should be calibrated as a percentage of annual gross issuance and this ceiling should be gradually raised.

6.24 The Committee's recommendations for further development of the government securities market are as follows:

(i) Over time, it would be preferable to progressively increase the share of mark-to-market category.

(ii) Promoting a two-way market movement would require permitting participants to freely undertake short-selling. Currently, only intra-day short-selling is permitted. This would need to be extended to short-selling across settlement cycles; this would, however, require adequate regulatory/supervisory safeguards.

(iii) To stimulate retail investments in gilts, either directly or through gilt mutual funds, the gilt funds should be exempted from the dividend distribution tax and income up to a limit from direct investment in gilts could be exempted from tax.

(iv) In line with advanced financial markets, the introduction of Separate Trading of Registered Interest and Principal of Securities (STRIPS) in G-secs should be expedited.

(v) Expanding investor base would be strengthened by allowing, *inter alia,* entry to non-resident investors, especially longer term investors like foreign central banks, endowment funds, retirement funds, etc.

(vi) To impart liquidity to government stocks, the class of holders of G-secs needs to be widened and repo facility allowed to all market players without any restrictions on the minimum duration of the

repo; this would, however, necessitate adequate regulatory/ supervisory safeguards. This will improve the incentive for a wide range of economic agents to hold G-secs for managing their liquidity needs through repos.

(vii) A rapid debt consolidation process that is tax neutral, by exempting the gains arising from exchange of securities from all taxes, may be taken up. If necessary, a condition may be stipulated that gains arising from such an operation cannot be distributed to the shareholders.

(viii) The limit for FII investment in G-secs could be fixed at 6 per cent of total gross issuances by the Centre and States during 2006-07 and gradually raised to 8 per cent of gross issuance between 2007-08 and 2008-09, and to 10 per cent between 2009-10 and 2010-11. The limits could be linked to the gross issuance in the previous year to which the limit relates. The allocation by Securities and Exchange Board of India (SEBI) of the limits between 100 per cent debt funds and other FIIs should be discontinued.

Corporate Bond Market

6.25 The corporate bond market in India has not matured in tandem with the government securities market. Bank funding and internal resources are the predominant means of corporate funding. As the corporate sector expands and Indian financial markets get progressively integrated with the rest of the world, there is a need for a well developed corporate bond market.

6.26 As of now, the corporate bond market is the least transparent and totally illiquid segment of the financial market. The market does not follow any of the well established practices that are needed to create a healthy primary and secondary market segments in bonds issued by both public and private sectors. Currently, both the issuers and the investors have adopted practices that do not distinguish corporate bonds from the typical loan instruments. With fiscal consolidation and progressive reduction in fiscal deficit and also public debt levels in relation to GDP, the corporate bond market should be geared to crowd in financial savings for promoting long-term investment in industry and infrastructure.

6.27 As regards corporate debt, figures on outstanding stock are not readily available. The High-Level Expert Committee on Corporate Bond Market

(Chairman: Dr. R.H. Patil) has provided data on resources raised by the corporate sector by way of debt, both through public issues and private placements for the period 1995-96 to 2004-05. The annual issuance since 1999-2000 is in the range of Rs.50,000 to Rs.60,000 crore. Assuming an average of 5-7 year maturities, the outstanding stock can be roughly placed at around Rs.3 lakh crore.

6.28 The present FIIs' limit for investment in corporate bonds of US$ 1.50 billion would work out to an estimated 11 per cent of the gross issuance in 2004-05. The present limits allowed for corporate debt seems to be far more liberal than the limits allowed for G-Secs and the present absolute limit could be retained for 2006-07; thereafter, the limit could be fixed as a percent of gross issuance in the previous year.

6.29 The Committee notes that issues relating to the corporate bond market have been recently addressed comprehensively by a High-Level Expert Committee on Corporate Bond Market, which has made wide-ranging recommendations for the advancement of the corporate bond market. If corporate bonds have to become really tradable instruments like G-secs or equities, an elevated and significant level of reforms will be needed on the basis of recommendations of the High Level Committee.

6.30 The corporate bond market is essentially an institutional market. During the past decade, commercial banks in India have been investing in corporate bonds in a big way. Some of the private sector banks' portfolio of corporate bonds is almost equivalent to that of G-sec investments. Retail interest in corporate bonds continues to be relatively small in India. Given the institutional character of the corporate bond market, it would be desirable to adopt a flexible approach that allows development of institutional trading and settlement arrangements, so long as there is transparency in primary issuances and safe trading and settlement mechanisms, besides development of stock exchange platforms.

6.31 The Committee's recommendations for the development of the corporate bond and securitised debt market are:

(i) GOI, RBI and SEBI should be able to evolve a concerted approach to deal with the complex issues identified by the High Level Committee on Corporate Bond Market.

(ii) Institutional trading and settlement arrangements need to be put in place and investors should have the freedom to join any of the trading and settlement platforms they find to be convenient.

(iii) The issuance guidelines have to be changed so as to recognise the institutional character of the market. Since issuers may like to tap the bond market more frequently than the equity market and since subscribers are mainly institutional investors, issuance and listing mechanisms in respect of instruments being placed with institutional investors should be simplified by relying more on the assessment of a recognised rating agency rather than on voluminous and tedious disclosures as required by the public issues of equities.

(iv) Until transparent trading platforms become more popular, reliable trade reporting systems should be made mandatory. Clearing and settlement arrangements like those offered by CCIL in the case of G-secs should be in place to ensure guaranteed settlement.

(v) Stamp duty at the time of bond issues as also on securitised debt should be abolished by all the state governments.

(vi) The FII ceiling for investments in corporate bonds of US$ 1.50 billion should in future be linked to fresh issuances and the present absolute limit should be retained for the year 2006-07 and be fixed at 15 per cent of fresh issuances between 2007-08 and 2008-09 and at 25 per cent between 2009-10 and 2010-11. The allocation by SEBI of the limits between 100 per cent debt funds and other FIIs should be discontinued.

(vii) Corporate bonds may be permitted as eligible securities for repo transactions subject to strengthening of regulatory and supervisory policies.

(viii) In the case of the securitised debt market, the tax treatment of special vehicles that float the securitised debt has to be materially different. Government should provide an explicit tax pass-through treatment to securitisation Special Purpose Vehicles (SPVs) on par with tax pass through treatment granted to SEBI-registered venture capital funds.

(ix) Securitised debt should be recognised under the Securities Contract and Regulation Act (SCRA), 1956 as tradable debt.

(x) The limitations on FIIs to invest in securities issued by Asset Reconstruction Companies should be on par with their investments in listed debt securities.

Foreign Exchange Market

6.32 Liberalisation would lead to increased volume and liquidity in the spot and derivatives segments of the forex market. In order to increase the size of the forex market to enable it to handle larger flows, more Authorised Dealers (ADs) should be encouraged to participate in market making. The number of participants who can give two way quotes needs to be increased. It is, also, imperative that appropriate instruments and efficient markets are available to Indian corporates to manage their forex risk. The ICAI should extend the coverage of their comments on internal controls, to include market risks. Failure to properly hedge risks could pose serious difficulties, which could be transmitted across financial markets.

Inter-bank and Retail Market - Infrastructure

6.33 The major part of the foreign exchange market is the wholesale inter-bank market where the price discovery of different foreign currencies *vis-à-vis* the rupee takes place. The other component of the foreign exchange market is the retail market where some of the large corporate entities are at times able to negotiate more favourable rates by seeking quotations from different authorised dealers, whereas a large number of others, especially small and medium enterprises (SMEs) who do not have strong bargaining power end up dealing at rates which often may not be the most favourable. There is a strong case to delink forex transactions from the underlying credit facilities and provide a transparent infrastructure even for the smaller entities.

6.34 A price discovery model could be introduced that is similar to exchange trading. Under such an arrangement, an authorised dealer will fix certain limits for its clients for trading in forex, based on a credit assessment of each client or deposit funds or designated securities as collateral. A number of small foreign exchange brokers could also be given access to the forex trading screen by the authorised dealers. The buy/sell order for forex of an authorised dealer's client first flows from the client's terminal to that of the authorised dealers' dealing system. If the client's order is within the exposure limit, the dealing system will automatically route the order to the central matching system. After the order gets

matched, the relevant details of the matched order would be routed to the client's terminal through the trading system of the authorised dealer.

6.35 In the case of large sized deals, the authorised dealers prefer to resort to a negotiation mode on the screen. The authorised dealers will continue to be responsible for delivery of rupee or foreign exchange on their own behalf as also on behalf of their clients to CCIL for settlement of the transactions concluded on the screen. The proposed new arrangement will help in making foreign exchange market highly competitive, efficient, and transparent on a real time basis to all players in the system. The intervention of the RBI in the forex markets could also be through this system that will provide the desired anonymity.

Derivatives in Forex

6.36 Booking of contracts at present is conditional on having a position in the underlying. An exporter, for example, is permitted to book a forward sale of the export earnings. But, with the economy getting increasingly exposed to various types of forex/commodity risks/exposures arising out of exchange rates, their international competitive position needs to be strengthened by allowing them effective options to hedge. Presently, the domestic prices of commodities like ferrous and non-ferrous metals, basic chemicals, petro-chemicals, etc. have an import parity and given the two-way movement of the rupee against the US dollar in recent years, it is necessary for the producer/consumer of such products to hedge their economic exposures to exchange rates. The spot and forward markets should be liberalised and extended to all participants removing the constraint on past performance/underlying exposures in a phased manner. It should be noted that there are no restrictions as such on unhedged exposures.

6.37 A major structural weakness of the forex market is the absence of interest parity in the forward market, arising out of restrictions on capital flows. This has not only led to existence of arbitrage opportunities but has also abetted the development of non-deliverable forward (NDF) markets. One impediment is the lack of a liquid term inter-bank market. The second impediment is the limitation on banks' borrowings and placements in the international market. As of now, ADs have been given permission to borrow overseas up to 25 per cent of their Tier-I capital and invest up to limits approved by their respective boards. There is a

need to gradually liberalise flows, to nurture interest rate parity conditions in forward markets.

6.38 The NDF market in rupees is a symptom of growing international interest in the currency of a globally integrating economy with restrictions on the use of its currency by non-residents. Currently, the FIIs are not allowed to rebook contracts once cancelled. FDIs and FIIs should be permitted to cancel and rebook forward contracts. Similar facilities should also be available in relation to derivatives in general, including Rupee derivatives like MIBOR and MIFOR swaps.

6.39 A facility of guaranteed settlement of spot, cash and settlement next-day/tomorrow (TOM) transactions in the forex market is being offered by CCIL to all the authorised dealers during the past three years. Similar facility for forwards trades needs to be made available.

Derivatives Market

6.40 There is a general concern about the kind of complex derivatives being marketed to Indian corporates. Many complex products under the nomenclature of 'swaps' involve the corporate in writing options which it is unable to price or hedge. In the process, the stipulation that derivatives should be used by corporates only for hedging exposures, seem to be ignored and contravened. It is understood that FIMMDA is preparing a model code of conduct on the subject which should duly take into account these concerns. The RBI also needs to consider adequate risk management systems and appropriate standards for derivatives transactions, especially with end-users. Banks should be allowed to hedge currency swaps by buying and selling without any monetary limits in the forward market.

6.41 One of the objectives of setting up domestic interest rate futures market is to provide market participants and the public with more instruments for price-risk hedging, risk transfer, price discovery, liquidity and standardisation. Internationally, many investors use futures rather than the cash market to manage the duration of their portfolio or asset allocation because of the low upfront payments and quick transactions. Entities also trade in futures with the hope of making profit out of speculation or arbitrage opportunity between the futures market and the underlying market. By having widespread membership and

bringing together a large number of interested parties, the market provides liquidity, making quick transactions possible and providing immediate information on prices. Since futures, like any other derivatives, are linked to the underlying cash market, its availability improves trading volumes in the cash market as it provides an arrangement for handling risk. Speculative activity also tends to shift risk to a more controlled and organised market, away from the underlying cash market.

6.42 For the development of the forex market, the Committee recommends the following:

(i) The spot and forward markets should be liberalised and extended to all participants, removing the constraint on past performance/underlying exposures.

(ii) Similar to the attention shown in protecting the interest of bank customers in terms of transparency of charges etc., the authorities need to be equally concerned about bank margins on forex transactions of smaller customers. The best way to reduce margins would be first to separate forex business from lending transactions and second to introduce an electronic trading platform on which forex transactions could take place, the customer having the choice of trading with the bank quoting the best price. For very large trades, a screen negotiated deal system is proposed. It is desirable that the RBI's intervention in the forex market should be through the anonymous order matching system.

(iii) An important step that can be taken to nurture interest rate parity in forward markets, is to allow more flexibility for banks to borrow and lend overseas both on short-term and long-term and increase the limits that are prescribed now to promote more interest parity with international markets. To ensure that weak banks are not exposed to additional risks, as a result of having access to foreign markets, banks may continue to be allowed to access the market depending upon the strength of their balance sheet.

(iv) To minimise the influence of NDF markets abroad, the FIIs may be provided with the facility of cancelling and rebooking forward contracts and other derivatives booked to hedge rupee exposures.

(v) Currency futures may be introduced subject to risks being contained through proper trading mechanism, structure of contracts and regulatory environment.

(vi) The existing guaranteed settlement platform of CCIL needs to be extended to the forwards market.

(vii) Banking should be allowed to hedge currency swaps by buying and selling without any monetary limits.

Gold Market

6.43 As the largest consumer of gold in the world, India has the potential to develop into an international centre for bullion trade. The gold prices in India respond to global markets and the price differential has narrowed to thin margins after liberalisation measures. As the country moves to FCAC, further steps need to be taken to promote an orderly and well-regulated gold market in the country. Towards this end, the Committee recommends the following:

(i) It is an opportune time to liberalise import of gold by all entities. There are advantages in promoting a vibrant market in both physical gold and financial products based on gold.

(ii) It is necessary to establish an inter-bank spot/cash market in gold which will activate inter-bank borrowing and lending in gold. The setting up/developing of existing gold exchanges, both for physical and financial products, should be pursued further. A proper regulatory framework has to be put in place for the same.

(iii) Banks may be encouraged to lend to traders/jewellers in the gold industry, against primary gold with a view to preventing hoarding and speculation. This will facilitate the transition of gold from being considered as a commodity to a financial asset.

(iv) A gold deposit scheme introduced in 1999-2000 has not taken off. Alternatives, where depositors are offered the facility of investing in gold by depositing the rupees repayable in gold or equivalent rupees or gold certificate, have also been proposed. As such schemes will play a key role in weaning the investor away from physical gold holdings to financial assets in gold, they need to be promoted and widely publicised.

(v) The government has announced the introduction of Gold Exchange Traded Funds (GETF) with gold as the underlying asset, in order to enable any household to buy and sell gold in units for as little as Rs.100. Based on recommendations of a SEBI-appointed Committee, SEBI has notified a scheme enabling mutual funds to introduce GETF schemes with gold as the underlying asset.

(vi) Launching of GETFs by Mutual Funds will generate demand for custodial services. Banks should be encouraged to provide such custodial services.

(vii) Although, certain banks are authorised by Reserve Bank of India to import gold for sale to the public, the general public have no facility to store the gold in demat form and are constrained to hold the gold in physical form with attendant risks. There is thus, a need to provide this facility to the public.

Dollarisation and Internationalisation of the Indian Rupee

Dollarisation

6.44 Dollarisation refers to the use of foreign currency in domestic transactions. "Financial dollarisation" develops when residents hold financial assets or liabilities in foreign currency denominated instruments or linked to foreign interest rates. "Payments dollarisation" refers to the use of foreign currency for retail or wholesale transactions. "Real dollarisation" occurs when domestic prices and wages are indexed to the exchange rate though settled in the local currency. Partial dollarisation occurs when residents hold portion of their financial wealth in foreign assets. Official or full dollarisation occurs when foreign currency acquires status as a full legal tender. While there are only a few fully dollarised countries, most economies are partially dollarised.

6.45 The level of dollarisation in India, measured by the ratio of foreign currency deposits to broad money aggregate is negligible. As the degree of dollarisation grows, so do the risks in terms of greater exchange rate volatility, reduced independence of monetary policy and greater vulnerability of the financial and banking systems. In a liberalised capital account framework, therefore, a stable macroeconomic and fiscal environment with adherence to FRBM Act/Rules is of prime importance in controlling potential dollarisation of the economy and in managing the possible risks arising from such dollarisation.

Internationalisation of the Indian rupee

6.46 An "international currency" is a currency that is widely used for international transactions, such as the US dollar, Euro, British Pound, Swiss Franc and Japanese Yen. The "internationalisation" of a currency is an expression of its external credibility as the economy integrates globally. In practical terms, it would mean the use of the currency for invoicing and settlement of cross-border transactions, freedom for non-residents to hold financial assets/liabilities in that currency and freedom for non-residents to hold tradable balances in that currency at offshore locations. Some degree of internationalisation can coexist with capital controls.

6.47 The first and immediate impact of the internationalisation of a currency is the potential increase in volatility of its exchange rate. It also has implications for the conduct of monetary policy. When a currency starts getting used outside national territories, there would be some kind of economic integration with areas where it is actively traded, which in turn stimulates better growth.

6.48 When an economy is globally integrating, differences in tax rates and restrictions on use of its currency by non-residents result in development of off-shore non-deliverable forward markets for the currency. An NDF contract is essentially a outright forward contract in differences which is cash settled. The market expectations of the exchange and interest rates of the underlying currency form the basis for arbitrage and/or pressure on domestic markets. The Korean won, Taiwanese dollar and Chinese yuan are reportedly the most-traded Asian currencies in the NDF market.

6.49 By several indications, a cash market for the Indian rupee exists outside the country, e.g., in the Middle East and in South East Asia. The Rupee NDF market apparently is not very large or liquid. The size of Rupee NDF market is placed around US$ 100 million per day, with higher volumes occasionally. Although export of Indian Rupee currency notes beyond a very modest sum is not permitted, the fact is that a significant amount of Rupees in currency form is held outside the country, particularly in places where there are sizeable expatriate Indian population. This is perhaps some indication of the growing acceptability of the Rupee outside the shores of the country.

6.50 A matter of concern is that internationalisation of a currency can greatly accentuate an external shock, given the larger channels and independence to the residents and non-residents with respect to the flow of funds in and out of the country and from one currency to another. When non-residents hold significant balances of the domestic currency, particularly at offshore locations, any expectation that the country is vulnerable due to weak fundamentals or a contagion would lead to a sell-off resulting in a sharp fall in the currency. Withdrawal of short-term funds and portfolio investments by non-residents can be a major potential risk of internationalisation.

CHAPTER 7

REGULATORY AND SUPERVISORY ISSUES IN BANKING

Banking System in the context of FCAC

7.1 Under a FCAC regime, the banking system will be exposed to greater market volatility. Hence, it is necessary to address the relevant issues in the banking system including the regulatory and supervisory aspects to enable the system to become more resilient to shocks and sustain their operations with greater stability. This chapter examines these issues and makes appropriate recommendations.

7.2 As the economy gets increasingly integrated with the global system, the Indian banking system too would progressively integrate with the rest of the world. Unless the banking system is strengthened and appropriate regulatory/supervisory norms are in place, the domestic banking sector could be vulnerable. Liberalisation of cross-border capital flows that deepen financial intermediation and capital markets, also brings in its wake increased risks. A system has two dimensions, *viz.*, markets and institutions. The competitiveness and efficiency in the functioning of financial markets depend upon the strength and soundness of banks which are the major players in the markets. Only a vibrant, resilient and competitive banking sector would be able to act as an effective facilitator and be well-equipped to handle new, emerging opportunities as also threats which would characterise a more open economy.

7.3 Scheduled Commercial banks, which account for over 75 per cent of the market share in the financial sector, play an important role in the Indian financial system. The other components of the Indian financial system are financial institutions and urban cooperative banks which account for about 7 per cent and 9 per cent, respectively, of the market share. In terms of systemic relevance the contribution of cooperative banks may not be significant but there are over 3,000 cooperative banks and all of them are not direct participants in the payment and settlement system. The Committee has focussed primarily on the commercial banking segment given their pivotal position in the payments system. As the

banking system acts as an intermediary for allocation and transformation of economic resources, it becomes imperative that in a FCAC environment the capacity build-up of regulators and banks is so calibrated as to withstand and manage the risks associated with globalisation and to reap the maximum rewards.

7.4 The progress of financial sector reforms in India has been marked by growing market integration. Even as efforts are intensified for deepening and broadening financial market segments and developing a seamless and vibrant market continuum, the policy response in the transition would rely on multiple instruments and combination of instruments to ensure financial stability. The concomitants to liberalisation are a strong and resilient banking system, a robust banking regulation and supervision framework, an efficient clearing and settlement arrangement (in particular, for large transactions), appropriate accounting and public disclosure standards, auditing standards, codes of market conduct and institutional governance and conducive legal framework to deal with complex risks associated with increasingly diverse types of capital flows.

7.5 In a new environment, the commercial banks should be able to manage multi-dimensional operations in situations of both large inflows and outflows of capital. In particular, their own exposures to exchange rate risk, coupled with their exposures to corporates which are exposed to similar risks, panning across national jurisdictions add to the multiplicity of risks which need to be closely monitored and prudently managed. The RBI, therefore, needs to review the prudential standards applicable to commercial banks and should consider making the regulations activity-specific, instead of keeping them institution-specific. This approach will also help eliminating any regulatory arbitrage opportunities.

7.6 The risks to economic agents in a liberalised capital account environment also stem from the fact that as almost all economic agents and especially the larger and the more diversified ones get integrated in global fund/economic flows, they have to manage multi-currency balance sheets. This will place greater demands on the agents, especially banks, to manage risks related to assets and liabilities denominated in various currencies under a more dynamic environment. The skill and competency levels required to manage these risks are different and call for a very high level of technical proficiency which at present, is somewhat limited in

the Indian context. Development of such skills across all agents and all the regulators present a formidable challenge.

7.7 As the economy gets more integrated with the rest of the world, there is an increased potential for spill-over effects in the markets, and this calls for a higher level of co-ordination among regulators, domestic as well as international, than at present. Adequate institutional frameworks need to be developed to foster such close co-ordination.

Dimensions of Risks

7.8 Going forward, opening up of the system is expected to result in larger two-way flows of capital in and out of the country; this underscores the need for enhancing the risk management capabilities in the banking system. In a FCAC regime, banks will be expected to undertake transactions in multiple currencies acting as channels for flow of funds in and out of the country when they are enabled to receive deposits and raise borrowing from both residents and non-residents and lend and invest in both domestic and foreign jurisdictions. Likewise, non-resident banks and financial institutions are expected to undertake similar transactions. Similarly, the non-financial entities having links with the banking system would also be transacting in multiple currencies by way of their borrowing, lending and investment operations. All these types of transactions add to the risks of the banking system that are not so evident in a less open domestic banking system. These factors would make the following risk elements more prominent than at present:

(i) Currency Risk - Fluctuations in the exchange rates may adversely affect economic agents with long and short positions in foreign currency, and cause mismatches between foreign currency denominated assets and liabilities.

(ii) Counterparty Credit Risk - Collecting and analysing credit information, including knowledge of the risks to which the counterparty is exposed and their capacity to efficiently manage those risks can pose significant challenges in cross-border transactions.

(iii) Transfer risk – Tracking of the financial position of various economies and their capacities to honour claims on the residents of those economies as and when they fall due on an ongoing basis will pose considerable challenges to banks.

(iv) Legal Risk – Enhanced cross-border transactions may give rise to legal rights and obligations which are different from those arising from domestic transactions. This makes adequate knowledge of the relevant statutes, rights, obligations and procedures for their enforcement necessary, if the banks are to manage legal risk.

(v) Risk of Regulatory Arbitrage – The differences in regulatory and supervisory regimes across countries may create incentives for capital to flow across borders to countries with inadequately regulated and supervised financial markets.

(vi) Risk in Derivatives Transactions – Derivative prices respond to changes in market conditions for the underlying assets, and for many derivative products, their prices are more volatile than underlying prices.

(vii) Reputation risk due to non-adherence to Transaction Appropriateness Standards (TAS), Anti-money Laundering (AML)/Know Your Customer (KYC) requirements and the attendant risks.

7.9 All these call for strengthening the risk management systems in banks. These risk management systems should be suitably supported by appropriate stress test frameworks. As the flow of funds will ultimately be through the banking system, strengthening the banking system becomes paramount if the real sector is to reap the benefits of a FCAC regime. Capital will need to reflect economic risks and regulatory capital move closer to economic capital.

Focal points for Strengthening the Banking System

Prudential Regulation

7.10 Issues in prudential regulation related to FCAC would encompass broadly the following components:

(i) Regulation of the specific and inter-related risks that arise from international capital flows, notably liquidity risk, interest rate risk, foreign currency risk, credit risk, counter-party risk and country risk.

(ii) Improvements in financial institutions' liquidity management and disclosure practices as they are encouraged to diversify funding sources to contain maturity mismatches and improve debt-equity mix.

(iii) There is scope for considerable improvements in corporate governance in public sector banks with the aim of ensuring operational autonomy and equipping them to compete with other banks as equals.

(iv) The Banking Regulation (BR) Act, 1949 allows issue of only one type of banking licence, *viz*., whole banking licence, which permits all licensed banks to undertake all banking activities. There may be a need for the RBI to issue restricted banking licences to some banking institutions to enable them to exploit their core competencies.

(v) Level of computerisation and branch interconnectivity and computer security should meet the standards of well developed financial markets.

(vi) Capital adequacy standards should enhance the resilience of banks. The system should move forward to a differential capital regime. Consideration should be given to introducing a higher core capital ratio than at present. The risk weighting system should be modified to reflect the actual economic risk undertaken by banks. At present the directed lending exposures are unrated and are largely to persons who are financially weak which increases the inherent risk in these exposures. Coupled with this, the banking system is not able to price the risks efficiently. In the absence of a system of marking to market of these credit exposures, the extent of risks inherent in these exposures is not fully addressed. Hence, unrated or high risk sectors should be given much higher risk weights and/or the RBI should consider prescribing a higher level of minimum capital requirement than the present 9 per cent. Systems for ongoing scientific valuation of assets and available collateral should be established. Setting off losses against capital funds on an on-going basis should be considered without allowing banks to carry it as an intangible asset on its balance sheet.

(vii) The scope for undertaking enhanced activity particularly in new financial services should be linked to quality and adequacy of capital, risk management system and personnel.

(viii) On derivatives and related transactions, strengthening of risk management frameworks in banks and supervisory capacity, including oversight to limit excessive exposures, would be needed.

(ix) Uniform prudential limits prescribed by the RBI for interest rate risk (IRR) and capital market exposure (CME) need to be replaced with a differential limit regime which will factor-in the level and quality of risk management systems and capital in banks.

(x) Increased transparency and market discipline with quantitative and qualitative disclosures will be needed on risk exposures and risk management systems in banks.

(xi) Modifications to regulation to discourage or eliminate scope for regulatory arbitrage, focussing on activity-centric regulation rather that institution-centric regulation will be needed. This will require active involvement, coordination and cooperation among the financial sector regulators.

Differential Prudential Regime

7.11 While the move to a differential capital regime under Basel II is envisaged, it is recognised that there should be a differential treatment of *'complex'* banks, *viz*., those which are diversified into areas other than conventional banking; are parts of a large group/conglomerate; undertake significant cross-border transactions; act as market makers; and are counter-parties to complex transactions, since these banks would be exposed to the complexities of various risks. The RBI may consider prescribing a higher minimum capital ratio for these banks. The Committee further suggests that the RBI should review and revise its policy to allow banks to undertake market making; to deal with complex instruments such as derivatives; and to undertake large cross-border borrowing, lending and investment operations.

Supervisory Practices

7.12 Supervisory issues which need attention are as follows:

(i) Adaptations in supervisory practices would include global consolidated supervision of internationally active financial institutions and establishing contact and information exchange with various other supervisors, primarily host country supervisory authorities.

(ii) The existing supervisory reporting formats would need to be reviewed and revised in a post-FCAC scenario after studying the supervisory reporting formats operational in leading territories (e.g. UK, USA, Continental Europe)

(iii) Consideration needs to be given to introducing the concept of relationship managers in the RBI where a dedicated desk official would be tracking all developments in the allotted bank on a day-to-day basis.

(iv) Focus should be given on liquidity risks, interest rate risks, currency risks and currency mismatches, asset concentrations and exposure to price-sensitive assets – to entities and to countries – all at a global level – i.e., at whole bank level as well as bank group level.

(v) Adaptation of new technology will be required for putting in place an on-line connectivity with banks enabling a wide system aggregation of various critical parameters on near real time basis. Move toward a central point data centre in the RBI with appropriate analytical tools will be needed.

(vi) Significant upgradation of regulatory and supervisory skills in the RBI would be needed, which will also include building up a supervisory strategic strike force for dealing with issues expeditiously before they became major endemic problems. Scope for appointing specialists on short term/assignment basis, secondment of officials in regulation and supervision departments to select reputed regulatory/supervisory bodies in various countries, development of specialised skills in specific areas like technology – based supervision, modelling and model validation skills and regular exposure to new and evolving concepts in banking all will become necessary in the ensuing years. While adopting the international best practices and models, the RBI should ensure that the same are adapted to suit/reflect the Indian markets, after due empirical testing. Furthermore, the exchange of officials on deputation between the RBI and banks should be strengthened and serious attention given to redesigning this programme.

7.13 To conclude, as the country moves to an FCAC regime, it is necessary to improve relevant regulatory and supervisory standards across the banking system to enable them to become more resilient and sustain their operations with greater stability. The key requirements in this regard would be: robust and sophisticated risk management systems in banks supplemented by a regimen of appropriate stress testing framework; efficient and reliable IT systems providing on-line data to support the risk management systems in banks; robust accounting and auditing framework; adoption of economic capital framework and risk-based allocation of capital; upgradation of skills; upgradation of IT-based surveillance systems and manpower skills in the RBI; fuller compliance with Anti-money Laundering (AML)/Know Your Customer (KYC) and Financial Action Task Force (FATF) requirements; and a need for prescription of a limit on the off-balance sheet items with reference to balance sheet size. The tabular material attached to this chapter identifies specific measures for strengthening regulation and supervision in the banking sector.

MEASURES FOR STRENGTHENING REGULATION AND SUPERVISION

Present Position	Issues	Proposed Measures
1. **Liquidity Risk** At present banks are required to monitor their liquidity position with regard to their assets and liabilities (including off-balance sheet items) at the domestic branches. The prudential limits on the negative mismatches in the first two time buckets, *viz*., 1-14 days and 15-28 days has been fixed at 20 per cent of the cash outflows. At the foreign branches, banks are required to comply with the following prudential limits at each territory which focus on mismatches in the long term and medium term: (A) Long term liabilities should be at least 70 per cent of long term assets; and (B) Long and medium term liabilities should be at least 80 per cent of long and medium term assets.	Large, uneven flows of funds will expose the banks to greater fluctuations in their liquidity position and hence refinements in the management of liquidity risk by banks would be required.	(a) The liquidity position should be monitored at the head/ corporate office level on a global basis - including both at the domestic branches and at foreign branches. (b) The liquidity positions should be monitored for each currency – where the total liabilities in that currency exceed a stipulated percentage of the bank's total assets or total liabilities. (c) Banks should be required to monitor their liquidity position at a more granular level over the near term. Accordingly, they should monitor their liquidity positions on a daily basis for the next seven days. i.e., next day + six following days. (d) RBI should consider reviewing and reducing the regulatory limit on negative mismatches in the first bucket (1- 14 days) which is 20 per cent at present to say 10 per cent, to reduce the extent of mismatch in that bucket. (e) Banks should be required to fix internal limits on the positive mismatches in the medium term and long term time buckets – say from '3 to 5 years' and 'more than 5 years'. This will ensure that banks do not assume large mismatch positions whereby they depend heavily on short term resources for long term deployment. These mismatch limits should be monitored by the RBI – to look for outliers and initiate appropriate remedial measures. RBI may consider prescribing tolerance levels for mismatches in the medium term and long term.

Present Position	Issues	Proposed Measures
		(f) RBI may introduce capital requirements for banks with reference to the degree of their maturity mismatches. (g) Banks should continue to monitor the liquidity positions territory-wise where there are restrictions on free movement of funds to/from other territories. (h) RBI should examine the need for a limit on the short term borrowings (less than one year) of banks.
2. Interest Rate Risk (IRR) RBI had issued guidelines on Asset Liability Management vide Circular No. DBOD. BP. BC. 94/ 21.04.098/99 dated February 10, 1999, which, inter alia, covered interest rate risk measurement/ reporting frameworks. The immediate impact of changes in interest rates is on bank's earnings (i.e. reported profits) through changes in its Net Interest Income (NII). These guidelines approach interest rate risk measurement from the 'earnings perspective' using the Traditional Gap Analysis (TGA). To begin with, the TGA was considered as a suitable method to measure Interest Rate Risk. RBI had also indicated its intention to move over to modern techniques of Interest Rate Risk measurement, which included Duration Gap Analysis (DGA). A long-term impact of changes in interest rates is on bank's Market Value of Equity (MVE) or Net Worth through changes in the economic value of its assets, liabilities and off-balance sheet positions. The interest rate risk,	With interest rate movements becoming more frequent/dynamic and the potential for greater fluctuations in interest rates, it would be necessary for banks to improve their interest rate risk management systems.	(a) Banks are presently following the Traditional Gap Analysis which will enable them to capture the impact of Interest Rate Risk (IRR) on their earnings. Banks may upgrade their IRR management framework to assess the impact of the IRR assumed by them. With the opening of the capital account and the resultant flows, as also the ease with which such flows can materialise on either side, banks should adopt the duration gap analysis to measure interest rate risk in their balance sheet from the economic value perspective and manage the IRR. Furthermore, banks may be required to fix appropriate internal limits on their IRR exposures. Towards this end, the RBI has issued draft guidelines for upgrading the Asset Liability Management guidelines. In terms of the draft guidelines banks would be required to adopt the modified duration gap approach; compute the volatility of earnings (in terms of impact on Net Interest Income); compute the volatility of equity (in terms of impact on the book value of net worth) under various interest rate scenarios; fix internal limits under both earnings and economic value perspective. The RBI should

Present Position	Issues	Proposed Measures
when viewed from this perspective, is known as 'economic value' perspective.		finalise the guidelines and require banks to fully implement the above revised requirements by March 2008. (b) RBI should introduce capital requirements for banks with reference to the extent of IRR assumed by it and the likely impact of such risks on the bank's net worth during stress situations.
3. Forex Open Position At present banks are required to fix their open foreign exchange position limits and approach the RBI for approval. While approving the open position limits RBI relates the proposed limits to the bank's capital funds.	Under a more liberalised environment, banks would expect greater freedom to fix their own open foreign exchange position limits without prior approval of the RBI, since the open forex position limits attract capital requirements.	While the fact that banks' open position limits attract capital requirements may give some comfort, RBI should consider reviewing the process for approving open position limits and consider issuing prudential limits for open position limits, which will be linked to the banks' capacity to manage the foreign currency risks and their unimpaired Tier 1 capital funds. The RBI should undertake the review before March 2007 and implement the revised procedure by March 2008.
4. Asset Concentration The following limits have been prescribed for credit exposures to : (a) Individual exposure : • 15 per cent of the capital funds • 20 per cent, if exposure is on infrastructure sector	With the greater inflows into the Indian banking system, proper deployment is crucial. Hence it is necessary to address the issue of asset concentrations in banks more comprehensively.	Following prudential limits may be laid down to identify and manage concentrations within the portfolio: (a) Banks were advised to fix internal limits for substantial exposures vide RBI guidelines issued in October 1999. Since these were not mandatory, many banks may not be adopting these limits. Banks should be directed to monitor their 'large exposures' (i.e., exposures in excess of 10 per cent of capital funds) and ensure that the aggregate of these large exposures do not exceed the *substantial exposure*

Present Position	Issues	Proposed Measures
(b) Group of borrowers : • 40 per cent of the capital funds • 50 per cent, if exposure is on infrastructure sector In addition to the above, in exceptional circumstances, banks may assume an additional exposure up to 5 per cent of capital funds with the approval of Board.		*limit*, i.e., sum total of all large exposures not to exceed a specified multiple of capital funds say 600 per cent to 800 per cent. This should be done immediately. (b) With a view to ensure diversification/ avoid concentration, banks may be required to fix internal limits on exposure to the following: i) a particular sector/industry; ii) a particular counterparty category; iii) a particular country, region or state. (c) RBI may fix a regulatory umbrella limit on sensitive sector exposures with relation to the bank's net worth/capital funds. The umbrella limit can be in addition to the sector/exposure specific limits like the capital market exposure limits. This will help in limiting banks' capacity to deploy the likely inflows into sensitive sectors which may prove difficult to exit without a considerable loss of value during times of crisis. For this purpose, the RBI should identify the sensitive sectors and review periodically the need for fresh inclusion or exclusion of certain sectors.
5. Income Recognition Asset Classification and Provisioning (IRAC) Norms Banks are required to follow strict prudential norms with regard to identification of NPAs and making provisions therefor. These are largely in alignment with the international best practices. (a) The current provisioning norms for Non Performing Assets (NPAs) require banks to	With the prospect of greater inflows under a fuller CAC regime, it may be necessary for tightening the provisioning requirements, so as to enhance the shock	(a) RBI should require banks to make provisions for their non fund based commitments in NPA accounts with reference to

Present Position	Issues	Proposed Measures
make provisions for funded exposures. The non-fund based exposures to entities whose fund based exposures are classified as NPAs do not attract a provisioning requirement as per the present RBI regulations. In terms of AS-29: Provisions, contingent liabilities and contingent assets; banks will be required to subject their contingent liabilities to an impairment test and if there is a likelihood of the bank incurring a loss in settlement of the obligations, they are required to make a provision therefor.	absorbing capacity of banks and thus enhance their resilience.	the credit equivalent amounts. RBI should consider prescribing explicit conditions/ situations when the banks should make a higher level of provisions for the contingent liabilities.
(b) At present the asset classification status of an account is based on the record of recovery in each bank. As a result, this gives rise to scope for a borrower to keep the non performing portion of his exposures in one particular bank and keep the other exposures as performing. Though the exposure to the banking system - when viewed at an aggregated level - might have become NPA.		(b) RBI should re-introduce the concept of uniform asset classification across the banking system such that if an exposure to a counterparty becomes NPA in any bank, all banks having an exposure to that counterparty should classify the exposure as NPA.
(c) The provisioning requirements for NPAs on the secured portion are as under:		(c) RBI should review the schedule of provisioning requirements for NPAs and consider tightening the provisioning requirements as under: • The provisioning requirements on substandard assets may be increased to 20 per cent for secured advances and 30 per cent for unsecured advances.

Present Position	Issues	Proposed Measures
Category **Age of delinquency** **Provi-sioning (per cent)** Substandard 90 days to 15 months Secured advances - 10 per cent of total outstanding. Unsecured advances – 20 per cent of total outstanding. Doubtful Over 15 months to 27 months 20 per cent Doubtful Over 27 months to 51 months 30 per cent Doubtful Over 51 months 100 per cent		• The age of delinquency may also be reviewed to ensure that all working capital exposures beyond a delinquency of 36 months are fully provided. • The proposed schedule for provisioning should be as under: **Category** **Age of delinquency** **Provisioning (per cent)** **Secured portion** **Unsecured portion** Substandard a) secured advances b) unsecured advances 90 days to 15 months 20 per cent 30 per cent

Present Position	Issues	Proposed Measures
		20 per cent 30 per cent Doubtful Over 15 months to 27 months 20 per cent 100 per cent Doubtful Over 27 months to 51 months 30 per cent** 100 per cent Doubtful Over 51 months 100 per cent 100 per cent **Note: The working capital exposures in NPA accounts will attract a 100 per cent provisioning requirement on both secured and unsecured portions when the delinquency exceeds 36 months. (d) These measures should be implemented in a phased manner over the period 2007-08 to 2010-11.
6. Capital Adequacy Banks in India are at present adopting the capital adequacy framework as required under Basel I.	Migration to a fuller CAC is likely to throw up numerous	(a) It will not be adequate to have a uniform 9 per cent norm for all banks. The system should move forward to a differential

Present Position	Issues	Proposed Measures
Banks are maintaining capital for both credit risk and market risk exposures. The minimum CRAR required to be maintained by the banks in India is 9 per cent as against the 8 per cent norm prescribed by the Basel Committee on Banking Supervision. As of March 2005, 86 banks were maintaining capital in excess of the regulatory minimum and 2 banks were falling short of the regulatory requirement. Reserve Bank has advised banks in India to implement the revised capital adequacy framework (popularly known as Basel II) with effect from March 31, 2007. Banks will be maintaining capital for operational risks under Basel II in addition to credit risks and market risks. The Indian banking system will be adopting the standardised approach for credit risk, standardised duration method for market risk and the basic indicator approach for operational risk. On a quick broad assessment, it is expected that the impact of Basel II on banks' CRAR will be adverse to the extent of 150 to 250 basis points.	challenges to banks' risk management systems. Migration to Basel II at the minimum approaches, would be making the banks' capital adequacy framework more risk sensitive than under Basel I. The capital adequacy framework, even under Basel II, will need to be strengthened even beyond the Basel II requirements with a view to ensure that it enhances banks' capacity to sustain unexpected losses/ shocks.	capital regime. The '*complex'* banks (as defined in Paragraph 7.11 of the Report) should be moved over to this regime in the next 3 years and all other banks may be moved over to this regime over the next 5 years. (b) Banks should be encouraged to migrate to an economic capital model for allocation of capital and measuring efficiency of capital. This may be dovetailed to the Pillar II requirement under Basel II which requires banks to have in place an internal capital adequacy assessment process (ICAAP). (c) Consider introducing a higher core capital ratio (than the default 50 per cent of total capital funds) at present. It may be raised to at least 66 per cent. (d) At present the banks are generally not adopting risk based pricing. Further almost 90 per cent of banks' credit portfolio is unrated. The risk weight structure under Basel II provides a perverse incentive for high risk borrowers to remain unrated. In view of this and since the system may not be able to rank risk objectively, the risk weighting system should be modified to reflect the actual economic risk undertaken by banks. Hence, unrated or high risk sectors should be subject to a 150 per cent or higher risk weights. (e) The 75 per cent risk weight considered for retail exposures under Basel II is low. Considering the fact that retail exposures include a much wider weaker segment, the risks to which banks are actually exposed to under retail exposures is not low. Hence, the risk weight for this sector

Present Position	Issues	Proposed Measures
		should also be appropriately increased. (f) Systems for ongoing scientific valuation of assets and available collateral should be established since in many banks these systems are conspicuous by their absence. (g) Framework linking branch authorisations, undertaking new financial services etc. to quality of capital and adequacy of capital should be established. (h) Banks should not be allowed to carry accumulated losses in their books. They should be required to set off losses against capital funds, including certain capital instruments other than equity shares, on an on-going basis. RBI should decide on the methodology for setting off the losses against capital funds. (i) These measures may be made operational over a period by 2009-10.

Present Position	Issues	Proposed Measures
7. Risk Mitigants Banks are having the benefit of the following hedging tools for managing their risk exposures: Credit – collateral, guarantees, insurance Interest – Interest Rate Swaps (IRS), Forward Rate Agreement (FRA), Interest Rate Futures (IRF) Equity – None Forex – forwards, currency swaps, options	In view of the potential for greater fluctuations and uncertainties, banks may assume a greater degree of risks and, therefore, would need to have access to greater array of risk mitigants.	Banks may feel the need for the following risk mitigants to hedge or manage their risk exposures in a situation where there is FCAC. These are at present not effectively available to the banks and hence will need to be made available: (a) Interest rate futures and options (b) Credit derivatives (c) Commodity derivatives (d) Equity derivatives However, it is essential for the RBI to put in place the appropriate infrastructure to enable banks to conduct their operations in the above products in a stable and efficient manner. Some of these essential pre-requisites are: (a) a robust accounting framework; (b) a robust independent risk management framework in banks, including an appropriate internal control mechanism, before it is allowed to undertake these activities; (c) appropriate senior management oversight and understanding of the risks involved; (d) Comprehensive guidelines from the RBI on derivatives, including prudential limits wherever necessary; (e) Appropriate and adequate disclosures.

Present Position	Issues	Proposed Measures
8. Stress Testing Framework At present banks are not required to undertake any specific mandated stress tests on their portfolios. In the Annual Policy Statement in April 2006, Reserve Bank has mentioned that stress tests would enable banks to assess risks more accurately and, thereby, facilitate planning for appropriate capital requirements. This stress testing would also form a part of preparedness for Pillar 2 of the Basel II framework. Against this backdrop, RBI is in the process of advising banks to undertake sound stress testing practices.	With a view to sustain the impact of lumpy and unpredictable inflows and outflows in the new environment which will be routed through the banking system it is necessary not only to strengthen the risk management systems in banks, but should also be suitably supported by appropriate stress test frameworks.	While the stress testing framework proposed to be introduced by the RBI now will be addressed at the entire banking system, the focus under a FCAC regime would be: (a) to assess the robustness of the frameworks put in place by banks to ensure that they meet the minimum requirements prescribed for the entire system; (b) to ensure that banks are using the findings of their stress tests as an active ingredient of their risk management systems; (c) to consider encouraging banks, which are exposed to greater risks or greater complexities of risk, to have a more scientific stress testing framework in place.
9. Level of Computerisation and Branch Interconnectivity At present the new private sector banks and the foreign banks are largely computerised and networked. This equips them to address MIS and risk management issues effectively. Due to the lack of equally efficient systems, many of the public sector banks and the old private sector banks are lagging in adoption of real time (or near real time) MIS for business decisions and risk management.	Going forward, level of computerisation and branch interconnectivity will be of significant importance to banks. The quality of MIS will make a significant difference to banks' capabilities.	Banks should have the following IT infrastructure : A few banks are attempting to achieve this through their core banking solutions. Whatever be the mode banks should strive to achieve: (a) On-line connectivity to all major branches (75 per cent of business within 3 years and 90 per cent within 5 years and 100 per cent within 7 years).

Present Position	Issues	Proposed Measures
Some of these banks are attempting to achieve this through the core banking solutions model which will be adapted to meet the other MIS/ risk management requirements.		(b) MIS content should support the risk management requirements and supervisory reporting requirements. With a view to reduce the time lag, the supervisory reports should be system generated with appropriate authentication and submitted to the RBI using the IT medium.
10. Need for Prudential Limits on Off-Balance Sheet (OBS) items Banks' activities are distributed between on-balance sheet business and off-balance sheet business. Though there are no specific norms in terms of the size of these two broad business categories, it is observed that in some banks the size of off-balance sheet business is becoming disproportionate to the on-balance sheet business.	With the increasing use of off-balance sheet products for meeting customer requirements, the pace at which banks use these instruments and the customer demand for these are expected to grow at an increasing pace under an open regime. In the absence of advanced risk management systems in banks, the risks that are assumed by them through the derivatives book can be cause for worry.	RBI should study the composition of the off-balance sheet business of banks and consider issuing prudential norms establishing a linkage between the off-balance sheet business of banks and their risk management systems. They may also take into account the international practices in this regard.
11. Off-balance sheet Exposures – comfort letters		

Present Position	Issues	Proposed Measures
While assessing the risks to which banks are exposed the focus should be on balance sheet items, off-balance sheet items and also other items through which resident entities might have assumed risks – in the form of comfort letters issued to non residents. This will also include the comfort letters issued by head offices of banks to the host regulators while establishing some of their foreign operations and comfort letters issued to other banks on behalf of their clients.	While the capital outflows may be triggered due to various reasons, the commitments undertaken through off-balance sheet items in the form of comfort letters are not reckoned at times. This might pose an additional threat.	Banks issue comfort letters in two situations: (i) covering operations of their subsidiaries to the Regulators in the host country; and (ii) comfort letters on behalf of their customers. Banks should reckon exposures assumed through such comfort letters also and have appropriate strategies in place to - (a) ensure that such contingencies do not arise – by ensuring that the operations for which comfort letters have been issued are always well managed and solvent. (b) have contingency plans in place to ensure that they are able to meet the demands as and when made without any serious disruption of the overall operations. (c) banks should be required to make appropriate disclosures with regard to the nature and extent of comfort letters issued by them.
12. Accounting Standards (a) The Institute of Chartered Accountants of India (ICAI) has issued an Accounting Standard, *viz*., AS -11: The Effects of changes in foreign exchange rates. The RBI has issued guidelines to banks requiring them to comply with the AS but with the use of certain approximations, *viz*., weekly or quarterly average rate instead of daily rate. (b) At present India does not have any accounting standards which specifically	(a) Banks will be undertaking a significantly larger number of foreign exchange transactions with growing integration with international markets. Hence, the accounting framework may need to be made more robust.	(a) Banks should be encouraged to move towards full compliance with AS–11 without any approximations over a 5 year period. The *'complex'* banks should be required to comply with the AS within the next three years and the other banks within the next five years. (b) The ICAI has initiated a move in this regard for issuing corresponding Indian Standards assimilating the principles of IAS 39 on Financial Instruments: Recognition and Measurement, IAS 32 : Financial Instruments : Disclosure and Presentation and IAS 30 : Disclosures in financial statements of banks and similar financial institutions. This

Present Position	Issues	Proposed Measures
address accounting of derivatives. (c) In terms of AS 25 – Interim Financial Reporting, banks are required to make interim financial disclosures at a periodicity as they may choose. RBI has advised banks to make half-yearly disclosures on the quantitative aspects in a summary form as per disclosure format approved by RBI in consultation with SEBI. The listed companies are also required to make quarterly disclosures as per the listing agreements with the various stock exchanges. These disclosures are also on quantitative parameters.	(b) It is imperative to align the Indian accounting standards with the international best practices. Adequate public disclosures by both banks and non-banks are essential to assess the extent of risks, especially un-hedged foreign currency exposures and derivative exposures assumed by non banks. This becomes necessary in view of the likelihood of the risks assumed by the non banks becoming indirectly risks of the banks through their exposures to the non banks.	would ensure accounting of financial instruments, including derivatives, in a uniform and consistent manner. This would also foster a better understanding of the risk exposures of various entities through the disclosures mandated under the accounting standards. Pending issue of the relevant accounting standards, RBI should issue derivative accounting guidelines to banks adopting the broad principles of the above international standards. It would not be adequate if these accounting standards/ principles are mandated on the banks. These should also be made applicable to non bank market participants (corporates) also. Hence, issue of these accounting standards (corresponding to IAS 32 and IAS 39) by the ICAI would be necessary. RBI should pursue this with the ICAI. (c) It would be useful to enhance the scope of disclosures under AS 25 to include qualitative aspects which will bring out the level and direction of risks assumed by the various entities, including non-banks, in consultation with the ICAI. In the absence of the ICAI making such disclosures an integral part of the AS, RBI should coordinate with the other regulators (SEBI – for corporates and securities firms; and IRDA - for insurance firms)
13. Disclosures Over a period the RBI has enhanced the disclosure requirements of banks by prescribing additional disclosures in the Notes on accounts to Balance sheets. These disclosures are largely quantitative in nature with a focus on capital adequacy, NPAs,	For greater transparency and market confidence in the system and to activate the market discipline process, it will be necessary to place more information in the	The disclosures to be made by banks in future should include the following, in addition to the disclosures required by the Basel II guidelines: (a) Concentration of deposit base.

Present Position	Issues	Proposed Measures
investments, provisions, productivity ratios, maturity pattern of assets and liabilities, risk exposures on account of derivatives, etc. The Basel II framework recognises the importance of public disclosures and the role of market discipline by requiring banks to make greater disclosures. Accordingly, banks in India will be required to make additional disclosures with regard to the following: (a) capital and capital structure; (b) capital requirements for each major risk (credit, market and operational) and the capital adequacy; (c) Qualitative disclosure requirement regarding banks' risk management policies for the three major risks and credit risk mitigation. (d) Geographical and industrial concentrations of credit risk exposures.	public domain.	(b) Concentration of borrowings. (c) Extent of dependence on models for risk management and pricing purposes. (d) Framework in place for building and validating models. (e) Disclosure should shift from the position as on the date of balance sheet to the average during the year. (f) Currency-wise maturity pattern of deposits and liabilities where the position exceed a certain percentage of total assets or liabilities. (g) Disclosures on managed assets basis for securitised and assigned assets. (h) Disclosure of top 20 shareholders. (i) Make segment disclosures in greater detail – to include 'corporate', 'retail' and 'priority' sectors, including disclosures pertaining to movement of NPAs in these segments. (j) Greater disclosures on contingent liabilities, including comfort letters. (k) Bank's holding out policy towards their subsidiaries/joint ventures/ associates.
14. Type of Supervision At present the RBI supervises the commercial banking system primarily through two modes, *viz*., off-site and on-site. While the banks' domestic branches are subjected to a periodical on-site inspection (normally annual), the foreign branches	The risks that may emerge under FCAC regime are likely to test the strengths of the supervisory mechanism and may expose its	(a) RBI should consider strengthening its supervisory framework, both off-site and on-site, to effectively capture the revised elements proposed above. The scope and focus of the revised supervisory framework may apply equally to

Present Position	Issues	Proposed Measures
are subjected to on-site examinations at a lesser frequency. The present regulatory and supervisory practices of the RBI are largely conventional in nature and approach.	weakness. It will be necessary for the supervisor to adopt refined and improved supervisory techniques and fix appropriate priorities. The traditional approach may not be adequate in an environment which is likely to be more dynamic.	both domestic branches and foreign branches. (b) Supervision should be geared to assess the adequacy and effectiveness of the risk management systems in place in banks. The risk management systems in banks may be required to explicitly address all material risks and at the minimum should address the following risks: credit risk; market risks; operational risk; liquidity risk and country/ transfer risks. RBI may monitor the risk profile of banks on an ongoing basis. Towards this, the Capital Adequacy, Asset Quality, Management, Earnings and Liquidity System (CAMELS) approach should be adjusted to accommodate the proposed focus and become Capital Adequacy, Asset Quality, Risk Management, Earnings and Liquidity System (CARMELS) approach. Additionally, RBI may undertake targeted appraisals of ‘risk management systems’ and ‘corporate governance’ in all banks at periodical intervals. (c) Supervision should also focus on the vulnerability of the bank due to developments in group entities. RBI may review its supervisory mechanism for the consolidated bank/conglomerates and initiate necessary measures/ mechanisms which will enable all the regulators to undertake coordinated off-site and on-site exercises. (d) RBI should put in place appropriate framework to ensure full adherence by banks with the Anti Money Laundering (AML)/Know Your Customer (KYC) and Financial Action Task Force (FATF) requirements to foster the integrity of the banking system. (e) With a view to contain the forex settlement risks in the

Present Position	Issues	Proposed Measures
		system, RBI should ensure that forex transactions in all currencies that are material are settled on a PVP basis. (f) RBI should consider strengthening the Prompt Corrective Action (PCA) framework making it non-discretionary to a larger extent to reduce the scope for regulatory forbearance. At the minimum, the identified banks may be placed under strict watch and RBI should also consider placing certain restrictions on the activities of these banks. (g) Putting in place an on-line connectivity with banks to support submission of timely system generated supervisory reports to the RBI. This connectivity should also provide for supervisory (read only) access to banks' database. RBI should be able to use this access and generate technology driven system wide aggregation of various critical parameters on near real time basis. Co-ordination between departments in sharing information and rationalisation of returns – move toward a central point data centre in the RBI with appropriate analytical tools and necessary redundancies. The existing supervisory reporting formats should be reviewed and revised in the light of the post fuller CAC scenario after studying the supervisory reporting formats operational in leading territories (UK, USA, continental Europe) (h) Consider introducing the concept of Central Point of Contact (CPOC) in RBI where a dedicated desk official would be tracking all developments in the allotted bank on a day-to-day basis. This should be supported by appropriate structures for triggering appropriate remedial/ supervisory response.

Present Position	Issues	Proposed Measures
		(i) Off-site focus on liquidity risks, interest rate risks, currency risks and currency mismatches, asset concentrations and exposure to price sensitive assets – to entities and to countries - all at a global level – i.e., at whole bank level as well as bank group level. (j) Derivatives and related transactions – Strengthen supervision capacity, including oversight to monitor excessive exposures, to assess the risks associated with derivatives - Strengthen accounting rules to properly measure the risks - Strengthen reporting by financial institutions on derivatives risks, and disclosure of counterparty exposures. (k) At present certain prudential limits prescribed by RBI (for IRR, Capital Market Exposure (CME), etc.) are uniform across the banking system irrespective of the quality of the risk management systems in place. This may be replaced with a differential limit regime which will factor-in the level and quality of risk management systems in banks. (l) Human Resources aspects: Significant upgradation of regulatory and supervisory skills in the RBI; Scope for appointing specialists on short term/assignment basis; Secondment of officials in regulation and supervision departments to select reputed regulatory/supervisory bodies in various countries; Development of specialised skills in specific areas like technology based supervision, modeling and model validation skills; Regular exposure to new and evolving concepts in banking.

Present Position	Issues	Proposed Measures
		(m) Global consolidated supervision of internationally active financial organisations, with adequate monitoring of prudential norms for all aspects of the business conducted by these banking organisations worldwide, including their foreign branches, joint ventures and subsidiaries. (n) Establishing contact and information exchange with various other supervisors, primarily host country supervisory authorities.
15. Licencing Methodology At present Reserve Bank of India issues a full bank licence to all applicants who are found suitable.	Under FCAC, it may be necessary to discriminate among different players on the role that they may play or the freedom they may have to undertake various types of business. This discrimination should be based on the relevance of the entity to the Indian economy and its risk management and risk bearing capacity.	The B R Act, 1949, allows issue of only one type of banking licence, *viz.,* whole banking licence, which permits all licensed banks to undertake all banking activities. However, there may be a need for RBI to issue restricted banking licences to some banking institutions which may not warrant granting of a full banking licence. RBI should have a methodology for issuing restricted licences to entities which the RBI does not deem eligible for a full bank licence. For example, this will be relevant to decide on entities that may undertake cross border transactions and those that may not. Until the statutory amendments are carried out RBI should consider allowing banks to undertake only those activities which the banks may declare at the time of application for a banking licence. They should be required to seek the prior approval of the RBI in case they desired to undertake a fresh activity, other than those declared initially.
16. Regulatory Arbitrage Under the current financial regulatory structure, a	This can lead to regulatory	In this context, as a first step, RBI may focus on activity–centric

Present Position	Issues	Proposed Measures
single financial institution is often supervised by multiple regulators, whose regulatory prescriptions may not be well aligned.	overlaps, the diffusion of regulatory power, and the lack of proper accountability, all of which can weaken supervision and increase risks. In this context, the emergence of financial conglomerates poses a new and complex challenge for regulators. The variances in the regulatory approaches may provide an adverse incentive for regulatory arbitrage. This will have serious implications for financial sector efficiency and stability.	regulation instead of entity-centric regulation to reduce or eliminate the regulatory arbitrage.
17. Inter-agency Cooperation/Coordination and Home - Host Supervisory Cooperation At present there are no formal methodologies for inter agency cooperation/coordination in regulation/supervision of the regulated entities especially where there may be a chance for overlapping of jurisdiction i.e., where the regulated entity performs an activity which may come under the purview of another regulator. With regard to cooperation with host/home supervisors (i.e., foreign regulators/ supervisors) the RBI ensures that the essential requirements for	In view of greater complexities of banking business under a FCAC regime the RBI should be establishing a strong formal mechanism for cooperation/ coordination with other regulatory/supervisory agencies in India and also with foreign regulators/ supervisors. This is essential	The RBI should consider placing the cooperation and coordination with other regulators within the country and with the host regulators/ supervisors in other territories on a more structured and formal platform to enhance the effectiveness of the regulation/supervision of the bank (on a global basis) as well as the banking group (on a consolidated basis).

Present Position	Issues	Proposed Measures
cooperation/ coordination are achieved through a healthy mix of informal and formal approaches.	for activating appropriate regulatory and supervisory responses to significant developments which may be relevant from the perspective of systemic stability.	
18. Financial Soundness Indicators (FSI) The Reserve Bank compiles a set of Financial Soundness Indicators at half-yearly intervals. The Financial Soundness Indicators (FSIs) are placed in the public domain through the Bank's publication – Trend & Progress of Banking in India.	There would be a need for improved monitoring.	The utility of FSIs would be enhanced if the information is put in public domain at half yearly intervals. Furthermore, the time lag in preparing the FSIs may also be reduced, in stages, to say two months from the end of the half year.
19. Legislation The current Indian laws do not explicitly recognise bilateral netting and multilateral netting.	Legislative reforms may be necessary for achieving effective financial sector regulation.	Some of the legislative changes which would be required include legalising bilateral netting and multilateral netting which will secure the netting arrangements under an insolvency situation

CHAPTER 8

TIMING AND SEQUENCING OF MEASURES FOR FULLER CAPITAL ACCOUNT CONVERTIBILITY

8.1 The concomitants for a move to FCAC and the need for attendant strengthening of policies, markets and regulation/supervision have been outlined in Chapters 4, 5, 6 and 7. Before discussing the recommended framework on the timing and sequencing of specific capital account liberalisation measures, it would perhaps be useful to refer to a few general issues. First, there are a number of items which straddle the current and capital accounts and items in one account have implication for the other account. Inconsistencies in the regulations of such items need to be ironed out. Secondly, while there is *de jure* current account convertibility, there are time-honoured stipulations which require surrender requirements for export proceeds. Surrender requirements, *per se,* are consistent with current account convertibility, but as part of overall management of the current and capital flows, it would be useful to consider whether the repatriation/surrender requirements could be gradually eased. Thirdly, there are a number of items where there are anomalous stipulations which date back to a very restrictive period. Illustratively, investments by NRIs in CPs are non-repatriable. It is not clear whether the sale proceeds of the CP are non-repatriable or whether they can be credited to a repatriable account; either way, a non-resident can make a remittance out of an NRO account. In other words, regulations of a period of extremely tight current and capital controls continue to remain even though the overall regime has undergone a significant degree of liberalisation. Fourthly, the knots in the forex management system need to be untied before the liberalisation can become meaningful. The Committee recommends that a *RBI Task Force* should be set up immediately to identify the anomalies in the present regulatory framework for the current and capital accounts and the rectification should be undertaken within a period of three months.

8.2 On an examination of the extant regulations relating to the capital account, as set out by the RBI in Annex III, the Committee is of the view that the extant matrix is a mixed bag of policy measures and procedural/operational matters. The

Committee has, therefore, separated the extant regulations into policy issues and procedural/operational matters and a list of items has been prepared by the Committee to be reviewed by the RBI. (List attached at the end of the Tabular Material in this Chapter). The Committee recommends that the items identified as procedural/ operational matters should be reviewed by the RBI Task Force referred to above. The RBI Task Force should also review the delegation of powers on foreign exchange regulation as between the Central Office and the Regional Offices of the RBI and *inter alia*, examine, selectively, the efficacy in the functioning of the delegation of powers by the RBI to ADs.

8.3 As regards the substantive regulations on the capital account, the Committee recommends a five-year roadmap with three phases on the timing and sequencing of measures. Phase I would be the current year 2006-07, while Phase II would be the following two years, 2007-08 and 2008-09, and the last phase would be the last two years, 2009-10 and 2010-11. After each phase there should be a stock taking and the phasing of measures could be modulated. The Committee recommends that at the end of the five-year period, ending in 2010-11, there should be a comprehensive review to chalk out the future course of action.

8.4 The approach of the Committee is to rationalise and gradually liberalise the controls. The process of phased liberalisation, to have meaning, would require that the authorities get out of the mindset of controls while liberalising the capital account. This will greatly facilitate the process under which the capital controls regime would be limited to a few specific areas which are significant from the viewpoint of macro policies.

8.5 The major measures proposed by the Committee relate to the liberalisation for capital outflows by corporates and individuals. As regards inflows by the non-resident, the Committee has recommended that NR and NRIs should be treated on a uniform basis.

8.6 The various measures for relaxing capital controls and the timing and sequencing thereof, recommended by the Committee, are tabulated in this Chapter. Brief notes on some of the significant measures are set out in the paragraphs following the tabulated list of measures.

FULLER CAPITAL ACCOUNT CONVERTIBILITY – TIMING AND SEQUENCING OF MEASURES

(USD indicates US dollars)

Item	**Present Position**	**Committee's Recommendation**		
		Phase I (2006-07)	**Phase II** (2007-08 and 2008-09)	**Phase III** (2009-10 and 2010-11)
I. CORPORATES/BUSINESSES **Corporates/Businesses – Residents**				
1. Financial capital transfers abroad including for opening current/cheque-able accounts.	(i) Listed Indian companies are permitted to invest up to 25 per cent of their net worth in overseas listed companies having at least 10 per cent stake in listed Indian companies and in rated bonds/fixed income securities. (AP(DIR).Cir.No.66/ dated 13.01.2003; AP(DIR).Cir.No.97 dated 29.04.2003 & AP(DIR).Cir.No 104 dated 31.05.2003)	This separate facility should be terminated and made a sub-limit of Item I.A.4	--	--
2. External Commercial Borrowings (ECB).	An overall limit is fixed annually for ECB in consultation with GOI. Within this limit entities are eligible to avail of ECBs under the Automatic route and Approval route. ECB upto USD 500 million per financial year can be availed	(i) The current overall limit for ECB of US$ 18 billion should be retained for 2006-07 but the scheme should be restructured. (ii) The limit for Automatic Approval should be retained at US$ 500 million.	(i) The overall ceiling for ECB should be raised gradually. (ii) The limit for Automatic Approval could be raised to US$ 750 million per financial year. (iii) ECBs of over 7 years'	(i) The overall ceiling for ECB should be raised gradually. (ii) The limit for Automatic Approval could be raised to US $ 1 billion per financial year.

Item	Present Position	Committee's Recommendation		
		Phase I (2006-07)	**Phase II** (2007-08 and 2008-09)	**Phase III** (2009-10 and 2010-11)
	by corporates under automatic route. NGOs engaged in microfinance activities are permitted to borrow up to US$ 5 million under the automatic route. The cases falling outside the purview of automatic route are examined by the Empowered Committee of ECB on the merits of the case, and are placed in public domain. End-use restrictions exist on ECB for • working capital, general corporate purpose and repayment of existing rupee loans • Utilisation of ECB proceeds for on-lending or investment in capital market or acquiring a company (or a part thereof) in India by a corporate. • Utilisation of ECB proceeds for investment	(iii) ECBs of over 10 years' maturity should be outside the overall limit without call/put options upto 10 years. (iv) If an ECB is denominated in rupees (but payable in foreign currency) it should be outside the ECB limit. Furthermore, ECBs of 1-3 years maturity should be allowed if they are denominated in rupees and such borrowing should be outside the overall ECB limit. (v) The end use restriction on ECBs should be removed.	maturity should be outside the ECB ceiling without call/put options upto 7 years. (iv) Rupee denominated foreign currency borrowing as in Phase I.	(iii) ECBs of over 7 years' maturity should be outside the overall ceiling without call/put options upto 7 years, as in Phase II. (iv) Rupee denominated foreign currency borrowing as in Phase I.

Item	Present Position	Committee's Recommendation		
		Phase I (2006-07)	**Phase II** (2007-08 and 2008-09)	**Phase III** (2009-10 and 2010-11)
	in real estate (end use relaxation in case of companies where the lender is holding more than 51per cent in the borrower company). (AP(DIR).Cir.No.60 dated 31.01.2004 & AP(DIR).Cir.No. 5 dated 01.08..2005) ECBs can be retained overseas in bank accounts with debits permitted for purposes for which the loan was raised. FCCB are permitted subject to the same terms and conditions as ECBs (AP(DIR).Cir.No. 60 dated 31.01..2004)			
	Prepayment of ECB upto US$ 200 million may be allowed by ADs without prior approval of the RBI subject to compliance with the minimum average maturity period as applicable to the loan.	Prepayment without RBI approval should be raised to US$ 300 million.	Prepayment without RBI approval should be raised to US$ 400 million.	Prepayment without RBI approval should be raised to US$ 500 million.

Item	Present Position	Committee's Recommendation		
		Phase I (2006-07)	**Phase II** (2007-08 and 2008-09)	**Phase III** (2009-10 and 2010-11)
	(AP(DIR) Circular No.5 dated 01.08 2005)			
3. Trade credit	Import linked short term loans (Trade credit) upto US$ 20 million per transaction for all permissible imports with a maturity period of less than 1 year is allowed. Trade credit upto US$ 20 million per import transaction with maturity between 1-3 years is allowed for import of capital goods.	Import linked short term loans (trade credit) should be monitored regularly and in a comprehensive manner. The per transaction limit of US$ 20 million should be reviewed and the scheme revamped to avoid unlimited borrowing.	As in Phase I	As in Phase I
4. Joint ventures/wholly owned subsidiaries abroad.	Proposals for investment overseas by Indian companies/registered partnership firms upto 200 per cent of their net worth as per the last audited balance sheet, in any bonafide business activity are permitted by ADs irrespective of the export/exchange earnings of the entity concerned within this limit loans and guarantees by the parent	The present limit of 200 per cent should be raised to 250 per cent but the separate limit of 25 per cent for financial transfers abroad (including opening current/ chequable accounts) should be a sub-limit (25 per cent of the overall limit of 250 per cent; the stipulation of a 10 per cent stake in an Indian Company should be withdrawn.	The overall limit should be raised to 300 per cent and the sub-limit of 25 per cent raised to 35 per cent.	The overall limit should be raised to 400 per cent and the sub-limit raised to 50 per cent.

Item	Present Position	Committee's Recommendation		
		Phase I (2006-07)	**Phase II** (2007-08 and 2008-09)	**Phase III** (2009-10 and 2010-11)
	company and associates are also permitted. The condition regarding dividend balancing has been dispensed with.			
5. Establishment of offices abroad	No prior approval of RBI is required for opening offices abroad. AD banks have been permitted to allow remittance upto 10 per cent for initial and upto 5 per cent for recurring expenses of the average annual sales/income or turnover during last two accounting years. RBI permits remittance of higher percentage based on the merits of the case. Permission to acquire property for the Branch office is accorded by RBI. (AP(DIR).Cir.No.32 dated 21.04.2006 and AP(DIR). Cir.No.71 dated 13.01.2003)	To be subsumed under I.A.4	To be subsumed under I.A.4	To be subsumed under I.A.4
6. Direct investment abroad by partnership	Partnership firms registered under the Indian Partnership Act, 1932 and having a good track record are permitted to	Same as for I.A.4	Same as for I.A.4	Same as for I.A.4

Item	Present Position	Committee's Recommendation		
		Phase I (2006-07)	**Phase II** (2007-08 and 2008-09)	**Phase III** (2009-10 and 2010-11)
firms.	make direct investments outside India in any bonafide activity 200 per cent of their net worth under the automatic route. (AP(DIR) Circulars No. 41 dated 06.12.2003, 57 dated 13.01.2004 & 42 dated 12.05.2005)			
7. Investment in agriculture overseas by resident corporates and registered partnership firms other than through JV/WOS abroad.	Resident corporates and registered partnership firms are allowed to undertake agricultural activities including purchasing of land incidental to this activity either directly or through their overseas office (i.e. other than through JV/WOS) within the overall limit available for investment under the automatic route. (AP(DIR) Circular No. 57 dated 13.01.2004)	To be subsumed under I.A.4	To be subsumed under I.A.4	To be subsumed under I.A.4
8. Direct investment overseas by proprietorship/	RBI will consider applications from proprietorship/unregistered partnership concerns which	Same as for I.A.4	Same as for I.A.4	Same as for I.A.4

Item	Present Position	Committee's Recommendation		
		Phase I (2006-07)	**Phase II** (2007-08 and 2008-09)	**Phase III** (2009-10 and 2010-11)
unregistered partnership concerns	satisfy eligibility criteria as stated in the circular. (AP(DIR) Circular No. 29 dated 27.03. 2006)			
9. Exchange Earners Foreign Currency (EEFC) accounts for exporters and exchange earners.	EEFC accounts are permitted for any person resident in India who are exporters or exchange earners, subject to the limits indicated below : (i) Status holder Exporter (as defined by Foreign Trade Policy in force) – 100 per cent. (ii) A resident in India for professional services rendered in his individual capacity – 100 per cent. (iii) 100 per cent EOU/units in EPZs/STP/EHPT – 100 per cent. (iv) Any other person resident in India – 50 per cent (AP(DIR).Cir.No. 96 dated 15.06. 2004)	The limit for 'any other person resident in India' should be raised from 50 per cent to 100 per cent. The EEFC holders should be allowed Foreign Currency Current/Savings accounts with cheque writing facilities and interest bearing terms deposits.	As in Phase I	Same as in Phase I

Item	Present Position	Committee's Recommendation		
		Phase I (2006-07)	**Phase II** (2007-08 and 2008-09)	**Phase III** (2009-10 and 2010-11)
	EEFC accounts can be opened with banks in India. Cheque writing facility is allowed. EEFC accounts can be maintained only in the form of current account and no interest on EEFC account is allowed. Credit facilities (both fund based and non fund based) against balances in EEFC accounts is not allowed. Use of funds is allowed for permitted current and capital account transactions. (Sch. to Notification No.FEMA 10 dated 03.05. 2000)			
10. Project Exports	Powers have been delegated to ADs/Exim Bank to approve Project/Service export proposals up to contract value of USD 100 mn. Contracts of value more than USD 100 mn are approved by the Working Group. ADs/Exim Bank	(i) Large turnkey project exporters with satisfactory track record may be permitted to operate one account with the facility of inter-project transferability of funds and/or machineries. There should be no stipulation regarding	As in phase I	As in phase I

Item	Present Position	Committee's Recommendation		
		Phase I (2006-07)	**Phase II** (2007-08 and 2008-09)	**Phase III** (2009-10 and 2010-11)
	have also been delegated powers to approve various facilities such as initial remittance, overseas borrowing to meet temporary mismatch in cash flow, inter- project transfer etc. (AP(DIR).Cir.No.32 dated 28.10. 2003) Project/service exporters are required to furnish half-yearly progress report to the concerned R.O. Inter-project transfer of funds need prior approval of RBI. Temporary surplus can be brought into India with prior permission of RBI.	recovery of market value of machinery from the transferee project. (ii) Provisions regarding purchase of machinery/ equipment by project exporters from third country sources should be permitted. (iii) Project exporters with good track record may be given freedom to deploy temporary cash surpluses either as investments in bank deposits or AAA short-term paper and/or in other projects being executed by them. (iv) Similar facilities should be provided for service exports.		
I. Corporates - **B. Non -Residents**				
1. Foreign Direct Investment	GOI have permitted FDI under the Automatic Route	As a strong signal for encouraging FDI the FIPB/RBI	As in Phase I	As in Phase I

Item	Present Position	Committee's Recommendation		
		Phase I (2006-07)	**Phase II** (2007-08 and 2008-09)	**Phase III** (2009-10 and 2010-11)
(FDI)	in items/activities in all sectors up to the sectoral caps except in certain sectors where investment is prohibited. There is no requirement of RBI approval for foreign investments. Investments not permitted under the automatic route require approval from FIPB. The receipt of remittance has to be reported to RBI within 30 days from the date of receipt of funds and the issue of shares has to be reported to RBI within 30 days from the date of issue by the investee company. (Sch.1 to Notification No.FEMA.20 dated 03.05.2000) FDI through the process of acquisition of shares from residents requires prior approval of RBI where such investment is in the financial services sector, where the activity attracts the SEBI [Substantial Acquisition of	regulations/procedures should be liberalised and a sunset clause of two years put on all regulations/procedures unless specifically reintroduced afresh.		

Item	Present Position	Committee's Recommendation		
		Phase I (2006-07)	**Phase II** (2007-08 and 2008-09)	**Phase III** (2009-10 and 2010-11)
	Shares and Takeover] (SAST) Regulations. FDI through the process of acquisition of shares from residents requires prior approval of FIPB and RBI where the activity is under the Government Approval route. Investment by capitalisation of imports requires prior approval of FIPB.			
2. Portfolio Investment in India through stock exchanges in shares/debentures.	Investments by non residents is permitted under the Portfolio Investment Scheme to entities registered as FIIs and their sub accounts under SEBI(FII) Regulations and is subject to ceilings indicated therein. No RBI approval is required for registration of FIIs. The transactions are subject to daily reporting by designated ADs to RBI. (Sch. II to Notification No.FEMA 20 dated	(i) Fresh inflows under Participatory Notes (P-Notes) should be banned and existing P-Notes should be phased out over a period of one year. (ii) Corporates should be allowed to invest in Indian stock markets through SEBI registered entities (including Mutual Funds and Portfolio Management Schemes), who will be individually responsible for fulfilling KYC and FATF norms. The	(i) As in Phase I (ii) As in Phase I	(i) As in Phase I (ii) As in Phase I

Item	Present Position	Committee's Recommendation		
		Phase I (2006-07)	Phase II (2007-08 and 2008-09)	Phase III (2009-10 and 2010-11)
	03.05.2000 and AP(DIR).Cir.No 53 dated 17.12.2003).	money should come through bank accounts in India.		
3. Disinvestment	RBI approval for transfer of shares from non-residents to residents has been dispensed with in cases where shares are sold on stock exchange or in case of sale under private arrangements, where it complies with the pricing guidelines. The cases of transfer of shares involving deviation from the pricing guidelines requires to be approved by RBI. (AP(DIR)Cir. No 16 dated 04.10.2004)	The disinvestment procedures, particularly for FDI, should be simplified so as to provide for symmetry between investments and disinvestments.	As in Phase I	As in Phase I
4. Multilateral institutions permitted to raise resources in India	Multilateral institutions like International Finance Corporation (IFC) have been allowed to raise resources in India by way of issue of Rupee Bonds with prior approval of Government/ RBI.	This should be liberalised to allow other institutions/ corporates to raise rupee bonds (with an option for conversion into foreign exchange). The regulator should devise a suitable scheme with overall limits.	As in Phase I but the cap should be gradually raised.	As in Phase I but the cap should be gradually raised.

Item	Present Position	Committee's Recommendation		
		Phase I (2006-07)	**Phase II** (2007-08 and 2008-09)	**Phase III** (2009-10 and 2010-11)
II. BANKS **A. Banks - Residents**				
1. Loans and borrowings from overseas banks and correspondents including overdrafts in nostro account.	ADs are allowed to borrow from overseas banks and correspondent banks subject to a limit of 25 per cent of the unimpaired Tier I capital as at the close of the previous quarter or US$ 10 mio (or its equivalent), whichever is higher. Within this limit, there is no further restriction regarding short-term borrowings. The Overseas borrowings by ADs for the purpose of financing export credit as well as Subordinated debt placed by head offices of foreign banks with their branches in India as Tier-II capital is excluded from the limit. (AP(DIR) Cir.No. 81 dated 24.03.2004)	The limit should be raised to 50 per cent of paid up capital and free reserves of which there should be a sub-limit of one-third of the overall limit for short-term upto less than one year. The stipulation of US$ 10 million should be withdrawn.	The limit should be raised to 75 per cent of paid up capital plus free reserves with a sub-limit of one-third for short term.	The limit should be raised to 100 per cent of paid up capital plus free reserve with a sub-limit of one-third for short term.
2. Investments in overseas markets	Authorised Dealers are allowed to undertake investments in overseas	No change	As in Phase I	As in Phase I

Item	Present Position	Committee's Recommendation		
		Phase I (2006-07)	**Phase II** (2007-08 and 2008-09)	**Phase III** (2009-10 and 2010-11)
	markets up to the limits approved by their Board of Directors within a ceiling in terms of section 25 of BR Act 1949. Such investments may be made in overseas money market instruments and/or debt instruments issued by a foreign state with a residual maturity of less than one year and rated at least as AA (-) by Standard & Poor/FITCH IBCA or Aa3 by Moody's. (AP(DIR).Cir.No 63 dated 21.12.2002 & 90 dated 29.03.2003). Authorised Dealers are also allowed to invest the undeployed FCNR (B) funds in overseas markets in long-term fixed income securities subject to the condition that the maturity of the securities invested in do not exceed the maturity of the underlying FCNR(B) deposits. (AP(DIR).Cir.No.40 dated			

Item	Present Position	Committee's Recommendation		
		Phase I (2006-07)	**Phase II** (2007-08 and 2008-09)	**Phase III** (2009-10 and 2010-11)
	29.04.2002 & 38 dated 02.11.2002)			
III. NON BANKS - FINANCIAL **A. Residents**				
1. SEBI registered Indian investors (including Mutual Funds) investments overseas.	The aggregate ceiling on investment overseas by Mutual Funds is US$ 2 billion with an individual ceiling as decided by SEBI. In terms of SEBI instructions it has been stipulated that limit for individual fund would be 10 per cent of net asset value (NAV) as on 31st January, subject to US$ 5 million and maximum of US$ 50 million.	The aggregate ceiling of US$ 2 billion should be raised to US$ 3 billion. This facility should be extended to SEBI registered portfolio management schemes. The individual fund limit and proportion of NAV should be removed.	The aggregate ceiling should be raised to US$ 4 billion.	The aggregate ceiling should be raised to US$ 5 billion.
Non-Banks - Financial **B. Non Residents**				
1. FIIs (a) Portfolio Investment	Investments by non residents is permitted under	Fresh inflows in P-Notes should be banned and existing P-Notes	As in Phase I	As in Phase I

Item	Present Position	Committee's Recommendation		
		Phase I (2006-07)	**Phase II** (2007-08 and 2008-09)	**Phase III** (2009-10 and 2010-11)
	the portfolio investment scheme to entities registered as FIIs and their sub accounts under SEBI(FII) regulations and is subject to ceilings of 10 per cent for each FII, and 10 per cent for each of their sub-accounts, within the overall ceiling for FIIs investment in each company. No RBI approval is required for registration of FIIs. The transactions are subject to daily reporting by designated ADs to RBI. (Sch II to Notification No.FEMA 20 dated 03.05.2000 & AP(DIR).Cir.No 53 dated 17.12.2003).	should be phased out over a period of one year.		
(b) Primary market investment/ private placement.	FII investments in primary market is now allowed. The ceiling referred to above is inclusive of primary market investments/private placements.	No Change	No Change	No Change

Item	Present Position	Committee's Recommendation		
		Phase I (2006-07)	**Phase II** (2007-08 and 2008-09)	**Phase III** (2009-10 and 2010-11)
(c) Dis-investment	RBI approval for transfer of shares from non-residents to residents has been dispensed with in cases where shares are sold on stock exchange or in case of sale under private arrangements, where it complies with the pricing guidelines. (AP(DIR).Cir.No 16 dated 04.10.2004)	No Change	No Change	No Change
(d) Investments debt instruments	The FII investments in debt permitted subject to a sub ceiling within the overall ECB ceiling as indicated below : (i) Government securities and T-bills –US$ 2.00 Billion) (ii) Corporate debt – US$ 1.5 Billion. (Cir IMD/FII/20/2006 dated 05.04.2006 issued by SEBI)	(a) Limit of 6 per cent of total gross issuance by Centre and States in a year. (b) Limit of US$ 1.5 billion (c) The allocation by SEBI of the limits between 100 per cent debt funds and other FIIs should be discontinued.	(a) Limit of 8 per cent of total gross issuance by Centre and States in a year. (b) Limit of 15 per cent of fresh issuance during a year	(a) Limit of 10 per cent of total gross issuance by Centre and States in a year. (b) Limit of 25 per cent of fresh issuance during a year.

Item	Present Position	Committee's Recommendation		
		Phase I (2006-07)	**Phase II** (2007-08 and 2008-09)	**Phase III** (2009-10 and 2010-11)
IV. INDIVIDUALS **A Individuals – Residents**				
1. Financial capital transfers including for opening current/cheque able accounts.	(i) Resident individuals have been permitted to freely remit upto US$ 25,000 per calendar year for any permissible. current or capital account transactions or a combination of both from February 2004. Residents can use this amount to open foreign currency accounts abroad. (AP(DIR).Cir.No. 64 dated 04.02.2004)	(i) This limit should be raised to US$ 50,000 per calendar year (where limits for current account transactions are restricted, gifts, donation and travel, this should be raised to an overall ceiling of US$ 25,000 without any sub-limits).	This limit should be raised to US$ 100,000 per calendar year	This limit should be raised to US$ 200,000 per calendar year.
	(ii) They can invest, without limit, in overseas companies listed on a recognised stock exchange and which have the shareholding of at least 10 per cent in an Indian company listed on a recognised stock exchange in India (as on 1st January of the year of	(ii) This facility should be abolished.	As in Phase I	As in Phase I

Item	Present Position	Committee's Recommendation		
		Phase I (2006-07)	**Phase II** (2007-08 and 2008-09)	**Phase III** (2009-10 and 2010-11)
	the investment) as well as in rated bonds/fixed income securities. No current chequable accounts are permitted. (AP(DIR).Cir.No.66 dated 13.01.2003, 97 dated 29.04.2003 & 104 dated 31.05.2003)			
2. RFC Account	Under the RFC scheme, persons of Indian nationality or origin, who, having been resident outside India for a continuous period of not less than one year, have become persons resident in India are eligible to open and maintain the RFC accounts with authorised dealers in India in any freely convertible foreign currency. (The amounts may be retained in a current, savings or term deposit account.)	General permission should be given to RFC Account holders to move their foreign currency balances to overseas banks; those wishing to continue RFC Accounts should be provided Foreign Currency Current/Savings chequable accounts in addition to Foreign Currency term deposits	As in Phase I	As in Phase I
2. RFC(D) Account	Residents are permitted to open, hold and maintain	Merge with RFC Accounts and give General Permission to	As in Phase I	As in Phase II

Item	Present Position	Committee's Recommendation		
		Phase I (2006-07)	**Phase II** (2007-08 and 2008-09)	**Phase III** (2009-10 and 2010-11)
	with an AD in India Resident Foreign Currency (Domestic) Account, out of foreign exchange acquired in the form of currency notes, bank notes and travellers cheques from specified sources. The account has to be maintained in the form of current account and shall not bear any interest. Cheque facility is available. There will be no ceiling on the balances held in the account. (AP(DIR) Cir. No. 37 dated 01.11. 2002)	move balances to overseas banks. Holders could be given time to choose either option after which the scheme should be terminated.		
B. Individuals: Non Residents				
1. Capital transfers from non repatriable assets held in India (including NRO and NRNR RD accounts)	Remittance, upto USD one million, per calendar year, out of balances held in NRO accounts/sale proceeds of assets/the assets in India acquired by way of inheritance is permitted. Repatriation of sale proceeds of a House bought out of domestic assets is	RBI should ensure collection of relevant data on outflows under this scheme in view of the large limit for individuals.	As in Phase I	As in Phase I

Item	Present Position	Committee's Recommendation		
		Phase I (2006-07)	**Phase II** (2007-08 and 2008-09)	**Phase III** (2009-10 and 2010-11)
	repatriable after 10 years of acquisition. (AP(DIR).Cir.No.67 dated 13.01.2003, 104 dated 31.05.2003 & 43 dated 13.05.2005)			
2. Remittance of assets	ADs have been permitted to allow remittance/s upto US$ 1 million per calendar year on account of legacy, bequest or inheritance to a citizen of foreign state permanently resident outside India subject to conditions. (AP(DIR).Cir.No . 67 dated 13.01.2003)	RBI should ensure collection of relevant data on outflows under this scheme in view of the large limit for individuals.	As in Phase I	As in Phase I
3. Deposit Schemes for Non-Resident Indians (NRI)	NRIs are permitted two special bank deposit facilities, *viz.*, Non-Resident (External) Rupee Account [NR(E)RA] and Foreign Currency Non-Resident (Banks) Scheme [FCNR(B)]	(i) While the FCRN(B) and NR(E)RA deposit schemes for NRIs could be continued, the present tax benefits on these deposit schemes should be reviewed by the Government. (ii) A separate and distinct deposit facility should be provided to non-residents (other than NRI) to open FCNR(B) Accounts without	(i) As in in Phase I (ii) As in Phase I	(i) As in Phase I (ii) As in Phase I

Item	Present Position	Committee's Recommendation		
		Phase I (2006-07)	**Phase II** (2007-08 and 2008-09)	**Phase III** (2009-10 and 2010-11)
		tax benefits and subject to KYC and FATF norms.	(iii) A separate and distinct NR(E)RA deposit scheme, with cheque writing facilities, without tax benefits, should be made available to non-residents, other than NRIs, subject to KYC and FATF norms.	(iii) As in Phase II
4. Portfolio Investment in India through stock exchange.	Individual NRIs can invest upto 5 per cent of the total paid up capital (PUC) of the investee company or 5 per cent of the total paid-up value of each series of the convertible debentures of the company. The aggregate ceiling for NRI investments in a company is 10 per cent of the PUC or 10 per cent of the total paid-up value of the each series of debentures. This ceiling can be raised upto 24 per cent of the PUC by the company.	Individual Non-Residents should be allowed to invest in Indian stock markets through SEBI registered entities including Mutual Funds and Portfolio Management Schemes, who will be individually responsible for fulfilling KYC and FATF norms. The money should come through bank accounts in India.	As in Phase I	As in Phase I

Item	Present Position	Committee's Recommendation		
		Phase I (2006-07)	**Phase II** (2007-08 and 2008-09)	**Phase III** (2009-10 and 2010-11)
	NRIs can invest in Perpetual Debt Instruments (Tier-I capital) issued by banks upto an aggregate ceiling of 24 per cent of each issue and investments by individual NRIs can be up to 5 per cent of each issue. NRIs can invest in Debt Capital Instruments (Tier II) of banks without limit. (AP(DIR).Cir.No. 24 dated 25.01.2006)			

List of Items for RBI to Review Separately

Item	Present Position
I. CORPORATE/BUSINESS **A. Corporates/Business – Residents**	
1. Accessing capital markets abroad through GDRs & ADRs other forms of equity issues.	(a) Companies eligible to issue equity in India and falling under the automatic route for FDI are allowed to access the ADR/GDR markets without approval from Govt./RBI subject to reporting to RBI within 30 days from close of issue. GOI considers cases not permitted under the automatic route. (Para 4 of Sch.1 to Notification No. FEMA 20 dated 03.05.2000) (b) Companies eligible to raise ADRs GDRs are permitted to open foreign currency accounts abroad to retain the proceeds and invest the proceeds in rated bonds/fixed income securities pending repatriation of proceeds.
2. Disinvestment from JV/WOS overseas.	General permission for disinvestment has been given to Indian Parties (i) in cases where the JV/WOS is listed in the overseas stock exchange (ii) where the Indian promoter is listed on a stock exchange in India and has a networth of not less than Rs.100 crore and (iii) where the Indian promoter is an unlisted company and the investment in the overseas venture does not exceed US$ 10 million. Reporting requirements to RBI are prescribed for this purpose.(AP (DIR) Circular No. 29 dated 27.03.2006)
3. Foreign Currency Accounts for Units in SEZs	Units located in a Special Economic Zone have been allowed to open, hold and maintain a Foreign Currency Account with an authorised dealer in India subject to the following conditions: (i) all foreign exchange funds received by the unit in the Special Economic Zone (SEZ) are credited to such account, (ii) no foreign exchange purchased in India against rupees shall be credited to the account without prior permission from the Reserve Bank, (iii) the funds held in the account shall be used for bonafide trade transactions of the unit in the SEZ with the person resident in India or otherwise,

	(iv) the balances in the accounts shall be exempt from the restrictions imposed under Current Account Rules. (AP(DIR) Circular No.28 dated 03.10.2002)
4. Rupee loans to NRI employees	A body corporate registered or incorporated in India, has been permitted to grant rupee loans to its employees who are Non-Resident Indians or Persons of Indian Origin, subject to the following conditions. (i) The loan is to be granted only for personal purposes including purchase of housing property in India; (ii) The loan is to be granted in accordance with the lender's Staff Welfare Scheme/Staff Housing Loan Scheme and subject to other terms and conditions applicable to its staff resident in India; (iii) The lender shall ensure that the loan amount is not used for the following purposes; • the business of chit fund, or • as Nidhi Company, or • agricultural or plantation activities or real estate business; or construction of farm houses, or • trading in Transferable Development Rights (TDRs). (iv) The lender shall credit the loan amount to the borrower's NRO account in India or shall ensure credit to such account by specific indication on the payment instrument; (v) The loan agreement shall specify that the repayment of loan shall be by way of remittance from outside India or by debit to NRE/NRO/FCNR Account of the borrower and the lender shall not accept repayment by any other means. (AP(DIR) Circular No.27 dated 10.10.2003)
5. Conversion of ECB and Lumpsum Fee/Royalty into equity	Capitalisation of Lumpsum Fee/Royalty/ECB has been permitted subject to the following conditions : i) The activity of the company is covered under the Automatic Route for FDI or they had obtained Government approval for foreign equity in the company,

	ii) The foreign equity after such conversion of debt into equity is within the sectoral cap, if any, iii) Pricing of shares is as per SEBI and erstwhile CCI guidelines/regulations in the case of listed/unlisted companies as the case may be. iv) Compliance with the requirements prescribed under any other statute and regulation in force. (AP(DIR) Circulars No.34 dated 14.11.2003 and 15 dated 01.10.2004)
I. Corporates – **B. Non-Residents**	
1. Establishment of project offices in India	ADs have been delegated powers to permit foreign companies to establish project offices in India subject to the following conditions. (a) It has secured from an Indian company a contract to execute a project in India; and (b) the project is funded by inward remittance from abroad; or (c) the project is funded by a bilateral or multilateral International Finance Agency; or (d) the project has been cleared by an appropriate authority; or (e) a company or entity in India awarding the contract has been granted Term Loan by a Public Financial Institution or a bank in India for the project. Banks have been allowed to remit surplus on winding up/completion of the project. (A.P.(DIR) Cir. No. 37 dated 15.11.2003)
2. Buyers' credit/ acceptance for financing goods and services from India. (including financing of overseas projects)	Banks in India are permitted to provide at their discretion Buyer's Credit/Acceptance Finance to overseas parties for facilitating export of goods and services from India, on "Without Recourse" basis and with prior approval of RBI.
3. Lending to non-residents	Banks have been allowed to grant rupee loans to NRIs as per the loan policy laid down by the bank's Board of Directors, barring certain specific purposes. Repayment of the loan may be made by debit to NRE/FCNR/NRO accounts of the non-resident borrowers or out of inward remittances by the borrowers. The quantum of loan, rate of interest,

	margins etc. on such loans to be decided by the Banks based on relevant directives issued by the DBOD. (AP(DIR) Circular No. 69 dated 12.02.2004 & Regulation 7 C of Notification No. FEMA 4 dated 03 05.2000).
B. Banks – Non-Residents	
1. Rupee Accounts of non resident banks	Banks are permitted to allow overdrafts in the rupee accounts of overseas banks. The Overdraft limit has been increased to Rs.500 lakh. However no investments are allowed and no forward cover is permitted. (Para B 8 of the Master Circular on risk management and inter-bank dealings)
III. NON-BANKS – FINANCIAL **A. Residents**	
1. Insurance policies in foreign currency	Insurance companies registered with IRDA have been permitted to issue general insurance policies denominated in foreign currency and receive premium in foreign currency without prior approval of RBI. (AP(DIR) Cir. No.8 dated 13.10.2001 & No. 36 dated 02.04.2002)
IV. NON-BANKS – FINANCIAL **A. Individuals – Residents**	
1. Loans from non residents	Borrowings upto US$ 250,000 with a minimum maturity of one year permitted from close relatives on interest free basis. (AP(DIR).Cir.No 24 dated 27.09.2003)
2. Diplomatic Missions/Personnel - immovable property.	Foreign Embassy/Diplomat/Consulate General have been allowed to purchase/sell immovable property in India other than agricultural land/plantation property/farm house provided (i) clearance from Government of India, Ministry of External Affairs is obtained for such purchase/sale, and (ii) the consideration for acquisition of immovable property in India is paid out of funds remitted from abroad through banking channel. (AP(DIR) Cir. No.19 dated 23.09.2003)
3. Employees Stock Options (ESOP)	ADs can allow remittance for acquiring shares of a foreign company offered under an ESOP scheme either directly by the issuing company or indirectly through a Trust/SPV/step down subsidiary to employees or directors of the Indian office or branch of a foreign company or of a subsidiary in India of a foreign company or of an Indian company in which

	the company issuing shares effectively holds directly or indirectly at least 51 per cent stake. Foreign companies have been given general permission to repurchase the shares issued to residents in India under any ESOP scheme. (AP(DIR) Cir. No.30 dated 05.04.2006)
B. Individuals – Non-Residents	
1. Foreign Direct Investment (FDI) in India (other than in real estate)	GOI have permitted FDI under the Automatic Route in items/activities in all sectors up to the sectoral caps except in certain sectors where investment is prohibited. There is no requirement of RBI approval for foreign investments. Investments not permitted under the automatic route require approval from FIPB. The receipt of remittance has to be reported to RBI within 30 days from the date of receipt of funds and the issue of shares has to be reported to RBI within 30 days from the date of issue by the investee company. Non-resident individuals are at par with non-resident corporate for the purposes of FDI.
2. Loans from non-residents.	(a) NRIs are permitted to invest in NCDs offered under a public issue subject to conditions regarding end use, minimum tenor and rate of interest: Minimum tenor – 3 years Rate of interest – not exceeding SBI PLR + 300 basis points The funds shall be used for the company's own funds. It cannot be used for business of chit fund/nidhi company, agriculture on plantation activities or real estate business or construction of farm house or trading in Transferable development Rights. (b) NRIs are also permitted to subscribe to CPs issued by Indian companies on non-repatriation basis, subject to compliance with the Regulations governing issue of CPs. The CPs are also not transferable.
3. Disinvestment	Sale of shares through private arrangement is allowed. However sale transactions which are not in compliance with pricing guidelines requires approval of RBI. (AP(DIR).Cir.No.16 dated 04.10.2004)
4. Two way fungibility of ADRs/GDRs	A registered broker in India has been allowed to purchase shares of an Indian company on behalf of a person resident outside India for purpose of

	converting the shares into ADRs/GDRs subject to compliance with provisions of the Issue of Foreign Currency Convertible Bonds and Ordinary Shares (through Depository Receipt Mechanism) Scheme, 1993 and guidelines issued by the Central Government from time to time. (AP(DIR).Cir.No 21 dated 13.02.2002)
5. Housing loan to NRI that can be repaid by close relative in India	Close relatives of NRIs or PIOs can repay the loans taken by NRIs or PIOs for acquisition of a residential accommodation in India through their bank account directly to the borrower's loan account with the AD/Housing Finance Institution (AP(DIR).Cir.No ..93 dated 25.05.2004)

(i) **CORPORATES/BUSINESS**

I.A. Residents

I.A.2 *External Commercial Borrowing*

The Committee recommends that the overall ECB ceiling as also the ceiling for automatic approval should be gradually raised. Rupee denominated ECB (payable in foreign currency) should be outside the ECB ceiling. ECBs of over 10-year maturity in Phase I and over 7-year maturity in Phase II should be outside the ceiling. End use restriction should be removed in Phase I.

I.A.3 *Trade Credit*

The Committee has concerns about the volume of trade credit as there could be sudden changes in the availability of such credit. Furthermore, there are concerns as to whether the trade credit numbers are fully captured in the data even while noting that suppliers' credit of less than 180 days are excluded from these data. Import-linked short-term loans should be monitored in a comprehensive manner. The per transaction limit of US$ 20 million should be reviewed and the scheme revamped to avoid unlimited borrowing.

I.A.4 *Joint Ventures/Wholly Owned Subsidiaries Abroad*

Recognising that Indian industry is successfully building up its presence abroad, there is a strong case for liberalising the present limits for corporate investment abroad. The Committee recommends that the limits for such outflows should be raised in phases from 200 per cent of net worth to 400 per cent of net worth. As part of a rationalisation, these limits should also subsume a number of other categories (detailed in the Matrix); furthermore, for non-corporate businesses, it is recommended that the limits should be aligned with those for corporates.

I.A.9 *EEFC Accounts*

Although EEFC Accounts are permitted in the present framework, these facilities do not effectively serve the intended purpose. The Committee recommends that EEFC Account holders should be provided foreign currency

current/savings accounts with cheque writing facility and interest bearing term deposits. In practice some banks are erroneously providing cheque writing facilities only in rupees.

I.A.10 *Project Exports*

Project exports should be provided greater flexibility and these facilities should be also provided for service exports.

I.B Non-Residents

I.B.2 *Portfolio Investments*

(i) In the case of Participatory Notes (PNs), the nature of the beneficial ownership or the identity is not known unlike in the case of FIIs. These PNs are freely transferable and trading of these instruments makes it all the more difficult to know the identity of the owner. It is also not possible to prevent trading in PNs as the entities subscribing to the PNs cannot be restrained from issuing securities on the strength of the PNs held by them. The Committee is, therefore, of the view that FIIs should be prohibited from investing fresh money raised through PNs. Existing PN-holders may be provided an exit route and phased out completely within one year.

(ii) The Committee recommends that non-resident corporates should be allowed to invest in the Indian stock markets through SEBI-registered entities including mutual funds and Portfolio Management Schemes who will be individually responsible for fulfilling KYC and FATF norms. The money should come through bank accounts in India.

I.B.4 *Multilateral Institutions Raising Resources in India*

At present, only multilateral institutions are allowed to raise rupee bonds in India. To encourage, selectively, the raising of rupee denominated bonds, the Committee recommends that other institutions/corporates should be allowed to raise rupee bonds (with an option to convert into foreign exchange) subject to an overall ceiling which should be gradually raised.

II. BANKS

II.A Residents

II.A.1 *Borrowing Overseas*

The banks' borrowing facilities are at present restrictive though there are various special facilities which are outside the ceiling. The Committee recommends that the limits for borrowing overseas should be linked to paid-up capital and free reserves, and not to unimpaired Tier I capital, as at present, and raised substantially to 50 per cent in Phase I, 75 per cent in Phase II and 100 per cent in Phase III. Ultimately, all types of external liabilities of banks should be within an overall limit.

III. NON BANKS - FINANCIAL

III.A Residents

III.A.1 *SEBI-Registered Indian Investors' Investments Overseas*

At present, only mutual funds are permitted to invest overseas subject to stipulations for each fund. The Committee recommends that the various stipulations on individual fund limits and the proportion in relation to NAV should be abolished. The overall ceilings should be raised from the present level of US$ 2 billion to US$ 3 billion in Phase I, to US$ 4 billion in Phase II and to US$ 5 billion in Phase III. The Committee further recommends that these facilities should be available, apart from Mutual Funds, to SEBI registered portfolio management schemes.

IV. INDIVIDUALS

IV.A. Residents

IV.A.1 *Financial Capital Transfers*

(i) The present facility for individuals to freely remit US$ 25,000 per calendar year enables individuals to open foreign currency accounts overseas. The Committee recommends that this annual limit be successively raised to US$ 50,000 in Phase I, US$ 100,000 in Phase II and US$ 200,000 in Phase III. Difficulties in operating this scheme should be reviewed. Since this facility

straddles the current and capital accounts, the Committee recommends that where current account transactions are restricted, i.e., gifts, donations and travel, these should be raised to an overall ceiling of US$ 25,000 without any sub-limit.

(ii) Residents can at present invest, without any limit, directly in such overseas companies as have a shareholding of at least 10 per cent in an Indian company. This facility is cumbersome to operate and in the context of the large increase in limits for individuals proposed under (i) above, the Committee recommends that this facility should be abolished.

IV.A.2 and 3 *RFC and RFC(D) Accounts*

The Committee recommends that the Resident Foreign Currency (RFC) and Resident Foreign Currency (Domestic) [RFC(D)] Accounts should be merged. The account holders should be given general permission to move the foreign currency balances to overseas banks; those wishing to continue RFC Accounts should be provided foreign currency current/savings chequable accounts in addition to foreign currency term deposits.

IV.B Non-Residents

IV.B.3 *Deposit Schemes for Non-Residents*

At present only NRIs are allowed to maintain FCNR(B) and NR(E)RA deposits. The Committee recommends that non-residents (other than NRIs) should also be allowed access to these deposit schemes. Since NRIs enjoy tax concessions on FCNR(B) and NR(E)RA deposits, it would be necessary to provide FCNR(B)/NR(E)RA deposit facilities as separate and distinct schemes for non-residents (other than NRIs) without tax benefits. In Phase I, the NRs (other than NRIs) could be first provided the FCNR(B) deposit facility, without tax benefits, subject to KYC/FATF norms. In Phase II, the NR(E)RA deposit scheme, with cheque writing facility, could be provided to NRs (other than NRIs) without tax benefits after the system has in place KYC/FATF norms. The present tax regulations on FCNR(B) and NR(E)RA deposits for NRIs should be reviewed by the government.

IV.B.4 *Portfolio Investments*

At present, only NRIs are allowed to invest in companies on the Indian stock exchanges subject to certain stipulations. The Committee recommends that all individual non-residents should be allowed to invest in the Indian stock market though SEBI registered entities including mutual funds and Portfolio Management Schemes who will be responsible for meeting KYC and FATF norms and that the money should come through bank accounts in India.

CHAPTER 9

OBSERVATIONS/RECOMMENDATIONS OF THE COMMITTEE

The observations/recommendations of the Committee are summarised below:

Meaning of Capital Account Convertibility

1. Currency convertibility refers to the freedom to convert the domestic currency into other internationally accepted currencies and *vice versa.* Convertibility in that sense is the obverse of controls or restrictions on currency transactions. While current account convertibility refers to freedom in respect of 'payments and transfers for current international transactions', capital account convertibility (CAC) would mean freedom of currency conversion in relation to capital transactions in terms of inflows and outflows. The cross-country experience with capital account liberalisation suggests that countries, including those which have an open capital account, do retain some regulations influencing inward and outward capital flows. For the purpose of this Committee, the working definition of CAC would be as follows:

> CAC refers to the freedom to convert local financial assets into foreign financial assets and *vice versa*. 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. (Paragraphs 2.1 - 2.3)

Changing International and Emerging Market Perspectives

2. There is some literature which supports a free capital account in the context of global integration, both in trade and finance, for enhancing growth and welfare. The perspective on CAC has, however, undergone some change following the experiences of emerging market economies (EMEs) in Asia and Latin America which went through currency and banking crises in the 1990s. A few countries backtracked and re-imposed some capital controls as part of crisis resolution. While there are economic, social and human costs of crisis, it has also been argued that extensive presence of capital controls, when an economy opens

up the current account, creates distortions, making them either ineffective or unsustainable. The costs and benefits or risks and gains from capital account liberalisation or controls are still being debated among both academics and policy makers. These developments have led to considerable caution being exercised by EMEs in opening up the capital account. The link between capital account liberalisation and growth is yet to be firmly established by empirical research. Nevertheless, the mainstream view holds that capital account liberalisation can be beneficial when countries move in tandem with a strong macroeconomic policy framework, sound financial system and markets, supported by prudential regulatory and supervisory policies. (Paragraphs 2.4 - 2.5)

Objectives and Significance of Fuller Capital Account Convertibility (FCAC) in the Indian Context

3. India has cautiously opened up its capital account since the early 1990s and the state of capital controls in India today can be considered as the most liberalised it has ever been in its history since the late 1950s. Nevertheless, several capital controls continue to persist. In this context, an FCAC would signify the additional measures which could be taken in furtherance of CAC and in that sense, 'Fuller Capital Account Convertibility' would not necessarily mean zero capital regulation. In this context, the analogy to *de jure* current account convertibility is pertinent. *De jure* current account convertibility recognises that there would be reasonable limits for certain transactions, with 'reasonableness' being perceived by the user. FCAC is not an end in itself, but should be treated only as a means to realise the potential of the economy to the maximum possible extent at the least cost. Given the huge investment needs of the country and that domestic savings alone will not be adequate to meet this aim, inflows of foreign capital become imperative. The inflow of foreign equity capital can be in the form of portfolio flows or foreign direct investment (FDI). FDI tends to be also associated with non-financial aspects, such as transfer of technology, infusion of management and supply chain practices, etc. In that sense, it has greater impact on growth. The objectives of an FCAC are: (i) to facilitate economic growth through higher investment by minimising the cost of both equity and debt capital; (ii) to improve the efficiency of the financial sector through greater competition,

thereby minimising intermediation costs and (iii) to provide opportunities for diversification of investments by residents. (Paragraphs 2.6 - 2.8)

Some Lessons from the Currency Crises in Emerging Market Economics

4. The risks of FCAC arise mainly from inadequate preparedness before liberalisation in terms of domestic and external sector policy consolidation, strengthening of prudential regulation and development of financial markets, including infrastructure, for orderly functioning of these markets. Most currency crises arise out of prolonged overvalued exchange rates, leading to unsustainable current account deficits. A transparent fiscal consolidation is necessary and desirable, to reduce the risk of currency crisis. Short-term debt flows react quickly and adversely during currency crises. Domestic financial institutions, in particular banks, need to be strong and resilient. The quality and proactive nature of market regulation is also critical to the success of efficient functioning of financial markets during times of currency crises. (Paragraphs 2.9 - 2.11)

Committee's Approach to FCAC and Related Issues

5. The status of capital account convertibility in India for various non-residents is as follows: for foreign corporates, and foreign institutions, there is a reasonable amount of convertibility; for non-resident Indians (NRIs) there is approximately an equal amount of convertibility, but one accompanied by severe procedural and regulatory impediments. For non-resident individuals, other than NRIs, there is near-zero convertibility. Movement towards an FCAC implies that all non-residents (corporates and individuals) should be treated equally. This would mean the removal of the tax benefits presently accorded to NRIs via special bank deposit schemes for NRIs, *viz*., Non-Resident External Rupee Account [NR(E)RA] and Foreign Currency Non-Resident (Banks) Scheme [FCNR(B)]. The Committee recommends that the present tax benefit for these special deposit schemes for NRIs, [NR(E)RA and FCNR(B)], should be reviewed by the Government. Non-residents, other than NRIs, should be allowed to open FCNR(B) and NR(E)RA accounts without tax benefits, subject to Know Your Customer (KYC) and Financial Action Task Force (FATF) norms. In the case of the present NRI schemes for various types of investments, other than deposits,

there are a number of procedural impediments and these should be examined by the Government and the RBI. (Paragraph 2.12)

6. It would be desirable to consider a gradual liberalisation for resident corporates/business entities, banks, non-banks and individuals. The issue of liberalisation of capital outflows for individuals is a strong confidence building measure, but such opening up has to be well calibrated as there are fears of waves of outflows. The general experience is that as the capital account is liberalised for resident outflows, the net inflows do not decrease, provided the macroeconomic framework is stable. (Paragraph 2.14)

7. As India progressively moves on the path of an FCAC, the issue of investments being channelled through a particular country so as to obtain tax benefits would come to the fore as investments through other channels get discriminated against. Such discriminatory tax treaties are not consistent with an increasing liberalisation of the capital account as distortions inevitably emerge, possibly raising the cost of capital to the host country. With global integration of capital markets, tax policies should be harmonised. It would, therefore, be desirable that the Government undertakes a review of tax policies and tax treaties. (Paragraph 2.15)

8. A hierarchy of preferences may need to be set out on capital inflows. In terms of type of flows, allowing greater flexibility for rupee denominated debt which would be preferable to foreign currency debt, medium and long term debt in preference to short-term debt, and direct investment to portfolio flows. There are reports of large flows of private equity capital, all of which may not be captured in the data (this issue needs to be reviewed by the RBI). There is a need to monitor the amount of short-term borrowings and banking capital, both of which have been shown to be problematic during the crisis in East Asia and in other EMEs. (Paragraphs 2.17)

9. Greater focus may be needed on regulatory and supervisory issues in banking to strengthen the entire risk management framework. Preference should be given to control volatility in cross-border capital flows in prudential policy measures. Given the importance that the commercial banks occupy in the Indian

financial system, the banking system should be the focal point for appropriate prudential policy measures. (Paragraph 2.18)

Broad Framework for Timing, Phasing and Sequencing of Measures

10. On a review of existing controls, a broad time frame of a five year period in three phases, 2006-07 (Phase I), 2007-08 and 2008-09 (Phase II) and 2009-10 and 2010-11 (Phase III) has been considered appropriate by the Committee. This enables the authorities to undertake a stock taking after each Phase before moving on to the next Phase. The roadmap should be considered as a broad time-path for measures and the pace of actual implementation would no doubt be determined by the authorities' assessment of overall macroeconomic developments as also specific problems as they unfold. There is a need to break out of the "control" mindset and the substantive items subject to capital controls should be separated from the procedural issues. This will enable a better monitoring of the capital controls and enable a more meaningful calibration of the liberalisation process. (Paragraph 2.20)

Liberalisation of the Capital Account Since 1997

11. The action taken on the 1997 Committee Report is set out in Annex III provided by the RBI. This does bring out that by and large the RBI has taken action on a number of recommendations but the extent of implementation has been somewhat muted on some of the proposed measures (e.g., outflows by resident individuals and overseas borrowing by banks), while for some other measures, the RBI has proceeded far beyond the Committee's recommendations (e.g. outflows by resident corporates). RBI has, however, taken a number of additional measures outside the 1997 Committee's recommendations. (Paragraph 3.10)

12. The core of the capital account liberalisation measures proposed by the 1997 Committee were essentially in relation to residents. While resident corporates have been provided fairly liberal limits, the liberalisation for resident individuals has been hesitant and in some cases inoperative because of procedural impediments. (Paragraph 3.19)

13. In a tightly regulated regime, with a myriad of specific schemes and controls, the monitoring was related to these individual schemes. While there has, no doubt, been a fair amount of liberalisation, the basic framework of the control system has remained unchanged. The RBI has liberalised the framework on an *ad hoc* basis and the liberalised framework continues to be a prisoner of the erstwhile strict control system. Progressively, as capital account liberalisation gathers pace it is imperative that there should be a rationalisation/simplification of the regulatory system and procedures in a manner wherein there can be a viable and meaningful monitoring of the capital flows. The Committee recommends that there should be an early rationalisation/consolidation of the various facilities. Furthermore, it is observed that with the formal adoption of current account convertibility in 1994 and the subsequent gradual liberalisation of the capital account, some inconsistencies in the policy framework have emerged and the Committee recommends that these issues should be comprehensively examined by the RBI. (Paragraph 3.21)

Concomitants for a Move to Fuller Capital Account Convertibility

14. While a certain extent of capital account liberalisation has taken place, since 1997, it would be necessary to set out a broad framework for chalking out the sequencing and timing of further capital account liberalisation. The key concomitants discussed below are not in any order of priority. (Paragraph 4.3)

Fiscal Consolidation

15. The Fiscal Responsibility and Budget Management (FRBM) Legislation was enacted in 2003 and the Rules were notified in 2004. Steps are required to be taken to reduce the fiscal and revenue deficits and the revenue deficit was to be eliminated by March 31, 2008 and adequate surpluses were to be built up thereafter. The target for reducing the Centre's fiscal deficit to 3 per cent of GDP and elimination of the revenue deficit has been extended by the Central Government to March 31, 2009. The Twelfth Finance Commission (TFC) recommended that the revenue deficits of the States should be eliminated by 2008-09 and that the fiscal deficits of the States should be reduced to 3 per cent of GDP. (Paragraphs 4.4 - 4.5)

16. The Committee notes that apart from market borrowings, at the general government level, there are several other liabilities of governments – both explicit and implicit - such as small savings and unfunded pension liabilities which are large but not easily quantifiable. As the interest rate conditions and climate for investment and growth are dependent upon the totality of such resource dependence, generation of revenue surplus to meet repayment of the marketable debt should be viewed but as a first step towards fiscal prudence and consolidation. A large fiscal deficit makes a country vulnerable. In an FCAC regime, the adverse effects of an increasing fiscal deficit and a ballooning internal debt would be transmitted much faster and, therefore, it is necessary to moderate the public sector borrowing requirement and also contain the total stock of liabilities. (Paragraph 4.6)

17. The system of meeting government's financing needs is set out in terms of *net* borrowing, i.e., the *gross* borrowing minus repayments. This masks the repayment issue totally as no arrangement is made for the repayment. This approach of financing repayments out of fresh borrowings poses the danger of a vicious cycle of higher market borrowings at a relatively higher cost, chasing higher repayments. While repayment obligations financed through gross borrowings would not affect the gross fiscal deficit for the particular year of borrowings, the concomitant interest burden would fuel the revenue deficit as well as the gross fiscal deficit in subsequent years. This development would not only result in higher accumulation of debt but also further aggravate the problem of debt sustainability. (Paragraph 4.7)

18. With the progressive move to market determined interest rates on government securities and the dilution of the captive market, there is no certainty that repayments would smoothly and automatically be met out of fresh borrowings without a pressure on real interest rates. Progressively, therefore, it is the *gross* borrowing programme and not the *net* borrowing programme which has to be related to the absorptive capacity of the market as also in gauging potential borrowing costs of the government. The Committee recommends that a substantial part of the revenue surplus of the Centre should be earmarked for meeting the

repayment liability under the Centre's market borrowing programme, thereby reducing the *gross* borrowing requirement. (Paragraph 4.8)

19. The Committee recommends that as part of better fiscal management, the Central Government and the States should graduate from the present system of computing the fiscal deficit to a measure of the *Public Sector Borrowing Requirement (PSBR)*. The PSBR is a more accurate assessment of the fisc's resource dependence on the economy. Rough indications point to the probability of the PSBR being about 3 per cent of GDP above the fiscal deficit. The RBI should attempt a preliminary assessment of the PSBR and put it in the public domain which would then facilitate the adoption of the PSBR as a clearer indicator of the public sector deficit. (Paragraph 4.9)

20. For an effective functional separation enabling more efficient debt management as also monetary management, the Committee recommends that the Office of Public Debt should be set up to function independently outside the RBI. (Paragraph 4.10)

Monetary Policy Objectives

21. In the rapidly changing international environment and the drawing up of a roadmap towards fuller capital account convertibility, the issue of greater autonomy for monetary policy needs to be revisited. The Committee recommends that, consistent with overall economic policy, the RBI and Government should jointly set out the objectives of monetary policy for a specific period and this should be put in the public domain. Once the monetary policy objectives are set out, the RBI should have unfettered instrument independence to attain the monetary policy objectives. Given the lagged impact of monetary policy action, the monetary policy objectives should have a medium-term perspective. The Committee recommends that the proposed system of setting objectives should be initiated from the year 2007-08. Strengthening the institutional framework for setting monetary policy objectives is important in the context of an FCAC. The RBI has instituted a *Technical Advisory Committee on Monetary Policy.* While this is a useful first step, the Committee recommends that a formal Monetary Policy Committee should be the next step in strengthening the institutional

framework. At some appropriate stage, a summary of the minutes of the Monetary Policy Committee should be put in the public domain with a suitable lag. (Paragraphs 4.13 - 4.15)

Strengthening of the Banking System

22. On the strengthening of the banking system, the Committee has the following recommendations:

(i) All commercial banks should be subject to a single Banking Legislation and separate legislative frameworks for groups of public sector banks should be abrogated. All banks, including public sector banks, should be incorporated under the Companies Act; this would provide a level playing field.

(ii) The minimum share of Government/RBI in the capital of public sector banks should be reduced from 51 per cent (55 per cent for SBI) to 33 per cent as recommended by the Narasimham Committee on Banking Sector Reforms (1998). There are, admittedly, certain social objectives in the very nature of public sector banking and a reduction in the Government/RBI holding to 33 per cent would not alter the positive aspects in the public sector character of these banks.

(iii) With regard to the proposed transfer of ownership of SBI from the RBI to government, the Committee recommends that given the imperative need for strengthening the capital of banks in the context of Basel II and FCAC, this transfer should be put on hold. This way the increased capital requirement for a sizeable segment of the banking sector would be met for the ensuing period. The Committee, however, stresses that the giving up of majority ownership of public sector banks should be worked out both for nationalised banks and the SBI.

(iv) In the first round of setting up new private sector banks, those private sector banks which had institutional backing have turned out to be the successful banks. The authorities should actively encourage similar initiative by institutions to set up new private sector banks.

(v) Until amendments are made to the relevant statutes to promote consolidation in the banking system and address the capital requirements of the public sector banks, the RBI should evolve policies to allow, on a case by case basis, industrial houses to have a stake in Indian banks or promote new banks. The policy may also encourage non-banking finance companies to convert into banks. After exploring these avenues until 2009, foreign banks may be allowed to enhance their presence in the banking system.

(vi) Issues of corporate governance in banks, powers of the Boards of public sector banks, remuneration issues, hiring of personnel with requisite skills in specialised functions and succession planning need early attention.

(vii) The voting rights of the investors should be in accordance with the provisions of the Companies Act.

(viii) Following the model of the comprehensive exercise undertaken on Transparency, a number of Groups/Committees could be set up for examining each set of issues under the overall guidance/coordination of a High Level Government – RBI Committee to ensure concerted and early action to expeditiously prepare the financial system to meet the challenges in the coming years in the context of Basel II and the move to an FCAC. As part of this comprehensive exercise, the proposed Committee should revisit the issue of investments by foreign banks in Indian banking. In this Committee's view, this has relevance in the context of issues relating to bank recapitalisation, governance, induction of technology and weak banks. (Paragraph 4.26)

External Sector Indicators

23. Given the present CR/GDP ratio of 24.5 per cent, the CR/CP ratio of 95 per cent and a debt service ratio in the range of 10-15 per cent, a CAD/GDP ratio of 3 per cent could be comfortably financed. Should the CAD/GDP ratio rise substantially over 3 per cent there would be a need for policy action. (Paragraphs 4.28 - 4.30, 4.32)

24. In terms of total external liabilities, which include portfolio liabilities, India's reserves cover over one half of the external liabilities. In the context of large non-debt flows in recent years, greater attention is required to the concept of reserve adequacy in relation to external liabilities. (Paragraph 4.34)

25. While the reserves are comfortable in relation to various parameters, the Committee has some concerns about the coverage of data on short-term debt, including suppliers' credit. Again there are concerns whether the flow of private equity capital are fully captured in the data (on FDI). The Committee suggests that the RBI should undertake an in-depth examination of the coverage and accuracy of these data. (Paragraph 4.35)

Monetary Policy Instruments and Operations

26. The sterilisation and open market operations (OMO) and interventions in the forex markets have to be so calibrated along with domestic monetary instruments so as to be consistent with the monetary policy objectives. A major objective of monetary policy is containing inflationary expectations and to attain this objective, monetary policy action needs to be undertaken well before the economy reaches the upper turning point of the cycle. If the measures are delayed, small incremental changes are ineffective and moreover could be destabilising, particularly if monetary tightening is undertaken during the downturn of the cycle. With transparency in setting objectives, there would be improved credibility if the RBI had greater independence in optimising the use of instruments and operating procedures. (Paragraphs 5.5 and 5.7)

27. Given the nascent state of development of market based monetary policy instruments and the size of capital flows, it would be necessary to continue to actively use the instrument of reserve requirements. (Paragraph 5.8)

28. The LAF should be essentially an instrument of equilibrating very short-term liquidity. The Committee recommends that, over time, the RBI should build up its stocks of government securities so as to undertake effective outright OMO. (Paragraph 5.9)

29. The interest cost of sterilisation to the Government and the RBI in 2005-06 is reported to be in the broad range of Rs.4,000 crore (though reduced somewhat by corresponding earnings on the forex reserves). While the costs of sterilisation are often highlighted, the costs of non-intervention and non-sterilisation are not easily quantifiable as the costs are in terms of lower growth, lower employment, loss of competitiveness of India, lower corporate profitability and lower government revenues; these costs could be much more than the visible costs of sterilisation. (Paragraph 5.10)

30. While appreciating the RBI's dilemma of a shortage of instruments, the Committee recommends the following:

(i) The RBI should activate variable rate repo/reverse repo auctions or repo/reverse repo operations on a real time basis.

(ii) RBI should consider somewhat longer-term LAF facilities.

(iii) To the extent the RBI assesses the excess liquidity to be more than transient, it should also use the cash reserve ratio (CRR) and Statutory Liquidity Ratio (SLR). Where there is a large increase in liquidity and credit expansion way above the trend line, bank profitability is higher and the banks can be legitimately expected to bear a part of the burden of containing the deleterious expansion of liquidity. The Committee recognises that the CRR cannot be as effective as in earlier years as banks are anyway maintaining large balances for settlement operations. Nonetheless, it can be a supportive instrument and the entire burden should not be on the LAF and the Market Stabilisation Scheme (MSS).

(iv) To the extent the capital inflows are exceptionally high and the economy is inundated with excess liquidity, arising out of FII inflows, the authorities may consider, in very exceptional circumstances, the imposition of an unremunerated reserve requirement on fresh FII inflows. The Committee recommends that measures of such a nature should be exceptional, to be used only in extreme situations wherein the liquidity arising out of extremely large and volatile FII inflows reaches unmanageable proportions.

Furthermore, such a measure, to be effective, should be used as a temporary measure only for a few months. (Paragraph 5.11)

Exchange Rate Management

31. The articulation of the exchange rate policy gives the Committee some concern. The authorities have centred the articulation of the exchange rate policy on managing *volatility*. The Committee is of the view that apart from volatility what is more important is the *level* of the exchange rate. The Committee recommends that work needs to be undertaken by the RBI to refine the REER index by incorporation of services to the extent possible. Furthermore, for periods where there are large import duty adjustments, these should be built into the construction of the REER. According to the RBI, these indices are constructed "as part of its communication policy and to aid researchers and analysts". The Committee would, however, stress that the REER should also be a valuable input into the formulation of the RBI's exchange rate policy. (Paragraphs 5.12 - 5.13)

32. The 1997 Committee recommended 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."

The present Committee endorses the recommendations of the 1997 Committee. (Paragraph 5.14)

33. The Committee recommends that, as an operative rule, if the CAD persists beyond 3 per cent of GDP (referred as an outer sustainable limit, at the present time) the exchange rate policy should be reviewed. (Paragraph 5.15)

Development of Financial Markets

34. Any country intending to introduce an FCAC needs to ensure that different market segments are not only well developed but also that they are well

integrated. Otherwise, shocks to one or more market segments would not get transmitted to other segments efficiently so that the entire financial system is able to absorb the shocks with minimal damage. Broadly, there are three main dimensions of a well developed financial system. These are: (i) vibrancy and strength of the physical infrastructure of markets as reflected by the IT systems, communication networks, business continuity and disaster management capabilities, (ii) the skill and competency levels of people who man the offices of financial intermediaries like commercial and investment banks, institutions that manage trading platforms and clearing and settlement arrangements and market intermediaries like brokerage houses, etc. and (iii) quality of regulatory and supervisory arrangements. (Paragraph 6.4)

Equity Market

35. Indian equity market consists of primary and secondary segments, both of which have evolved to world class standards in terms of trading technology, disclosure standards and price discovery processes. Foreign institutional holding has risen to about 10 to 15 per cent of the market capitalisation, which itself is now approaching 100 per cent of GDP. In terms of trading intensity and liquidity, Indian stock exchanges are among the world's best. (Paragraph 5.16)

Money Market

36. The Committee's recommendations relating to development of the money market are set out in Paragraph 6.18 (i) - (xii).

Government Securities Market

37. The Committee's recommendations for further development of the government securities market are set out in Paragraph 6.24 (i) - (viii).

Corporate Bond Market

38. The Committee's recommendations for the development of the corporate bond and securitised debt market are set out in Paragraph 6.31 (i) - (x).

Foreign Exchange Market

39. The Committee's recommendations for the development of the forex market are set out in Paragraph 6.42 (i) - (vii).

Gold Market

40. The Committee's recommendations for the development of the gold market are set out in Paragraph 6.43 (i) - (vii).

Regulatory and Supervisory Issues in Banking

41. Under an FCAC regime, the banking system will be exposed to greater market volatility. Hence, it is necessary to address the relevant issues in the banking system including the regulatory and supervisory aspects to enable the system to become more resilient to shocks and sustain their operations with greater stability. (Paragraph 7.1)

42. In a new environment, the commercial banks should be able to manage multi-dimensional operations in situations of both large inflows and outflows of capital. In particular, their own exposures to exchange rate risk, coupled with their exposures to corporates which are exposed to similar risks, panning across national jurisdictions add to the multiplicity of risks which need to be closely monitored and prudently managed. The RBI, therefore, needs to review the prudential standards applicable to commercial banks and should consider making the regulations activity-specific, instead of keeping them institution-specific. (Paragraph 7.5)

Dimensions of Risks

43. Going forward, opening up of the system is expected to result in larger two-way flows of capital in and out of the country; this underscores the need for enhancing the risk management capabilities in the banking system. The risk elements which will become more prominent than at present are set out in Paragraph 7.8 (i) - (vii).

Prudential Regulation

44. Issues in prudential regulation are set out in Paragraph 7.10 (i) - (xi).

Supervisory Practices

45. The supervisory issues which need attention are set out in Paragraph 7.12 (i) - (vi).

46. As the country moves to an FCAC regime, it is necessary to improve relevant regulatory and supervisory standards across the banking system to enable them to become more resilient and sustain their operations with greater stability. The key requirements in this regard would be: robust and sophisticated risk management systems in banks supplemented by a regimen of appropriate stress testing framework; efficient and reliable IT systems providing on-line data to support the risk management systems in banks; robust accounting and auditing framework; adoption of economic capital framework and risk-based allocation of capital; upgradation of skills; upgradation of IT-based surveillance systems and manpower skills in the RBI; fuller compliance with Anti-money Laundering (AML)/Know Your Customer (KYC) and Financial Action Task Force (FATF) requirements; and a need for prescription of a limit on the off-balance sheet items with reference to balance sheet size. (Paragraph 7.13)

47. The tabular material attached to Chapter 7 sets out the proposed measures for strengthening regulation and supervision in the banking sector. (Paragraph 7.13).

Timing and Sequencing of Measures for Fuller Capital Account Convertibility

48. Before discussing the recommended framework on the timing and sequencing of specific capital account liberalisation measures, it would perhaps be useful to refer to a few general issues. First, there are a number of items which straddle the current and capital accounts and items in one account have implication for the other account. Inconsistencies in the regulations of such items need to be ironed out. Secondly, while there is *de jure* current account convertibility, there are time-honoured stipulations which require surrender

requirements for export proceeds. Surrender requirements, *per se,* are consistent with current account convertibility, but as part of overall management of the current and capital flows, it would be useful to consider whether the repatriation/surrender requirements could be gradually eased. Thirdly, there are a number of items where there are anomalous stipulations which date back to a very restrictive period. Illustratively, investments by NRIs in CPs are non-repatriable. It is not clear whether the sale proceeds of the CP are non-repatriable or whether they can be credited to a repatriable account; either way, a non-resident can make a remittance out of an NRO account. In other words, regulations of a period of extremely tight current and capital controls continue to remain even though the overall regime has undergone a significant degree of liberalisation. Fourthly, the knots in the forex management system need to be untied before the liberalisation can become meaningful. The Committee recommends that a *RBI Task Force* should be set up immediately to identify the anomalies in the present regulatory framework for the current and capital accounts and the rectification should be undertaken within a period of three months. (Paragraph 8.1)

49. On an examination of the extant regulations relating to the capital account, as set out by the RBI in Annex III, the Committee is of the view that the extant matrix is a mixed bag of policy measures and procedural/operational matters. The Committee has, therefore, separated the extant regulations into policy issues and procedural/operational matters and a list of items has been prepared by the Committee to be reviewed by the RBI. The Committee recommends that the items identified as procedural/operational matters should be reviewed by the RBI Task Force referred to above. The RBI Task Force should also review the delegation of powers on foreign exchange regulation as between the Central Office and the Regional Offices of the RBI and *inter alia*, examine, selectively, the efficacy in the functioning of the delegation of powers by the RBI to ADs. (Paragraph 8.2)

50. As regards the substantive regulations on the capital account, the Committee recommends a five-year roadmap with three phases on the timing and sequencing of measures. These are set out in the Tabular Material in Chapter 8. (Paragraph 8.3)

51. Some of the significant measures are set out below:

(i) The Committee recommends that the overall ECB ceiling as also the ceiling for automatic approval should be gradually raised. Rupee denominated ECB (payable in foreign currency) should be outside the ECB ceiling. ECBs of over 10-year maturity in Phase I and over 7-year maturity in Phase II should be outside the ceiling. End-use restriction should be removed in Phase I.

(ii) The Committee has concerns about the volume of trade credit as there could be sudden changes in the availability of such credit. Furthermore, there are concerns as to whether the trade credit numbers are fully captured in the data even while noting that suppliers' credit of less than 180 days are excluded from these data. Import-linked short-term loans should be monitored in a comprehensive manner. The per transaction limit of US$ 20 million should be reviewed and the scheme revamped to avoid unlimited borrowing.

(iii) Recognising that Indian industry is successfully building up its presence abroad, there is a strong case for liberalising the present limits for corporate investment abroad. The Committee recommends that the limits for such outflows should be raised in phases from 200 per cent of net worth to 400 per cent of net worth. As part of a rationalisation, these limits should also subsume a number of other categories (detailed in the Matrix); furthermore, for non-corporate businesses, it is recommended that the limits should be aligned with those for corporates.

(iv) Although EEFC Accounts are permitted in the present framework, these facilities do not effectively serve the intended purpose. The Committee recommends that EEFC Account holders should be provided foreign currency current/savings accounts with cheque writing facility and interest bearing term deposits. In practice some banks are erroneously providing cheque writing facilities only in rupees.

(v) Project exports should be provided greater flexibility and these facilities should be also provided for service exports.

(vi) In the case of Participatory Notes (PNs), the nature of the beneficial ownership or the identity is not known unlike in the case of FIIs. These PNs are freely transferable and trading of these instruments makes it all the more difficult to know the identity of the owner. It is also not possible to prevent trading in PNs as the entities subscribing to the PNs cannot be restrained from issuing securities on the strength of the PNs held by them. The Committee is, therefore, of the view that FIIs should be prohibited from investing fresh money raised through PNs. Existing PN-holders may be provided an exit route and phased out completely within one year.

(vii) The Committee recommends that non-resident corporates should be allowed to invest in the Indian stock markets through SEBI-registered entities including mutual funds and Portfolio Management Schemes who will be individually responsible for fulfilling KYC and FATF norms. The money should come through bank accounts in India.

(viii) At present, only multilateral institutions are allowed to raise rupee bonds in India. To encourage, selectively, the raising of rupee denominated bonds, the Committee recommends that other institutions/corporates should be allowed to raise rupee bonds (with an option to convert into foreign exchange) subject to an overall ceiling which should be gradually raised.

(ix) The banks' borrowing facilities are at present restrictive though there are various special facilities which are outside the ceiling. The Committee recommends that the limits for borrowing overseas should be linked to paid-up capital and free reserves, and not to unimpaired Tier I capital, as at present, and raised substantially to 50 per cent in Phase I, 75 per cent in Phase II and 100 per cent in Phase III. Ultimately, all types of external liabilities of banks should be within an overall limit.

(x) At present, only mutual funds are permitted to invest overseas subject to stipulations for each fund. The Committee recommends that the various stipulations on individual fund limits and the proportion in relation to NAV should be abolished. The overall ceilings should be raised from the present level of US$ 2 billion to US$ 3 billion in Phase I, to US$ 4 billion in Phase II and to US$ 5 billion in Phase III. The Committee further recommends that these facilities should be available, apart from Mutual Funds, to SEBI registered portfolio management schemes.

(xi) The present facility for individuals to freely remit US$ 25,000 per calendar year enables individuals to open foreign currency accounts overseas. The Committee recommends that this annual limit be successively raised to US$ 50,000 in Phase I, US$ 100,000 in Phase II and US$ 200,000 in Phase III. Difficulties in operating this scheme should be reviewed. Since this facility straddles the current and capital accounts, the Committee recommends that where current account transactions are restricted, i.e., gifts, donations and travel, these should be raised to an overall ceiling of US$ 25,000 without any sub-limit.

(xii) Residents can at present invest, without any limit, directly in such overseas companies as have a shareholding of at least 10 per cent in an Indian company. This facility is cumbersome to operate and in the context of the large increase in limits for individuals proposed under (i) above, the Committee recommends that this facility should be abolished.

(xiii) The Committee recommends that the RFC and RFC(D) Accounts should be merged. The account holders should be given general permission to move the foreign currency balances to overseas banks; those wishing to continue RFC Accounts should be provided foreign currency current/savings chequable accounts in addition to foreign currency term deposits.

(xiv) At present only NRIs are allowed to maintain FCNR(B) and NR(E)RA deposits. The Committee recommends that non-residents (other than NRIs) should also be allowed access to these deposit

schemes. Since NRIs enjoy tax concessions on FCNR(B) and NR(E)RA deposits, it would be necessary to provide FCNR(B)/NR(E)RA deposit facilities as separate and distinct schemes for non-residents (other than NRIs) without tax benefits. In Phase I, the NRs (other than NRIs) could be first provided the FCNR(B) deposit facility, without tax benefits, subject to KYC/FATF norms. In Phase II, the NR(E)RA deposit scheme, with cheque writing facility, could be provided to NRs (other than NRIs) without tax benefits after the system has in place KYC/FATF norms. The present tax regulations on FCNR(B) and NR(E)RA deposits for NRIs should be reviewed by the government.

(xv) At present, only NRIs are allowed to invest in companies on the Indian stock exchanges subject to certain stipulations. The Committee recommends that all individual non-residents should be allowed to invest in the Indian stock market though SEBI registered entities including mutual funds and Portfolio Management Schemes who will be responsible for meeting KYC and FATF norms and that the money should come through bank accounts in India. (Paragraph 8.6)

52. The Committee recommends that at the end of the five-year period ending in 2010-11, there should be a comprehensive review to chalk out the future course of action. (Paragraph 8.3)

July 25, 2006

Mr. A.V.Rajwade
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Malaviya Road,
Vile Parle (East),
Mumbai 400 057.

Chairman
Committee on Fuller Capital Account Convertibility
C/o Reserve Bank of India
Mumbai.

Dear Sir,

Report of CFCAC

I have reservations about some of the recommendations in the report. These are discussed in the following paragraphs:

1. Recommendation I.B.2, **P-notes**. The report recommends the banning of fresh inflows in the form of participatory notes. I feel that as the Lahiri Committee has gone into the issue in more detail, its views should be respected.

2. Recommendation III.B.1(d), **FII investment in the bond market**. The Committee has recommended a progressively increasing ceiling on the investment in the rupee bond market. In my view, investments in the rupee bond market, both G-sec and corporate bonds, should be freely allowed for the following reasons:

   i. Any ceiling has a negative connotation and dissuades intending investors.

   ii. Given the huge fund requirements of the infrastructure sector, there is obviously a need to lengthen maturities in the bond market, and broaden the base of investors, particularly longer term investors like pension funds.

   iii. Throwing open the bond market gives a strong signal to investors.

iv. The entry of large FIIs in the bond market would help improve the infrastructure and systems as has occurred in the equity market.

v. Most of the risks – exchange and interest rate – are with the investor.

It can be argued that, in the current, limited liquidity in the bond market, FII entry has the potential to create volatility in exchange and interest rates. To mitigate this possibility, a lock-in period can be prescribed. This would also help create a more balanced market as foreign investors would have to act counter-cyclically, in a market which is presently often unidirectional.

3. Recommendation IV.A.1, **facilities for residents to transfer capital** up to $ 25,000 a year, for any purpose. I had disagreed with a similar recommendation in the 1997 report. This facility has been in existence for a few years now, but does not seem to have been used much. While the Committee has recommended an increase in the limit, I am not in agreement with the recommendation for the following reasons:

i. The facility is aimed at giving an opportunity to domestic savers to diversify investments, admittedly one of the objectives of capital account liberalisation.

ii. While the facility does not seem to have been used much so far, it could be used extensively in a different market scenario. Indeed, investor behaviour often exhibits a herd instinct and, since the facility was introduced, for much of the time, not only were the returns in the Indian market more attractive but the rupee also appreciated against the dollar, reducing the attractions of investments abroad. (Incidentally, this environment also attracted large inflows from FIIs.)

iii. When there are pressures on the rupee, or a lack of confidence in the domestic economy for any reason, the direction of capital flows can surely reverse. FIIs may

start going out; leads and lags would be reversed; and domestic savers will be tempted to transfer moneys abroad, particularly when such transfers are legal. The phenomenon of domestic investors not being very “patriotic” when their returns are threatened, has been witnessed in south-east Asian countries at the time of the 1997-98 crisis, and time and again in Latin American and African countries.

iv. I imagine that there could well be a million residents capable of using the $ 25,000 facility. In a crisis, the potential outflow, even under the existing limit, is thus $ 25 bn! Such a capital flight can only put additional pressure on the exchange and interest rates and, to that extent, make countercyclical action by the central bank more difficult.

v. The reversal of other capital flows also has the same impact, but, in my view, they provide substantial benefits to the general economy – through lowering the cost of capital; helping real investment, growth and employment; and generally improving the efficiency of financial intermediation.

In short, to my mind, the risk reward relationship of the facility for residents is skewed more on the risk side, with rewards limited to a narrow section. In the case of capital inflows as well, the risk of reversal is there but, in my view, the rewards outweigh the risk.

Yours faithfully,

Sd/-
A.V.Rajwade

Dissent Note on the Report on Fuller Capital Account Convertibility

By
Surjit S Bhalla (member of Committee)
July 26, 2006

I have signed the "Report on Fuller Capital Account Convertibility (FCAC)" (hereafter Report) because I believe that a move towards FCAC is necessary if India wishes to grow at a faster rate, and especially if it wants to achieve the Prime Minister's (and Planning Commission) target of at least 9 % GDP growth per annum. The Report recommends some useful measures in this regard; hence, my signature on the report. It was a privilege to have been involved in this exercise, and I am appreciative for the sometimes frank discussions that the Committee had on the important issue of FCAC.

This dissent note is written to emphasize my *differences* with the Committee, differences that span several major issues relating to FCAC. I believe the Report on many occasions misses the "big picture" fact that India is a much different economy, and that the world environment is considerably different, than when the original capital account committee report was written in May 1997. The Report's concentration on the micro-detail is so intense that, for example, in one paragraph, it recommends that the RBI create a desk-job for a relationship officer (Chapter 7). Apart from my questioning the need for such micro-detail, my dissent also stems from the fact that on several occasions (some are detailed below) the Report does not empirically substantiate its conclusions/recommendations, and when it does, the conclusions suffer from faulty, or questionable, logic.

My overall conclusion is that the Committee has tended to look at issues in a gradual, incremental manner. Some are forward increments, and on these there is no dissent. Some recommendations are in the nature of politically correct but economically wrong tokenism, and on such issues there is dissent. Some recommendations are grossly inconsistent with the broad thrust of the Report; on such issues, the dissent is not minor.

The need to be politically correct (and perhaps economically incorrect) has led to contradictory conclusions in the Report; further, the Committee refuses to recognize that there has been a major *structural* change in the Indian (and world) economy since 1997. This recognition implies that what was appropriate ('fuller") in 1997 may be barely incremental today; hence, if the recommended policies are part of a slow continuum incremental package, which they are, then they might be inappropriate for Indian needs, circa 2006.

One small example encapsulates fully the need, and nature, of my dissent. The Committee, in its own perception, makes a "bold" move by recommending that Indian residents be allowed to remit upto $ 100,000 per year by the end of 2008-09. It is useful to recall that the 1997 Committee's recommendation was that this limit should have been reached fully 9 years earlier i.e. by 1999/2000. So, in a bid to reform, the Committee has actually regressed backwards. What the Indian resident *may* be allowed to remit, and that

too in 2008/09, is about 30 % less in real terms than she was recommended to remit in 1999/00. This is surely *not* a move towards "fuller" capital account convertibility.

Capital account convertibility, especially its fuller version, implies movement towards a greater integration of the Indian economy with the rest of the world, a movement towards the loosening of controls on inward and outward capital flows. There are two major conclusions with regard to inflows and outflows that the Committee (and I) are in full agreement. First, that the exchange rate should not be allowed to be significantly overvalued, and thereby hurt the competitive nature of the economy; second, that in terms of inflows, short-term debt is to be avoided and/or kept to a minimum. What is unfortunate is that the Report, via the eventual effect of its recommendations, violates either one, or both, of these commandments. This is detailed below.

Reserves, and exchange rate management: The report states that the exchange rate has been well managed in the last few years, etc. Yet the report also recommends that the RBI should be *constrained* to operate the exchange rate in a band of + - 5 percent around the REER; and when the REER moves beyond the band, the RBI "*should* ordinarily intervene" (para 5.14, emphasis added). Examination of the various series on REER maintained by the RBI (different country combinations, different base years) shows that the Indian rupee has moved in a very narrow REER band for the last 14 years. The reason for this "constancy" is that the rupee has been *managed* by the RBI; the RBI has implicitly "forced" the rupee not to deviate from the real 1993/94 level.

Given that the rupee management has fulfilled every explicit requirement of the Committee's objectives, then why does the Committee recommend a rigid rule for FX management, especially when countries have moved away from such rules in the last 10 years, and especially since the East Asian crisis of 1997?

The Committee's decision to mandate a band is untenable, and surprising. A band would just be a 'gift" to speculators. What the Committee is implicitly assuming, given the pattern of exchange rate movements, is that the exchange rate selected in 1993/94 is sacrosanct and was a perfect 10 i.e. the nominal (real) exchange rate conceived in 1993/94 is appropriate for all time to come! In a globalized world, competitor exchange rates are also relevant; and over the last decade, the Indian rupee has appreciated relative to the Chinese yuan, and consequently, Indian competitiveness has suffered. Part of the large success of the Chinese economy can be attributed to a very undervalued ("cheap") exchange rate. In this environment, to be fixated on our 1993/94 level of the real exchange rate, is inappropriate, and without reason, or empirical support.

The Report makes several other conceptual errors with regard to the exchange rate rule that it recommends. For example, the Report states that "the articulation of the exchange rate policy, however, gives the Committee some concern" (para 5.12). This articulation is in terms of volatility of the exchange rate whereas according to the Committee, what is "more important is the level of the exchange rate". Since volatility is a change in levels, it is not clear what the Committee's concern about "articulation" of policy is about, nor is it

clear why articulation is so important, and nor is it clear why the Committee was not able to see the large presence of "levels" in calculations of "volatility".

In conclusion, my view is that the RBI has shown itself to be capable of handling FX movements – when it ain't broke, you shouldn't fix it, especially by a method that is guaranteed to break what you are trying to preserve.

Capital Inflows

There are severe restrictions on capital inflows into India. Non-resident Indians (NRIs) are theoretically allowed to directly invest into Indian equity markets, but as the Report itself notes (para 2.12), there are severe RBI mandated impediments to such investments. With the effect that there is practically zero direct investment by NRIs into Indian equities, and Indian banks actively discourage the opening of NRI accounts (for investment in the stock market). This reality means that India is unique in the world in effectively banning its own (foreign based) citizens from directly participating in their own stock market. What this means is that if an Indian citizen is based in New York, she is *forced* to open an account with a non-Indian firm in New York, in order to buy some shares of SAIL and BHEL.

The present rules make very little sense. One remedy is that the NRI be allowed, via a rupee account, to directly invest into Indian securities (via SEBI regulated entities). However, the implementation of this much needed policy is recommended to occur, at best, in the second phase (2007 to 2009). Given the experience of the last capital account convertibility report, any *initia*l action that is in Phase II or Phase III is a code word for saying "we really don't want this action to be implemented".

Thus, at present (and if the Report has its way, in the foreseeable future) non-resident Indians cannot directly invest in the Indian stock market. And non-resident foreigners (NRFs) cannot invest either i.e. all foreign-based individuals (and corporates) are prohibited from directly accessing the Indian market. All investment into Indian equities *has* to come via FII flows; an Indian, cannot by definition, be an FII. Most unfortunately, the Committee did not recognize this simple reality: by endorsing a continuation of a ban on direct investments into Indian equities, the Committee endorses the policy that the employment, incomes, and taxes generated from foreign investment (FII flows) should not accrue to any Indian entity but rather should be gifted to foreign corporates and foreign governments. In the last year, it is estimated that some Rs. 10,000 crores of business income *tax* revenue accrued to foreign governments, instead of, perhaps rightfully, the Indian government. The Committee recommends that such gifts to foreign governments be continued, possibly indefinitely. I strongly dissent.

Non-resident investments in India and use of Participatory Notes (P-Notes)

All things considered, both the non-resident foreigner and Non-resident Indian pay a hefty premium to a firm which has managed to get the *license* to operate in the Indian stock market i.e. an FII. Instead of moving towards decreasing these transaction costs, the Committee recommends two actions that will further increase these costs: first, by delaying entry of individuals into the Indian market until 2008/9, and second by

recommending a ban on Participatory notes or P-notes. The license raj has shifted from the industrial sector to the financial sector. Instead of reforming this "license raj", the Committee, by recommending a ban on P-notes, is recommending a significant move backwards.

So as water finds its way, so do investors. The report reveals a lack of understanding of the underlying fundamentals, and reality, of stock market transactions. It is the bans and controls on investment by foreign based individuals and corporates that has created the off-shore P-notes market in Indian securities. P-notes primarily exist because of the large transaction costs that the Indian system imposes on foreign residents and corporates, and because of higher capital gains taxes in India than in other emerging markets. Most important, comparator emerging markets have zero short and long term capital gains taxes. (India has a 10 % tax on short-term gains and a 33 percent tax rate on short-term gains made via futures markets. Unfortunately, the Report did not deem it appropriate to discuss the influence of such differential tax rates on human and investment behavior).

Regrettably, P-Notes (an appropriate response to controls) is considered by the Committee to be of such an undesirable nature that it is recommended that they be banned immediately. That this might be a "politically correct" conclusion, at least in some institutions in India, is irrelevant. Like the FCAC committee, the government of India had also constituted an expert group to look at the issue of "Encouraging FII Flows and checking the vulnerability of capital markets to speculative flows". This GOI report was published in November 2005; it reached the *opposite* conclusion on P-Notes than that reached by the FCAC Committee.

The Committee's haste towards an immediate ban of P-Notes, and immediate reversal of existing GoI policy, *without any documentation or evidence*, suggests an ideological bureaucratic predisposition. And is in complete contrast, and perhaps out of character, with the Reports endorsement of a new policy, with *immediate* implementation, of industrial houses owning commercial banks – a policy, incidentally, I support. My only issue is that the Report is *inconsistent* in its recommendations. The recommendation on industrial houses does not come with any strings attached – somewhat surprising, given the extreme "caution" with which the report proceeds on other matters.

FCAC Report will encourage short-term debt inflows:
There are three problematic inter-linked Committee's decisions: the ban on P-Notes, the effective ban on foreign based individuals from investing directly in the Indian market, and the introduction of Indian bank dollar deposit schemes for foreign residents. Dollar deposit schemes will only succeed if the Indian banks provide considerably higher returns to investors than what the investor obtains in his home country bank e.g. USA.

Two of the Committee's recommendations are an endorsement of what prevailed in Thailand prior to the East Asian crisis, and have been noted by most observers (including implicitly the Report) to have been a major cause of the crisis. Prior to June 1997, Thailand was operating a fixed exchange rate, and high interest rates on dollar deposits. This was a free gift to foreigners: borrow at low rates in the US, invest in Thailand at

higher rates, and not have any exchange rate risk. The FCAC committee has recommended something very similar (and I strongly dissent). It recommends a narrow band for the exchange rate to move, and offers higher interest rates, and no permission to convert dollar deposits into rupee assets. In effect, what the Committee is saying is that we are very comfortable with short-term dollar deposits, but not at all comfortable with these deposits forming part of the savings pool of Indian firms.

The rest of the Report takes an opposite position. In several parts of the Report, it is mentioned how short-term dollar debt is the most problematic of foreign inflows, how short-term debt was one of the causes of the East Asian crises, etc. These conclusions I agree with; which is why I strongly dissent with the Committee's implicit endorsement of more short-term dollar debt for India, and the Committee's explicit recommendation to not transform such dollar debt into rupee debt, and even better, into rupee assets.

Some other problems with the Report

There are other not so major problems that I have with the report. It seems to be excessively pre-occupied with the size of the fiscal deficit, and less concerned than it should be about the integration of India's taxation policies with that of its competitors. It is more concerned about scoring narrow "moral" points than being pragmatic about what maximizes tax revenue. It is more concerned about the fiscal deficit than about runaway expenditures.

There is a part I strongly agree with, but an issue which the Report does not openly discuss i.e. the need for greater autonomy for the Reserve Bank of India. The Report's concerns are so covered in generalities and platitudes that a reader can be excused if she infers that the Report is recommending business as usual. The move towards FCAC was an ideal time to argue for considerably greater autonomy for the RBI; it is a pity that the Committee chose to heavily mask its view.

I had also written a dissent note (a much smaller one) in 1997. It is relevant to recall the issue involved – opening up of the Indian borders to portfolio *outflows*. This is what the 1997 Report said (p. 120), "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". I just hope I am as prescient, and accurate, with my present dissent as I was with my 1997 dissent.

Finally, I want to register a complaint against an implicit assumption of the FCAC committee (and other government Committees that I have had the privilege of being a member) i.e. that the committee's report should be cognizant of so-called political realities and prejudices. In my view, a committee is not doing justice to its selection if it

is constantly anticipating the reaction of politicians, bureaucrats and policy makers. An expert committee report should be objective, even if it means that none of the recommendations are accepted. A failed Report might be the biggest sign of its success.

Sd/-
(Surjit S Bhalla)
July 26, 2006

ANNEX I A

RESERVE BANK OF INDIA
CENTRAL OFFICE
MUMBAI

MEMORANDUM

Committee to set out the roadmap towards Fuller Capital Account Convertibility

Economic reforms in India have accelerated growth, enhanced stability and strengthened both external and financial sectors. Our trade as well as financial sector is already considerably integrated with the global economy. India's cautious approach towards opening of the capital account and viewing capital account liberalisation as a process contingent upon certain preconditions has stood us in good stead. However, given the changes that have taken place over the last two decades, there is merit in moving towards fuller capital account convertibility within a transparent framework. There is a need to revisit the subject and come out with a roadmap towards fuller Capital Account Convertibility based on current realities. Therefore, in consultation with the Government of India, Reserve Bank of India has appointed a Committee to set out the framework for Fuller Capital Account Convertibility. The Committee consists of the following:

i)	Shri S.S. Tarapore	Chairman
ii)	Dr. Surjit S. Bhalla	Member
iii)	Shri M.G. Bhide	Member
iv)	Dr. R.H. Patil	Member
v)	Shri A.V. Rajwade	Member
vi)	Dr. Ajit Ranade	Member

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

(i) To review the experience of various measures of capital account liberalisation in India,

(ii) To examine implications of fuller capital account convertibility on monetary and exchange rate management, financial markets and financial system,

(iii) To study the implications of dollarisation in India, of domestic assets and liabilities and internationalisation of the Indian rupee,

(iv) To provide a comprehensive medium-term operational framework, with sequencing and timing, for fuller capital account convertibility taking into account the above implications and progress in revenue and fiscal deficit of both centre and states,

(v) To survey regulatory framework in countries which have advanced towards fuller capital account convertibility,

(vi) To suggest appropriate policy measures and prudential safeguards to ensure monetary and financial stability, and

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

3. Technical work is being initiated in the Reserve Bank of India. The Committee will commence its work from May 1, 2006 and it is expected to submit its report by July 31, 2006.

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

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

Sd/-
(Y.V. Reddy)
Governor
March 20, 2006

Annex – IB

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

List of Organisations

1. Associated Chambers of Commerce and Industry of India (ASSOCHAM)
2. Bombay Chamber of Commerce and Industry
3. Foreign Exchange Dealers' Association of India (FEDAI)
4. HDFC Bank Ltd.
5. Indian Merchants' Chamber
6. Indian Association of Corporate CFOs & Treasurers
7. J.P. Morgan Chase Bank
8. Primary Dealers' Association of India (PDAI)

List of Persons

Reserve Bank of India

Department of External Investments and Operations

1. E.T. Rajendran
2. R.K. Misra
3. Dimple Bhandia
4. G.R. Kotian
5. Anand Prakash
6. J.G. Annunciation
7. A. Gowthaman
8. K. Surendran
9. Thangam Parmeshwaran

Department of Economic Analysis and Policy

10. D.Bose
11. Rekha Misra
12. Deepa Raj
13. Bhupal Singh
14. S.C. Dhal
15. Rajmal
16. Sangita Misra
17. Jaichander
18. Harendra Behera
19. Meena Ravichandran

Foreign Exchange Department

20. A.K. Salvi
21. Beena Abdurrahman
22. Shivaji Radhakrishnan
23. R.H. Parkar

Others

1. Dr. S.S. Nayak
2. Dr. Sitharam Gurumurthi

ANNEX II A

Real GDP Growth (per cent)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Argentina	-2.8	5.5	8.1	3.9	-3.4	-0.8	-4.4	-10.9	8.8	9.0	9.2
Brazil	4.2	2.7	3.3	0.1	0.8	4.4	1.3	1.9	0.5	4.9	2.3
China	10.5	9.6	8.8	7.8	7.1	8.4	8.3	9.1	10.0	10.1	9.9
India	7.6	7.5	5.0	6.0	7.0	5.3	4.1	4.2	7.2	8.1	8.3
Indonesia	8.2	8.0	4.5	-13.1	0.8	5.4	3.8	4.4	4.7	5.1	5.6
Korea	8.9	7.0	4.7	-6.9	9.5	8.5	3.8	7.0	3.1	4.6	4.0
Malaysia	9.8	10.0	7.3	-7.4	6.1	8.9	0.3	4.4	5.4	7.1	5.3
Mexico	-6.2	5.2	6.8	5.0	3.8	6.6	-0.2	0.8	1.4	4.2	3.0
Philippines	4.7	5.8	5.2	-0.6	3.4	6.0	1.8	4.4	4.5	6.0	5.1
Thailand	9.2	5.9	-1.4	-10.5	4.4	4.8	2.2	5.3	7.0	6.2	4.4
Turkey	6.9	6.9	7.6	3.1	-4.7	7.4	-7.5	7.9	5.8	8.9	7.4
Russia	-4.2	-1.0	1.8	-5.3	6.3	10.0	5.1	4.7	7.3	7.2	6.4

Source: World Economic Outlook

ANNEX II B

Investment/GDP (per cent)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Argentina	17.9	18.1	19.4	19.9	18.0	16.2	14.2	12.0	15.1	19.1
Brazil	20.5	19.1	19.5	19.6	19.1	21.8	19.5	18.3	17.8	19.6
China	33.4	32.8	31.9	32.7	32.9	32.9	33.6	34.8	37.7	38.4
India	24.4	22.8	21.7	21.5	21.8	22.0	22.0	22.2	22.7	23.7
Indonesia	28.4	29.6	28.3	25.4	20.1	19.9	19.2	19.0	18.9	21.0
Korea, Rep.	37.3	37.5	35.6	30.3	29.7	31.1	29.5	29.1	29.9	29.5
Malaysia	43.6	41.5	43.1	26.8	21.9	25.6	24.9	23.1	22.0	20.4
Mexico	16.1	17.8	19.5	20.9	21.2	21.4	20.0	19.2	18.9	20.2
Philippines	22.2	23.4	24.4	21.1	19.1	21.2	17.7	17.5	17.0	16.8
Russia	21.1	20.0	18.3	16.2	14.4	16.9	18.9	17.9	18.2	17.9
Turkey	23.8	25.1	26.4	24.6	21.9	22.4	18.2	16.6	15.5	17.8
Thailand	41.1	41.1	33.8	22.4	20.8	22.0	23.0	22.8	24.0	25.9

Source: World Bank Online Database

ANNEX II C

Inflation, CPI (per cent)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Argentina	3.4	0.2	0.5	0.9	-1.2	-0.9	-1.1	25.9	13.4	4.4	9.6
Brazil	66.0	15.8	6.9	3.2	4.9	7.1	6.8	8.4	14.8	6.6	6.9
China	17.1	8.3	2.8	-0.8	-1.4	0.4	0.7	-0.8	1.2	3.9	1.8
India	10.2	9.0	7.2	13.2	4.7	4.0	3.8	4.3	3.8	3.8	4.2
Indonesia	9.4	7.9	6.2	58.0	20.7	3.8	11.5	11.8	6.8	6.1	10.5
Korea, Rep.	4.5	4.9	4.4	7.5	0.8	2.3	4.1	2.7	3.6	3.6	NA
Malaysia	3.5	3.5	2.7	5.1	2.8	1.6	1.4	1.8	1.1	1.4	3.0
Mexico	35.0	34.4	20.6	15.9	16.6	9.5	6.4	5.0	4.5	4.7	4.0
Philippines	8.0	9.0	5.9	9.7	6.7	4.3	6.1	2.9	3.5	6.0	7.6
Russia	198.0	47.7	14.8	27.7	85.7	20.8	21.5	15.8	13.7	10.9	12.6
Turkey	93.6	82.3	85.0	83.6	63.5	54.3	53.9	44.8	25.2	8.6	8.2
Thailand	6.3	5.9	5.6	8.1	0.3	1.6	1.7	0.6	1.8	2.8	4.5

Source: World Economic Outlook and World Bank Online Database

ANNEX II D

Current account balance (% of GDP)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Argentina	-2.0	-2.5	-4.2	-4.9	-4.2	-3.2	-1.2	8.5	5.9	2.2
Brazil	-2.6	-3.0	-3.8	-4.3	-4.7	-4.0	-4.6	-1.7	0.8	1.9
China	0.2	0.8	3.9	3.1	1.9	1.7	1.3	2.4	2.8	3.6
India	-1.6	-1.5	-0.7	-1.7	-0.7	-1.0	0.3	1.4	1.1	1.7
Indonesia	-3.2	-3.4	-2.3	4.3	4.1	4.8	4.2	3.9	3.5	1.2
Korea, Rep.	-1.7	-4.2	-1.6	11.7	5.5	2.4	1.7	1.0	2.0	4.1
Malaysia	-9.7	-4.4	-5.9	13.2	15.9	9.4	8.3	7.5	12.9	NA
Mexico	-0.5	-0.8	-1.9	-3.8	-2.9	-3.2	-2.8	-2.1	-1.3	-1.1
Philippines	-2.7	-4.8	-5.3	2.4	9.5	8.2	1.8	5.7	1.8	2.5
Russia	1.8	2.8	0.0	0.1	12.6	18.0	11.0	8.4	8.2	10.3
Turkey	-1.4	-1.3	-1.4	1.0	-0.7	-4.9	2.3	-0.8	-3.3	-5.1
Thailand	-8.1	-8.1	-2.0	12.7	10.2	7.6	5.4	5.5	5.6	4.1

Source: World Bank Online Database NA: Not available

ANNEX II E

Current receipts to GDP (per cent)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Argentina	11.7	12.4	12.8	12.8	12.3	13.9	14.1	32.1	29.4	28.9
Brazil	8.5	7.9	8.3	8.3	11.4	11.6	14.3	16.5	17.8	19.2
China	22.0	22.1	24.2	22.8	23.5	27.7	26.7	29.7	35.3	36.2
India	13.1	13.9	14.4	13.7	14.5	16.3	16.8	17.9	18.5	22.0
Indonesia	27.3	25.9	30.7	61.0	42.6	45.4	40.4	34.7	30.5	37.0
Korea	30.0	28.9	33.7	48.4	40.8	42.9	40.2	37.7	40.3	46.6
Malaysia	97.4	94.9	96.4	118.6	124.9	127.4	119.1	116.6	117.9	125.1
Mexico	33.9	34.7	32.8	33.3	33.1	33.2	29.9	29.0	30.6	32.8
Philippines	45.9	49.2	60.4	67.8	62.6	65.4	59.1	59.8	64.4	65.3
Russia	31.3	27.6	26.1	33.8	45.8	46.3	39.4	37.0	38.4	37.2
Turkey	27.4	27.7	30.4	31.2	28.8	29.8	38.8	32.6	30.7	31.5
Thailand	44.8	42.3	51.4	62.6	61.4	70.8	70.0	67.6	68.7	74.0

Source: International Financial Statistics

ANNEX II F

Reserves* (US $ Billion)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Argentina	14.3	18.1	22.3	24.8	26.3	25.1	14.6	10.5	14.2	18.9	27.2
Brazil	49.7	58.3	50.8	42.6	34.8	32.5	35.7	37.7	49.1	52.7	53.6
China	75.4	107.0	142.8	149.2	157.7	168.3	215.6	291.1	408.2	614.5	821.5
India	17.9	20.2	24.7	27.3	32.7	37.9	45.9	67.7	98.9	126.6	131.9
Indonesia	13.7	18.3	16.6	22.7	26.4	28.5	27.2	31.0	35.0	35.0	33.0
Korea	32.7	34.0	20.4	52.0	74.0	96.1	102.8	121.3	155.3	199.0	210.3
Malaysia	23.8	27.0	20.8	25.6	30.6	29.5	30.5	34.2	44.5	66.4	70.2
Mexico	16.8	19.4	28.8	31.8	31.8	35.5	44.7	50.6	59.0	64.1	74.1
Philippines	6.4	10.1	7.3	9.3	13.3	13.1	13.5	13.3	13.7	13.1	15.9
Thailand	36.0	37.7	26.2	28.8	34.1	32.0	32.4	38.0	41.1	48.7	50.7
Turkey	12.4	16.4	18.7	19.5	23.3	22.5	18.9	27.1	34.0	35.7	50.6
Russia	14.4	11.3	12.9	7.8	8.5	24.3	32.5	44.1	73.2	120.8	175.9

*Total Reserves minus Gold.

Source: International Financial Statistics

ANNEX II G

Reserves */Imports (Months)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Argentina	9.1	9.7	9.4	10.1	13.1	12.6	9.1	14.9	12.9	10.6	11.4
Brazil	12.0	13.1	10.2	8.8	8.5	7.0	7.7	9.6	12.2	10.1	8.7
China	8.2	9.8	12.6	13.1	11.9	9.4	11.1	12.4	12.4	13.8	14.9
India	5.1	5.0	5.9	6.6	7.8	7.6	9.7	13.4	15.7	14.3	10.6
Indonesia	4.0	5.0	4.3	8.5	10.4	8.5	9.4	10.4	10.6	8.3	10.2
Korea	3.0	2.8	1.7	6.9	7.6	7.2	8.9	9.8	10.6	10.9	9.7
Malaysia	4.0	4.4	3.4	5.6	6.0	4.6	5.3	5.5	6.7	8.0	7.4
Mexico	2.8	2.6	3.1	3.0	2.7	2.4	3.2	3.6	4.1	3.9	4.0
Philippines	2.9	3.8	2.4	3.8	5.4	4.7	5.1	4.7	4.0	3.5	4.1
Thailand	6.8	7.1	5.7	9.5	9.6	6.8	7.1	8.0	7.4	6.9	5.7
Turkey	4.3	4.7	4.7	5.2	7.2	5.1	5.9	6.9	6.3	4.7	NA
Russia	2.8	2.0	2.1	1.6	2.6	6.5	7.3	8.7	11.5	14.9	16.8

*Total Reserves minus Gold NA: Not available

Source: International Financial Statistics

ANNEX II H

Exchange Rates {App. (+)/Dep. (-)} (Period Average)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Argentina #	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-67.4	5.6	-0.8	0.7
Brazil *	0.9	1.0	1.1	1.2	1.8	1.8	2.4	2.9	3.1	2.9	2.4
China #	3.2	0.4	0.3	0.1	0.0	0.0	0.0	0.0	0.0	0.0	1.0
India @	-3.3	-8.5	-2.4	-12.0	-4.2	-4.2	-4.8	-2.9	4.4	2.8	2.8
Indonesia @	-3.9	-4.0	-19.5	-70.9	27.5	-6.7	-17.9	10.2	8.6	-4.0	-7.9
Korea @	4.2	-4.1	-15.4	-32.1	17.9	5.1	-12.4	3.2	5.0	4.0	11.8
Malaysia #	4.6	-0.5	-10.6	-28.3	3.3	0.0	0.0	0.0	0.0	0.0	0.3
Mexico @	-47.3	-15.5	-4.0	-13.3	-4.4	1.1	1.2	-3.2	-10.5	-4.4	3.6
Philippines @	2.7	-1.9	-11.0	-27.9	4.6	-11.5	-13.3	-1.2	-4.8	-3.3	1.7
Thailand #	0.9	-1.7	-19.2	-24.2	9.4	-5.7	-9.7	3.4	3.6	3.1	0.0
Turkey	-40.0	-37.5	-46.7	-42.3	-38.1	-33.3	-48.8	-18.5	0.7	4.9	6.7
Russia#	-52.0	-10.9	-11.4	-40.5	-60.6	-12.5	-3.6	-7.0	2.2	6.5	1.9

#: Official Rate; @: Market Rate *: Principal Rate

Source: International Financial Statistics, IMF.

ANNEX II I

Debt service ratio (per cent)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Argentina	30.2	39.4	49.8	57.4	75.3	70.7	42.0	16.5	37.8	28.5
Brazil	36.6	42.2	62.7	79.4	117.9	93.6	75.9	70.0	66.4	46.8
China	9.9	8.7	8.5	8.6	11.7	9.3	7.9	8.3	7.4	3.5
India	25.9	26.2	23.0	19.5	18.8	17.1	16.2	13.7	16.0	16.3
Indonesia	29.9	36.6	30.0	31.7	30.0	22.5	23.6	24.7	25.5	22.1
Malaysia	7.0	8.9	7.4	7.2	4.9	5.6	6.0	7.2	7.9	NA
Mexico	27.0	35.2	31.9	20.9	22.3	30.4	25.5	23.3	21.7	22.9
Philippines	16.1	13.4	9.3	10.9	13.6	14.3	22.5	22.4	20.3	20.9
Russia	6.3	6.8	6.7	12.0	13.7	9.9	14.3	11.2	11.7	9.8
Turkey	27.7	21.6	20.5	24.0	35.4	35.4	40.0	46.5	38.6	35.9
Thailand	11.6	12.6	15.5	18.4	21.8	16.3	25.4	23.2	15.6	10.6

Source: World Bank Online Database NA: Not available

ANNEX II J

Budgetary Balance/GDP (per cent)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Argentina	-0.6	-1.9	-1.5	-1.4	-2.9	-2.4	-3.3	-1.1	0.1	2.1
Brazil	NA	NA	NA	NA	NA	-3.6	-3.6	-4.6	-5.1	-2.7
China	-1.6	-1.3	-1.2	-1.6	-2.5	-3.1	-4.4	-2.9	-2.4	NA
India	-5.1	-4.9	-5.8	-6.5	-5.3	-5.6	-6.2	-5.9	-4.5	-4.0
Indonesia	2.2	1.2	-0.7	-2.9	-1.1	0.2	-2.4	-1.3	-1.7	-1.2
Korea	0.3	0.1	-1.7	-4.3	-3.3	1.3	0.6	2.3	2.8	2.0
Malaysia	0.8	0.7	2.4	-1.8	-3.2	-5.7	-5.5	-5.6	-5.3	-4.3
Mexico	-0.5	-0.2	-1.1	-1.4	-1.6	-1.3	-0.7	-1.8	-1.1	-1.0
Philippines	0.6	0.3	0.1	-2.6	-5.9	-1.1	-7.7	-11.1	-10.5	-9.8
Russian Federation	-4.9	-7.4	-6.4	-4.8	-1.2	2.4	3.1	1.7	2.4	4.9
Turkey	-4.1	-8.4	-8.5	-8.4	-13.0	-11.4	-19.6	-15.1	NA	NA
Thailand	3.2	0.9	-0.3	-2.8	-3.3	-2.2	-2.4	-1.4	0.4	0.3

Source : International Financial Statistics, IMF Article IV Documents NA: Not available

ANNEX K

	Year	Reserves	Reserves to Imports	Reserves to Imports and Debt Service Payments	Short-term Debt and Portfolio Stocks/ Reserves	NFA to Currency	Reserves to Broad Money
		($ million)	(in months)	(in months)	(per cent)	(per cent)	(percent)
Argentina	**1991**	6005	9.5	5.6	421.8	-117.7	30.0
	1992	9990	8.7	6.4	338.8	33.0	31.9
	1993	13791	10.6	7.7	517.3	78.2	30.3
	1994	14327	8.5	6.6	501.5	57.0	26.8
	1995	14288	9.1	6.2	745.8	22.5	30.7
	1996	18104	9.7	6.2	717.7	65.1	31.9
	1997	22320	9.4	5.7	690.3	102.2	28.9
	1998	24752	10.1	5.8	667.0	120.4	29.0
	1999	26252	13.1	6.3	588.7	109.4	29.5
	2000	25147	12.6	5.9	553.1	124.2	27.8
	2001	14553	9.1	5.0	468.6	-85.7	20.0
	2002	10489	14.9	9.1	478.0	-265.5	36.8
	2003	14153	12.9	6.3	561.1	-84.4	36.3
	2004	18884	10.6	6.7	523.8	10.1	41.8
	2005	27179	11.4	NA	NA	110.3	NA
Brazil	**1991**	8033	4.6	3.3	468.6	-1626.7	NA
	1992	22521	13.1	9.3	147.1	-1019.6	NA
	1993	30604	14.5	10.1	140.6	-1084.9	10.2
	1994	37070	13.4	9.0	126.7	183.0	19.0
	1995	49708	12.0	8.4	93.4	211.5	27.3
	1996	58323	13.1	8.9	88.6	222.7	31.3
	1997	50827	10.2	6.0	92.5	105.5	24.4
	1998	42580	8.8	4.7	98.9	-6.4	20.0
	1999	34796	8.5	3.5	115.3	-6.2	23.9
	2000	32488	7.0	3.2	124.2	66.0	21.7
	2001	35739	7.7	3.9	633.0	14.8	27.3
	2002	37684	9.6	4.5	579.9	-55.7	28.7
	2003	49111	12.2	5.5	577.0	21.1	38.1
	2004	52740	10.1	5.4	618.5	72.7	32.6
	2005	53574	8.7	NA	NA	167.9	23.1

	Year	Reserves	Reserves to Imports	Reserves to Imports and Debt Service Payments	Short-term Debt and Portfolio Stocks/ Reserves	NFA to Currency	Reserves to Broad Money
		($ million)	(in months)	(in months)	(per cent)	(per cent)	(percent)
Indonesia	**1991**	9258	4.5	3.1	221.2	184.9	18.2
	1992	10449	4.7	3.2	237.6	274.8	17.8
	1993	11263	4.8	3.2	219.4	213.4	NA
	1994	12133	4.5	3.1	234.1	141.4	NA
	1995	13708	4.0	2.9	281.6	162.1	15.2
	1996	18251	5.0	3.3	253.9	229.6	16.2
	1997	16587	4.3	3.0	267.3	212.3	14.5
	1998	22713	8.5	5.4	124.7	270.2	41.3
	1999	26445	10.4	6.6	104.0	199.0	33.5
	2000	28502	8.5	6.0	103.5	245.9	33.0
	2001	27246	9.4	6.5	162.0	300.2	34.1
	2002	30971	10.4	7.1	163.0	289.8	33.8
	2003	34962	10.6	7.2	196.4	269.0	32.6
	2004	34953	8.3	5.9	108.9	231.6	31.4
	2005	32989	10.2	NA	NA	254.5	NA
Korea	**1991**	13701	2.1	1.9	88.9	104.0	12.0
	1992	17121	2.6	2.3	93.1	143.0	13.9
	1993	20228	2.9	2.6	110.0	146.5	14.5
	1994	25639	3.1	2.8	103.2	155.0	15.5
	1995	32678	3.0	NA	NA	149.1	16.4
	1996	34037	2.8	2.7	NA	129.6	15.4
	1997	20368	1.7	1.6	NA	118.6	9.6
	1998	51975	6.9	6.5	NA	366.8	28.2
	1999	73987	7.6	7.3	NA	442.7	26.8
	2000	96131	7.2	7.0	NA	715.5	26.4
	2001	102753	8.9	8.5	NA	775.9	28.4
	2002	121345	9.8	9.3	NA	667.5	29.3
	2003	155284	10.6	10.1	NA	847.9	33.5
	2004	198997	10.9	10.4	NA	942.8	41.5
	2005	210317	9.7	NA	NA	NA	NA

	Year	Reserves	Reserves to Imports	Reserves to Imports and Debt Service Payments	Short-term Debt and Portfolio Stocks/ Reserves	NFA to Currency	Reserves to Broad Money
		($ million)	(in months)	(in months)	(per cent)	(per cent)	(percent)
Malaysia	**1991**	10886	3.9	3.6	143.0	200.4	33.4
	1992	17228	5.6	5.1	94.0	278.6	37.9
	1993	27249	7.6	6.8	74.2	410.5	47.9
	1994	25423	5.5	5	77.1	388.5	40.4
	1995	23774	4.0	3.7	NA	333.9	32.8
	1996	27009	4.4	4.0	NA	280.9	31.2
	1997	20788	3.4	3.1	NA	167.2	22.7
	1998	25559	5.6	5.1	NA	471.2	39.4
	1999	30588	6.0	5.5	NA	461.7	38.6
	2000	29523	4.6	4.2	NA	520.6	33.4
	2001	30474	5.3	4.8	80.9	546.5	33.7
	2002	34222	5.5	4.9	78.1	534.5	36.5
	2003	44515	6.7	6.0	NA	605.9	43.3
	2004	66384	8.0	7.4	NA	844.6	53.9
	2005	70172	7.4	NA	NA	805.6	NA
Mexico	**1991**	17726	4.3	3.3	176.4	-112.5	21.7
	1992	18942	3.7	2.7	178.1	-120.0	19.4
	1993	25110	4.6	3.4	198.3	-100.7	22.6
	1994	6278	0.9	0.8	914.3	-392.2	5.0
	1995	16847	2.8	2.1	329.1	-503.9	19.4
	1996	19433	2.6	1.8	220.8	-303.2	20.7
	1997	28798	3.1	2.3	130.5	-76.9	20.3
	1998	31799	3.0	2.5	116.5	-9.0	22.0
	1999	31782	2.7	2.2	103.9	46.6	19.4
	2000	35509	2.4	1.8	69.5	113.1	22.4
	2001	44741	3.2	2.5	413.5	183.9	24.8
	2002	50594	3.6	2.9	356.3	192.1	26.8
	2003	58956	4.1	3.3	374.6	165.7	32.6
	2004	64141	3.9	3.1	424.4	132.9	33.5
	2005	74054	4.0	NA	NA	151.1	NA

	Year	Reserves	Reserves to Imports	Reserves to Imports and Debt Service Payments	Short-term Debt and Portfolio Stocks/ Reserves	NFA to Currency	Reserves to Broad Money
		($ million)	(in months)	(in months)	(per cent)	(per cent)	(percent)
Philippines	**1991**	3246	3.2	2.5	217.9	-25.7	18.5
	1992	4403	3.6	2.8	164.1	46.7	23.0
	1993	4676	3.2	2.5	147.9	129.2	20.4
	1994	6017	3.4	2.8	138.2	131.6	20.6
	1995	6372	2.9	2.4	122.7	106.3	20.2
	1996	10058	3.8	3.2	113.9	57.1	25.2
	1997	7297	2.4	2.1	218.1	-34.1	17.1
	1998	9274	3.8	3.2	88.9	63.3	27.1
	1999	13270	5.4	4.5	51.2	127.4	30.8
	2000	13090	4.7	3.9	54.7	157.2	32.3
	2001	13476	5.1	3.9	206.7	169.4	37.4
	2002	13329	4.7	3.6	242.5	218.4	35.7
	2003	13655	4.0	3.2	293.0	240.3	37.8
	2004	13116	3.5	2.8	59.7	243.2	33.8
	2005	15928	4.1	NA	NA	322.7	NA
Russia	**1991**	NA	NA	NA	NA	NA	NA
	1992	NA	NA	NA	NA	NA	NA
	1993	5835	NA	NA	193.5	266.3	14.1
	1994	3980	0.9	0.9	357.7	172.2	6.7
	1995	14383	2.8	2.5	96.8	81.7	23.8
	1996	11276	2.0	1.8	201.4	43.9	16.2
	1997	12895	2.1	2.0	295.9	8.2	16.2
	1998	7801	1.6	1.4	700.5	-52.4	12.0
	1999	8457	2.6	2.0	327.1	36.8	21.0
	2000	24264	6.5	5.1	5.0	172.9	43.5
	2001	32542	7.3	5.5	21.0	187.2	44.4
	2002	44054	8.7	7.0	59.7	206.7	48.3
	2003	73175	11.5	9.2	64.7	182.8	56.7
	2004	120809	14.9	12.2	47.9	209.2	65.7
	2005	175891	16.8	NA	NA	244.4	68.9

	Year	Reserves	Reserves to Imports	Reserves to Imports and Debt Service Payments	Short-term Debt and Portfolio Stocks/ Reserves	NFA to Currency	Reserves to Broad Money
		($ million)	(in months)	(in months)	(per cent)	(per cent)	(percent)
Thailand	**1991**	17517	6.1	5.4	102.0	277.1	24.4
	1992	20359	6.7	5.8	99.5	249.2	24.4
	1993	24473	7.2	6.2	127.0	217.6	24.7
	1994	29332	7.3	6.3	145.2	61.1	26.1
	1995	35982	6.8	6	209.8	0.5	27.8
	1996	37731	7.1	6.2	217.9	-26.5	26.3
	1997	26180	5.7	4.7	245.4	-168.5	19.4
	1998	28825	9.5	7.0	196.4	21.6	25.7
	1999	34063	9.6	6.9	134.3	142.4	26.2
	2000	32016	6.8	5.5	127.1	253.2	25.2
	2001	32355	7.1	5.2	117.9	300.8	27.6
	2002	38046	8.0	6.0	106.2	340.3	31.0
	2003	41077	7.4	6.0	145.4	355.7	30.5
	2004	48664	6.9	6.0	NA	346.1	33.2
	2005	50691	5.7	NA	NA	380.8	NA
India	**1991**	3627	1.8	1.5	146.5	14.9	4.9
	1992	5757	3.0	2.3	76.8	17.5	5.3
	1993	10199	4.7	2.8	67.0	33.0	12.6
	1994	19699	7.2	5.8	39.1	62.7	15.0
	1995	17922	5.1	4.2	26.2	56.9	14.1
	1996	20170	5.0	4.3	68.6	61.1	14.1
	1997	24688	5.9	5.1	74.5	71.2	14.1
	1998	27341	6.6	5.8	67.4	76.3	14.6
	1999	32667	7.8	7.0	58.0	79.1	15.3
	2000	37902	7.6	7.0	56.4	92.1	15.8
	2001	45871	9.7	9.1	56.2	101.3	17.3
	2002	67666	13.4	11.9	45.9	129.5	22.3
	2003	98938	15.7	13.4	36.4	153.5	27.4
	2004	126593	14.3	13.7	34.4	166.9	29.0
	2005	131924	10.6	13.2	35.9	163.9	27.5

	Year	Reserves	Reserves to Imports	Reserves to Imports and Debt Service Payments	Short-term Debt and Portfolio Stocks/ Reserves	NFA to Currency	Reserves to Broad Money
		($ million)	(in months)	(in months)	(per cent)	(per cent)	(percent)
China	**1991**	43674.3	10.4	9.0	35.3	44.1	7.3
	1992	20620.4	3.8	3.4	98.2	30.7	17.8
	1993	22386.9	3.1	2.8	122.1	26.8	22.6
	1994	52914.1	6.7	6.0	71.8	61.1	9.4
	1995	75377	8.2	7.2	62.2	84.6	9.1
	1996	107039	9.8	8.7	49.7	108.7	8.2
	1997	142763	12.6	11.1	48.1	132.2	7.6
	1998	149188	13.1	11.5	34.8	122.9	8.3
	1999	157728	11.9	10.2	29.6	110.5	9.1
	2000	168278	9.4	8.4	30.4	106.4	9.6
	2001	215605	11.1	10.1	48.8	126.6	8.6
	2002	291128	12.4	11.2	44.4	134.5	7.6
	2003	408151	12.4	11.4	45.8	157.7	6.5
	2004	614500	13.8	13.2	42.6	220.3	5.0
	2005	821514	14.9	NA	NA	268.2	NA
Turkey	**1991**	5144	2.9	2.1	439.3	225.1	
	1992	6159	3.2	2.3	490.6	243.1	20.1
	1993	6272	2.5	2.0	682.4	243.2	12.5
	1994	7169	3.8	2.6	511.1	367.7	17.4
	1995	12442	4.3	3.2	357.1	471.5	24.7
	1996	16436	4.7	3.7	293.2	642.3	24.1
	1997	18658	4.7	3.8	272.9	711.7	25.9
	1998	19489	5.2	3.9	281.4	669.2	24.8
	1999	23346	7.2	4.9	363.8	734.7	23.9
	2000	22488	5.1	3.7	375.4	520.1	24.6
	2001	18879	5.9	3.7	273.5	689.9	21.6
	2002	27069	6.9	4.3	202.7	699.7	29.5

Year	Reserves	Reserves to Imports	Reserves to Imports and Debt Service Payments	Short-term Debt and Portfolio Stocks/ Reserves	NFA to Currency	Reserves to Broad Money
	($ million)	(in months)	(in months)	(per cent)	(per cent)	(percent)
2003	33991	6.3	4.4	245.9	522.8	32.1
2004	35669	4.7	3.4	363.6	421.1	26.3
2005	50579	NA	NA	NA	395.2	27.9

Notes:

Broad Money is measured by M3 in case of India and M2 for all other countries.
NA: Not Available
NFA: Net Foreign Exchange Assets.
Imports are given in c.i.f. basis.
Reserves exclude gold.
Portfolio Stock is calculated by adding up flow figures.

Sources:

International Financial Statistics, May 2006, IMF.
World Bank Online Database
Global Development Finance 2005

ANNEX II L

Cross-Country - Exports/GDP and FDI/GDP (Per cent)

		1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Argentina	Exports/GDP	9.6	10.4	10.5	10.4	9.8	10.9	11.5	27.7	25.0	25.3
	FDI/GDP	2.2	2.6	3.1	2.4	8.5	3.7	0.8	2.1	1.3	2.7
Brazil	Exports/GDP	7.7	7.1	7.5	7.3	10.3	10.7	13.2	15.5	16.4	18.0
	FDI/GDP	0.7	1.4	2.4	4.1	5.3	5.4	4.4	3.6	2.0	3.0
India	Exports/GDP	11.0	10.6	10.9	11.2	11.8	13.9	13.5	15.3	14.9	19.1
	FDI/GDP	0.6	0.6	0.9	0.6	0.5	0.8	1.1	1.1	0.8	0.8
Indonesia	Exports/GDP	26.3	25.8	27.9	53.0	35.5	41.0	38.2	32.0	30.7	30.9
	FDI/GDP	2.2	2.7	2.2	-0.3	-1.3	-2.8	-1.8	0.1	-0.3	0.4
Korea, Rep.	Exports/GDP	28.8	27.9	32.4	46.2	39.1	40.8	37.8	35.3	37.9	44.1
	FDI/GDP	0.3	0.4	0.6	1.6	2.1	1.8	0.7	0.4	0.6	1.2
Malaysia	Exports/GDP	94.1	91.6	93.3	115.7	121.3	124.4	116.4	114.6	113.4	121.2
	FDI/GDP	4.7	5.0	5.1	3.0	4.9	4.2	0.6	3.4	2.4	3.9
Mexico	Exports/GDP	30.4	32.1	30.3	30.7	30.7	31.0	27.5	26.8	27.8	30.1
	FDI/GDP	3.3	2.8	3.2	2.9	2.8	2.9	4.5	2.4	1.9	2.6
Philippines	Exports/GDP	36.4	40.5	49.0	52.2	51.5	55.4	48.6	49.7	50.5	51.5
	FDI/GDP	2.0	1.8	1.5	3.5	2.3	1.8	1.4	2.3	0.4	0.6
Russia	Exports/GDP	29.3	26.1	24.7	31.2	43.2	44.1	36.9	35.3	35.2	35.0
	FDI/GDP	0.5	0.7	1.2	1.0	1.7	1.0	0.9	1.0	1.8	2.1
Turkey	Exports/GDP	19.9	21.5	24.6	24.3	23.2	24.0	33.7	29.2	27.4	28.9
	FDI/GDP	0.5	0.4	0.4	0.5	0.4	0.5	2.2	0.6	0.7	0.9
Thailand	Exports/GDP	41.8	39.3	48.0	58.9	58.3	66.8	65.9	64.2	65.6	70.5
	FDI/GDP	1.2	1.3	2.6	6.5	5.0	2.7	3.4	0.8	1.4	0.9

Source: World Bank Online Database NA: Not available

ANNEX II M

India: Openness Indicators

	Trade Openness				Financial Openness		
	Trade as per cent of GDP	(Trade + Services) as per cent of GDP	Exports as per cent of GDP	(Exports + Services) as per cent of GDP	Capital Flows as per cent of GDP	Capital Flows(excluding NRI Deposits) as per cent of GDP	FDI as per cent of GDP
1993-94	18.0	21.7	8.3	11.9	17.9	11.9	0.3
1994-95	19.5	23.1	8.3	11.9	13.4	9.9	0.4
1995-96	21.5	25.7	9.1	13.4	12.5	10.1	0.6
1996-97	21.6	25.2	8.9	12.5	15.7	13.0	0.7
1997-98	21.2	25.5	8.7	13.0	16.8	13.4	0.9
1998-99	19.8	25.6	8.3	14.2	14.4	11.8	0.6
1999-00	20.6	26.6	8.3	14.4	15.6	12.7	0.5
2000-01	22.4	29.1	9.9	16.6	21.6	18.2	0.9
2001-02	21.1	27.6	9.4	15.8	16.3	12.1	1.3
2002-03	23.3	30.8	10.6	18.1	16.2	12.7	1.0
2003-04	24.3	31.6	11.0	18.3	22.4	18.3	0.7
2004-05	28.9	40.0	11.8	23.0	23.9	21.5	0.8
2005-06	32.7	45.2	13.1	25.6	31.9	27.8	1.0

Source: Handbook of Statistics of Indian Economy, 2004-05, RBI

Reserve Bank of India Bulletin (July 2006)

Annex III

EXTANT STATUS ON THE CAPITAL ACCOUNT

Position as on April 30, 2006

($ indicates US dollars)

Item	Position in 1997	Recommendations of 1997 Committee on Capital Account Convertibility			Present Position
		Phase I 1997-98	Phase II 1998-99	Phase III 1999-2000	
I. 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.	**Not implemented.**
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	**Implemented in part** Listed Indian companies are permitted to invest up to 25 % of their net worth in • overseas listed companies having at least 10 % stake in listed Indian companies and • in rated bonds/fixed income securities (Cir.No.66 dated 13.01.2003, Cir.No.97 dated 29.04.2003 & 104 dated 31.05.2003) Companies eligible to raise ADRs, GDRs and ECBs are permitted to open foreign currency accounts abroad and invest the proceeds in rated bonds/fixed income securities pending repatriation of proceeds. ECBs can also be retained overseas in bank accounts with debits permitted for purposes for which the loan was raised.

Source: Reserve Bank of India, Foreign Exchange Department

Item	Position in 1997	Recommendations of 1997 Committee on Capital Account Convertibility			Present Position
		Phase I 1997-98	Phase II 1998-99	Phase III 1999-2000	
3. Accessing capital markets abroad through GDRs & ADRs other forms of equity issues.	Permitted individually by Government. Approval under FERA given by RBI.	No approval to be taken from RBI/ Government. Reporting within 30 days from close of issue.	Same as Phase I.	Same as Phase I.	**Implemented** Companies eligible to issue equity in India and falling under the automatic route for FDI are allowed to access the ADR/GDR markets without approval from Govt/ RBI subject to reporting to RBI within 30 days from close of issue. GOI considers cases not permitted under the automatic route. (Para 4 of Sch.1 of No.FEMA 20 dated 03.05.2000)
4. External Commercial Borrowings (ECB).	ECB 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 –	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.	**Implemented in part** An overall limit is fixed annually for ECB in consultation with GOI. Automatic route ECB upto US$ 500 million per financial year can be availed by corporates under automatic route Approval route Cases falling outside the purview of automatic route are examined by the Empowered Committee of ECB on the merits of the case. End-use restrictions exist on ECB for • working capital, general corporate purpose and repayment of existing rupee loans • Utilisation of ECB proceeds for on-lending or investment in capital market or acquiring a company (or a part thereof) in India by a corporate. • Utilisation of ECB proceeds for investment in real estate (Cir.No.60 dated 31.01.2004 & Cir.No.5 dated 01.08.2005) Trade Credit

Item	Position in 1997	Recommendations of 1997 Committee on Capital Account Convertibility			Present Position
		Phase I 1997-98	Phase II 1998-99	Phase III 1999-2000	
	approved by RBI within sub-ceiling fixed by Government. (iv) All other loans are approved by Government (generally for financing requirements of infrastructure projects, export oriented units, etc.).				Import linked short term loans (Trade Credit) upto US$ 20 million per transaction for all permissible imports with a maturity period less than 1 year is allowed. Trade credit upto US$ 20 million per import transaction with maturity between 1 – 3 years is allowed for import of capital goods.
5. Foreign Currency Convertible Bonds/ Floating Rate Notes.	Permitted individually by Government within overall ECB ceiling.	To be within ECB ceiling with same procedure viz. queuing vide item 4.	Same as Phase I	Same as Phase I	**Implemented** FCCB are permitted subject to the same terms and conditions as ECBs. (Cir.No. 60 dated 31.01.2004)
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 to 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 repatriation of loan/interest.	**Not Implemented**
7. Joint ventures/wholly owned subsidiaries abroad.	Proposals for investments up to US$ 4 million are cleared by the RBI.	Direct investments abroad to be allowed for ventures up to $ 50 million by ADs	Same as Phase I	Same as Phase I	**Implemented** Proposals for investment overseas by Indian companies/registered partnership firms upto 200% of their networth as per the last audited balance

Item	Position in 1997	Recommendations of 1997 Committee on Capital Account Convertibility			Present Position
		Phase I 1997-98	Phase II 1998-99	Phase III 1999-2000	
	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 US$ 15 million without the specific approval of RBI.	subject to transparent guidelines to be laid out 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.			sheet, in any bonafide business activity are permitted by ADs irrespective of the export/exchange earnings of the entity concerned. (Cir.No.42 dated 12.05.2005) The condition regarding dividend neutralisation has been dispensed with.
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 as Phase I	**Implemented in part** • Powers have been delegated to ADs/Exim Bank to approve Project/Service export proposals up to contract value of US$ 100 mn. • Contracts of value more than US$ 100 mn are approved by the Working Group. ADs/Exim Bank have also been delegated powers to

Item	Position in 1997	Recommendations of 1997 Committee on Capital Account Convertibility			Present Position
		Phase I 1997-98	Phase II 1998-99	Phase III 1999-2000	
					approve various facilities such as initial remittance, overseas borrowing to meet temporary mismatch in cash flow, inter-project transfer etc. (Cir.No.32 dated 28.10.2003) Project/service exporters are required to furnish half-yearly progress report to the concerned R.O. • Inter-project transfer of funds need prior approval of RBI • Temporary surplus can be brought into India with prior permission of RBI
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 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.	Any corporate entity may open offices abroad without the need for prior approval from RBI. Capital expenditure towards opening of the offices and current expenditure for maintenance could be subject to overall value limits to be allowed by ADs.	Same as Phase I	Same as Phase I	**Implemented** No prior approval of RBI is required for opening offices abroad. AD banks have been permitted to allow remittance upto 10% for initial and upto 5% for recurring expenses of the average annual sales/income or turnover during last two accounting years (Cir.No. 32 dated 21.04.2006) • RBI permits remittance of higher percentage based on the merits of the case. • Permission to acquire property for the Branch office is accorded by RBI (Cir.No. 71 dated 13.01.2003)
10. EEFC accounts for exporters and exchange	50% for EOUs and 25% for others –	100% of earnings for all exporters/ exchange	Same as Phase I	Same as Phase I with additional	**Implemented in part** Amounts that are permitted to be credited by entities

Item	Position in 1997	Recommendations of 1997 Committee on Capital Account Convertibility			Present Position
		Phase I 1997-98	Phase II 1998-99	Phase III 1999-2000	
earners	restrictions on use of funds for current account and permitted capital account transactions.	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.		provision that EEFC accounts can be held with banks outside India at the option of the exporter and the exchange earners.	with EEFC accounts are as follows: 1. Status holder Exporter (as defined by Foreign Trade Policy in force) - 100%. 2. A resident in India for professional services rendered in his individual capacity - 100%. 3. 100 percent EOU/units in EPZs/STP/EHPT - 100%. 4. Any other person resident in India - 50% (Cir.No. 96 dated 15.06.2004). EEFC a/cs. can be opened with banks in India. Cheque writing facility is allowed. Use of funds is allowed for permitted current and capital account transactions (Sch. to No.FEMA 10)
Additional measures announced by the RBI					
Direct investment abroad by partnership firms					Partnership firms registered under the Indian Partnership Act, 1932 and having a good track record were first permitted to make direct investments outside India in any bonafide activity upto US$ 10 million or 100% of their net worth under the automatic route. Subsequently the monetary ceiling was removed and investment was permitted upto 100% of their networth which was enhanced upto 200% of their networth as is permitted to corporates. A.P. (DIR Series) Cir.Nos. 41 dated December 06.12.2003, 57 dated 13.01.2004 & 42 dated 12.05. 2005
Investment in agriculture overseas by resident corporates and registered partnership firms other than through JV/WOS abroad					Resident corporates and registered partnership firms are allowed to undertake agricultural activities including purchasing of land incidental to this activity either directly or through their overseas office (i.e. other than through JV/WOS) within the overall limit available for investment under the

Item	Position in 1997	Recommendations of 1997 Committee on Capital Account Convertibility			Present Position
		Phase I 1997-98	Phase II 1998-99	Phase III 1999-2000	
					automatic route. A.P. (DIR Series) Cir. No. 57 dated 13.01.2004
Direct investment overseas by proprietorship/unregistered partnership concerns					RBI will consider applications from proprietorship/unregistered partnership concerns which satisfy eligibility criteria as stated in the circular. A.P. (DIR Series) Cir. No. 29 dated 27.03.2006
Disinvestment from JV/WOS overseas					General permission for disinvestment has been given to Indian Parties (i) in cases where the JV/WOS is listed in the overseas stock exchange, (ii) where the Indian promoter is listed on a stock exchange in India and has a networth of not less than Rs.100 crore (iii) where the Indian promoter is an unlisted company and the investment in the overseas venture does not exceed $ 10 million. Reporting requirements are there A.P. (DIR Series) Cir. No. 29 dated 27.03. 2006
Foreign Currency Accounts for Units in SEZs					Units located in a Special Economic Zone have been allowed to open, hold and maintain a Foreign Currency Account with an authorised dealer in India subject to certain conditions. A.P. (DIR Series) Circular No.28 dated 03.10.2002
Rupee loans to NRI employees					A body corporate registered or incorporated in India, has been permitted to grant rupee loans to its employees who are Non-Resident Indians or Persons of Indian Origin, subject to certain conditions. A.P.(DIR Series) Cir.No.27 dated 10.10.2003

Item	Position in 1997	Recommendations of 1997 Committee on Capital Account Convertibility			Present Position
		Phase I 1997-98	**Phase II 1998-99**	**Phase III 1999-2000**	
Prepayment of ECB					Prepayment of ECB upto US$ 200 million may be allowed by ADs without prior approval of RBI subject to compliance with the minimum average maturity period as applicable to the loan A.P.(DIR Series) Cir. No.5 dated 01.08.2005
Conversion of ECB and Lumpsum Fee/Royalty into equity					Capitalisation of Lumpsum Fee/Royalty/ECB has been permitted subject to certain conditions A.P.(DIR Series) Cir.No. 34 dated 14.11.2003 and 15 dated 01.10.2004.
Foreign Currency Loans to employees of branches outside India					General permission has been given to Indian companies to grant loans in foreign currency to the employees of their branches outside India for personal purposes in accordance with the lenders Staff Welfare Scheme/Loan Rules A.P.(DIR Series) Cir. No.74 dated 20.02.2004
B. Corporates - Non Residents (including OCBs)					
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.	**Implemented** No RBI approval is required GOI have permitted FDI under the Automatic Route in items/activities in all sectors up to the sectoral caps except in certain sectors where investment is prohibited. Investments not permitted under the automatic route require approval from FIPB. The receipt of remittance has to be reported to RBI within 30 days from the date of receipt of funds and the issue of shares has to be reported to RBI within 30 days from the date of issue by the investee

Item	Position in 1997	Recommendations of 1997 Committee on Capital Account Convertibility			Present Position
		Phase I 1997-98	Phase II 1998-99	Phase III 1999-2000	
					company. (Sch 1 of No.FEMA 20) * *OCBs have been de-recognised as a class of investor for FDI* (Cir.No. 14 dated 16.09.2003)
2. Portfolio Investment in India through stock exchanges in shares/debentures.	Allowed within the 24% limit (can be increased to 30% 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% by individual NRIs/OCBs and 10% 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	**Implemented in part** No RBI approval is required for registration of FIIs. Investments by non residents is permitted under the portfolio Investment scheme to entities registered as FIIs and their sub accounts under SEBI(FII) regulations and is subject to ceilings indicated therein. The transactions are subject to daily reporting by designated ADs to RBI. (Sch II of No.FEMA 20, Cir 53 dated 17.12.2003) • *OCBs have been banned from investing under PIS* (Cir.No.13 dated 29.11.2001)
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	**Implemented in part** RBI approval for transfer of shares from non-residents to residents has been dispensed with in cases where shares are sold on stock exchange or in case of sale under private arrangements, where it complies with the pricing guidelines. (Cir.No.16 dated 04.10.2004)

Item	Position in 1997	Recommendations of 1997 Committee on Capital Account Convertibility			Present Position
		Phase I 1997-98	Phase II 1998-99	Phase III 1999-2000	
Additional relaxations permitted by RBI					
Multilateral institutions permitted to raise resources in India					Multilateral institutions like IFC have been allowed to raise resources in India by way of issue of Rupee Bonds with prior approval
Establishment of project offices in India					ADs have been delegated powers to permit foreign companies to establish project offices in India subject to certain conditions. Banks have been allowed to remit surplus on winding up/ completion of the project. A.P.(DIR Series) Cir.No.37 dated 15.11.2003
Establishment of branch offices/units in SEZ					General Permission has been given to foreign companies to set up branch offices/units in SEZ subject to certain conditions A.P.(DIR Series) Cir.No.58 dated 16.01.2004
V. BANKS **A. <u>Banks - Residents</u>**					
1. Loans and borrowings from overseas banks and correspondents including overdrafts in nostro account.	ADs are permitted to borrow up to US$ 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.	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.	**Implemented in part** The limit was raised from US$ 10 Mio to 15% of unimpaired Tier-I capital or US$ 10 Mio whichever is higher in October 1997(circular ADMA No 42) and was later revised to 25% of the unimpaired Tier I capital as at the close of the previous quarter or US$ 10 mio (or its equivalent), whichever is higher in March 2004. Within this limit, there is no further restriction regarding short-term borrowings. • Overseas borrowings by ADs for the purpose of financing export credit is excluded from the limit.

Item	Position in 1997	Recommendations of 1997 Committee on Capital Account Convertibility			Present Position
		Phase I 1997-98	**Phase II 1998-99**	**Phase III 1999-2000**	
		(ii) No restrictions on use of funds and repayment. Prudential norms regarding open position and gap limits to continue.			• Subordinated debt placed by head offices of foreign banks with their branches in India as Tier-II capital is also excluded from the limit. (Cir.No. 81 dated 24.03.2004)
2. Investments in overseas markets	Banks allowed to invest in overseas money market up to $ 10 million.	Investments may be in overseas money markets, mutual funds and foreign securities. To be allowed subject only to (i) requirements of Section 25 of BR Act 1949* (ii) open position/ gap limits.	Same as Phase I	Same as Phase I	**Implemented in part** Authorised Dealers are allowed to undertake investments in overseas markets up to the limits approved by their Board of Directors within a ceiling in terms of section 25 of BR Act 1949. Such investments may be made in overseas money market instruments and/or debt instruments issued by a foreign state with a residual maturity of less than one year and rated at least as AA (-) by Standard & Poor/ FITCH IBCA or Aa3 by Moody's. (Cir.Nos.63 dated 21.12.2002 & 90 dated 29.03.2003) Authorised Dealers are also allowed to invest the undeployed FCNR(B) funds in overseas markets in long-term fixed income securities subject to the condition that the maturity of the securities invested in do not exceed the maturity of the underlying FCNR(B) deposits. (Cir.No.40 dated 29.04.2002 & 38 dated 02.11.2002)
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	**Implemented in part** In terms of DBOD guidelines, banks are allowed to extend fund based/non fund based credit facilities to Joint Ventures (JVs) and Wholly owned subsidiaries (WOS) abroad by Indian entities upto 10 percent of the banks unimpaired capital.

Item	Position in 1997	Recommendations of 1997 Committee on Capital Account Convertibility			Present Position
		Phase I 1997-98	Phase II 1998-99	Phase III 1999-2000	
					(Cir.No. DBOD.IBS.BC 94 dated 08.04.2003)
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	**Implemented in part** Banks in India are permitted to provide at their discretion Buyer's Credit/Acceptance Finance to overseas parties for facilitating export of goods and services from India, on "Without Recourse" basis and with prior approval of RBI.
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	**Not Implemented**
*__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.					
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	**Implemented** All ADs are permitted to undertake forfaiting transactions. (ADMA No.42 dated 27.10.1997)
Additional relaxations permitted by RBI					
Lending to non-residents					Banks have been allowed to grant rupee loans to NRIs as per the loan policy laid down by the bank's Board of Directors, barring certain specific purposes. Repayment of the loan may be made by

Item	Position in 1997	Recommendations of 1997 Committee on Capital Account Convertibility			Present Position
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					debit to NRE/FCNR/NRO accounts of the non-resident borrowers or out of inward remittances by the borrowers. The quantum of loan, rate of interest, margins etc. on such loans to be decided by the Banks based on relevant directives issued by the DBOD. AP DIR Circular No. 69 dated 12.02.2004 & Regulation 7 C of Notification No. FEMA. 4/ 2000-RB dated 03.05. 2000 .
Remittance of insurance premium					Banks have been permitted to freely allow remittances towards premium for general insurance policies taken by units located in SEZs from insurers outside India provided the premium is paid by the units out of their foreign exchange balances. (AP (DIR Series) Cir. No.47 dated 17.05.2002)
Offshore Banking Units					Banks have been allowed to open OBUs subject to certain conditions under FEMA and DBOD guidelines Notification No.FEMA 71 dated 07.09.2002 DBOD.IBS.BC. 42/23.13.004/2002-03 dated 11.11.2002
B. Banks - Non Residents					
1. Rupee Accounts of non resident banks	Used only for merchant based transactions – investments not allowed. Overdrafts	Forward cover to be allowed to the extent of balances. Cancelling/ rebooking to be allowed. The present	Same as Phase I	Non resident banks may be allowed to freely open rupee accounts with banks in India without any	**Implemented in part** Overdraft limit has been increased to Rs. 500 lakh. (Para B 8 of the Master Circular on risk management and inter-bank dealings) No investments are allowed.

Item	Position in 1997	Recommendations of 1997 Committee on Capital Account Convertibility			Present Position
		Phase I 1997-98	Phase II 1998-99	Phase III 1999-2000	
	allowed upto Rs.150 lakhs for normal business requirements for temporary periods.	overdraft limit could be increased and limited investments may be allowed in rupee accounts.		restrictions on their operations.	No forward cover is permitted.
III. NON BANKS - FINANCIAL **A. Non Banks – Financial – Residents**					
1. SEBI 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.	**Implemented** The aggregate ceiling on investment overseas by Mutual Funds has been raised to US$ 2 billion with an individual ceiling as decided by SEBI. Mutual Funds registered with SEBI, investing overseas do not need separate permission from foreign exchange angle. (Announced in the budget for FY 2006-07. Operational instructions are under issue)
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. (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.	(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 3 months.	(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 6 months.	**Not Implemented** Financial institutions cannot raise ECB under the automatic route.

Item	Position in 1997	Recommendations of 1997 Committee on Capital Account Convertibility			Present Position
		Phase I 1997-98	Phase II 1998-99	Phase III 1999-2000	
Additional relaxations permitted by RBI					
Insurance policies in foreign currency					Insurance companies registered with IRDA have been permitted to issue general insurance policies denominated in foreign currency and receive premium in foreign currency without prior approval of RBI. A.P.(DIR Series) Cir. Nos.8 dated 13.10.2001 &. 36 dated 02.04.2002.
A. 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 company) which includes portfolio investment by NRIs, FIIs and OCBs with a 10 per cent limit for individual FIIs and 1 per cent by individual NRIs/OCBs. FERA approval is given by RBI which is valid for a period of five years.	To be allowed without RBI prior approval. Designated ADs would be required to report to RBI.	Same as Phase I.	Same as Phase I.	**Implemented in full** No RBI approval is required

Item	Position in 1997	Recommendations of 1997 Committee on Capital Account Convertibility			Present Position
		Phase I 1997-98	Phase II 1998-99	Phase III 1999-2000	
(b) Primary market investment/private placement.	(b) Primary market offering/private placement allowed with RBI approval up to 15% of the new issue/capital.	(b) RBI approval not required. Designated ADs to report to the RBI.	Same as Phase I.	Same as Phase I.	**Implemented in full** The ceiling in I.B.2 is inclusive of primary market investments/private placements
(c) Disinvestment	(c) (i) Disi-nvestment through stock exchange allowed freely. (ii) Other routes of disinvestment require RBI approval.	(ii) RBI approval for disinvestment to be dispensed with.	Same as Phase I.	Same as Phase I.	**Implemented in part** RBI approval for transfer of shares from non-residents to residents has been dispensed with in cases where shares are sold on stock exchange or in case of sale under private arrangements, where it complies with the pricing guidelines. (Cir.No.16 dated 04.10.2004)
(d) Investments 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	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.	**Implemented** FII investments in debt is subject to a sub ceiling within the overall ECB ceiling as indicated below a) G-secs and T-bills – US$ 2.00 Billion b) Corporate debt – US$ 1.5 Billion. The ceilings for FII investment in dated Govt. securities and T-Bills was US$ 1.5 Billion. This was increased to US$ 1.75 billion in November 2004. As this ceiling was exclusive of limits for investment in corporate debt, a separate limit of US$ 0.5 Billion was prescribed for FII investment in

Item	Position in 1997	Recommendations of 1997 Committee on Capital Account Convertibility			Present Position
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	debt instruments. The Debt Funds of FIIs are also allowed to invest in corporate debt securities (NCD, 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 SEBI.				corporate debt. This ceiling has been revised to the limits indicated above. (Cir.No. IMD/FII/20/2006 dated 05.04.2006 issued by SEBI)
Additional relaxations permitted by RBI.					
Liaison Office of foreign insurance companies					Foreign Insurance Companies having approval of IRDA have been granted general permission to establish Liaison Offices in India. (A.P. (DIR Series) Cir. No. 39 dated 25.04.2005)
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	**Not Implemented**

Item	Position in 1997	Recommendations of 1997 Committee on Capital Account Convertibility			Present Position
		Phase I 1997-98	Phase II 1998-99	Phase III 1999-2000	
2. Financial capital transfers including for opening current/chequeable accounts.	Not permitted.	$ 25,000 per annum.	$ 50,000 per annum	$ 100,000 per annum.	**Implemented in part** Resident individuals have been permitted to freely remit upto US$ 25,000 per calendar year for any permissible. current or capital account transactions or a combination of both from February 2004. (Cir.No.64 dated 04.2.2004) They can invest, without limit, in overseas companies listed on a recognised stock exchange and which have the shareholding of at least 10 per cent in an Indian company listed on a recognised stock exchange in India (as on 1st January of the year of the investment) as well as in rated bonds/fixed income securities. (Cir.Nos.66 dated 13.01.2003, 97 dated 29.04.2003 104 dated 31.05.2003)
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.	**Implemented in part** Borrowings with a minimum maturity of one year upto US$ 250,000 permitted from close relatives on interest free basis. (Cir.No. 24 dated 27.09.2003) Indian students have been given the status of non-resident (in addition to being resident) and as a result they are free to borrow unlimited amount outside India (Cir.No.45 dated 08.12.2003)
Additional relaxations permitted by RBI					

Item	Position in 1997	Recommendations of 1997 Committee on Capital Account Convertibility			Present Position
		Phase I 1997-98	Phase II 1998-99	Phase III 1999-2000	
RFC (D) Account					A person resident in India has been permitted to open, hold and maintain with an AD in India a Foreign Currency Account to be known as Resident Foreign Currency (Domestic) Account, out of foreign exchange acquired in the form of currency notes, bank notes and travellers cheques from specified sources. The account has to be maintained in the form of current account and shall not bear any interest. Cheque facility is available. There will be no ceiling on the balances held in the account. (A.P. (DIR Series) Cir.No.37 dated 01.11. 2002)
Diplomatic Missions/ Personnel - immovable property					Foreign Embassy/Diplomat/ Consulate General have been allowed to purchase/sell immovable property in India other than agricultural land/plantation property/farm house provided (i) clearance from Government of India, Ministry of External Affairs is obtained for such purchase/sale, and (ii) the consideration for acquisition of immovable property in India is paid out of funds remitted from abroad through banking channel. (A.P. (DIR Series) Cir. No.19 dated 23.09.2003)
Employees Stock Options (ESOP)					ADs can allow remittance for acquiring shares of a foreign company offered under an ESOP scheme either directly by the issuing company or indirectly through a Trust/SPV/step down subsidiary to employees or directors of the Indian office or branch of a foreign company or of a subsidiary in India of a foreign company or of an Indian company in which the company issuing shares effectively holds directly or indirectly atleast a 51% stake. Foreign companies have been given general permission to repurchase the shares issued to residents in India under any

Item	Position in 1997	Recommendations of 1997 Committee on Capital Account Convertibility			Present Position
		Phase I 1997-98	Phase II 1998-99	Phase III 1999-2000	
					ESOP scheme. (A.P.(DIR Series) Cir.No.30 dated 05.04.2006)
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	**Implemented** Remittance, upto USD one million, per calendar year, out of balances held in NRO accounts/sale proceeds of assets/the assets in India acquired by way of inheritance is permitted. (Cir.Nos.67 dated 13.01.2003, 104 dated 31.05.2003 & 43 dated 13.05.2005) Repatriation of sale proceeds of a House bought out of domestic assets is repatriable after 10 years of acquisition.
2. Foreign Direct Investment (FDI) in India (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	**Implemented** No RBI approval is required Non-resident individuals are at par with non-resident corporate for the purposes of FDI. As per I.B.1
3. Portfolio Investment in India through stock exchange.	Allowed to NRIs within the 24 per cent ceiling (can be increased to 30 per cent at the option of	Allowed to all non-residents without RBI prior approval. Designated ADs would be required to report to	Same as Phase I.	Same as Phase I.	**Implemented in respect of NRIs** Individual NRIs can invest upto 5% of the total paid up capital (PUC) of the investee company or 5% of the total paid-up value of each series of the

Item	Position in 1997	Recommendations of 1997 Committee on Capital Account Convertibility			Present Position
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	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.	RBI.			convertible debentures of the company. The aggregate ceiling for NRI investments in a company is 10% of the PUC or 10% of the total paid-up value of the each series of debentures. This ceiling can be raised upto 24% of the PUC. NRIs can invest in Perpetual Debt Instruments issued by banks upto an aggregate ceiling of 24% of each issue and investments by individual NRIs can be up to 5% of each issue. NRIs can invest in Debt Capital Instruments (Tier II) of banks without limit. (Cir.No.24 dated 25.01.2006)
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	**Implemented** Sale of shares through private arrangement which is not in compliance with pricing guidelines requires approval of RBI. (Cir.No.16 dated 04.10.2004)
Additional Relaxation permitted by RBI					
Two way fungibility of ADRs/GDRs					A registered broker in India has been allowed to purchase shares of an Indian company on behalf of a

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					person resident outside India for purpose of converting the shares into ADRs/GDRs subject to compliance with provisions of the Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipt Mechanism) Scheme, 1993 and guidelines issued by the Central Government from time to time (AP (Dir series) Cir.No.21 dated 13.02.2002)
Housing loan to NRI that can be repaid by close relative in India					Close relatives of NRIs or PIOs can repay the loans taken by NRIs or PIOs for acquisition of a residential accommodation in India through their bank account directly to the borrower's loan account with the AD/Housing Finance Institution (A.P.(DIR Series) Cir.No.93 dated 25.05.2004)
Remittance of assets					ADs have been permitted to allow remittance/s upto US$ 1 million per calendar year on account of legacy, bequest or inheritance to a citizen of foreign state permanently resident outside India subject to conditions. (AP.(DIR Series) Cir.No.67 dated 13.01.2003)
V. FINANCIAL MARKETS					
1. Foreign Exchange Market (a) Forward contracts	(a) Forward contracts are allowed to be booked on the basis	(a) To allow all participants in the spot market to participate in the forward market;	(a) Same as Phase I	(a) Same as Phase I. No restrictions on participants in spot/forward	**Implemented in part** Underlying exposure is necessary for a person resident in India for entering into a forward contract.

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	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.	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.		markets i.e. participation allowed without any underlying exposure.	Importer/Exporter can book forward contracts on past performance basis. Economic exposure cannot be hedged. Forward contracts cannot be undertaken with non-resident banks. Offer of two-way quotes to non-resident banks is prohibited. ADs may enter into forward contracts with persons resident outside India to the extent of investment in equity/debt instruments. Persons resident outside India may enter into forward sale contracts of tenors not exceeding 6 months with ADs for their proposed investment in India. These forward contracts booked by non-residents once cancelled are not eligible to be rebooked. (Para A 1-11 of Master Circular on risk management & inter bank dealings)
(b) Authorised dealers	(b) Authorised dealers at present are only banks.	(b) All India Financial Institutions which comply with the regulatory/ prudential requirements and fulfil well defined criteria should be allowed to participate as full-fledged ADs in the forex market.	(b) Same as Phase I	(b) to allow select NBFCs to act as full fledged authorised dealers on basis of criteria similar to FIs.	**Not implemented**
(c) Products (Derivatives)	(c) Currently the only derivative in the rupee $ market	(c) All derivatives including rupee based derivatives to be	(c) Direct access to overseas markets by corporates for	(c) Same as Phase I & II.	**Implemented in part** Swaps and Options and rupee based derivatives are

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	is the forward contract. 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.	allowed. Futures in 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.		allowed for a person resident in India through ADs. Currency futures have not been introduced.
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	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	**Implemented in part** Deposit rates have been freed excepting prescription on saving deposits and ceiling on non-resident deposits. Lending rates have also been freed except for a ceiling of BPLR on loans below Rs. 2 lakh and LIBOR-linked ceiling on export credits. Union budget, 2006-07 has proposed that the farmer receives short-term credit at 7 per cent, with an upper limit of Rs.3 lakh on the principal amount. Following the recommendations of Narasimham Committee II, since 2001 RBI has moved towards making call/notice money market a pure inter-bank market and prudential limits have been placed on lending/borrowing in this market. Accordingly the non-banks (except PDs) have been completely

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	deposits specified.				phased out of call money market since August 6, 2005. Non-banks are free to participate in collateralized market repo and Collateralised Lending and Borrowing Obligations (CBLO) as per extant guidelines. Minimum period is reduced to seven days for term deposits, CDs and CPs.
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 market offering two-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	(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 increased 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.	**Implemented** FIIs permitted to invest in G-secs and T-bills upto US$ 2.00 Billion. FIIs can invest in equity and debt in the ratio of 70:30 and Debt Funds of FIIs can invest upto 100 per cent in debt instruments subject to above ceiling. Multilateral FIs like IFC, ADB which have been permitted by the GOI to float Rupee Bonds in India can purchase Govt. dated securities out of such resources. (Cir.No. 63 dated 03.02.2004) There is a fairly active treasury Bill market in place. T-bills as well as bond futures introduced in 2003, but have not encountered success. No activity at present. LAF has been provided to PDs. Dedicated gilt funds have been provided liquidity support, but rarely being used.

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		share of PDs in underwriting. Commission 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.			In accordance with the FRBM Act, RBI has withdrawn participation in primary issues of all government securities, effective April 1, 2006. The system of PDs is being strengthened. Currently there are 17 PDs and the SD system has been discontinued. RBI has recently issued guidelines for banks' undertaking PD business through which permitted structure of PD business would be expanded to include banks' which fulfill certain minimum eligibility criteria. (Cir.No. 64 dated 27.02.2006) A revised scheme of underwriting commitment and liquidity support for PDs has been put in place (Cir.No.347 dated 04.04.2006). With this, PDs are underwriting the issues fully through compulsory and optional portions in equal proportions and the commission is related to the underwriting commitments and the success rate. Settlement of government securities in RBI's books is through CCIL on DVP-III on a net basis. As a central counterparty, CCIL guarantees settlements and risk mitigation procedures have been put in place.
4. Gold	At present, there are restrictions on import of gold. There are only three channels through which import of gold is allowed through canalising	(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	Steps to be taken by Government and the RBI for developing a well regulated market in India for gold and gold derivatives including forward	Same as Phase I and II.	**Implemented in part** Four nominated agencies, which are all PSUs and certain scheduled banks that fulfill eligibility criteria defined for this purpose are permitted to import gold in their own name. Residents are allowed to access these entities for their gold import requirements without any quantitative restrictions.

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	agencies (ii) through returning NRIs and (iii) through special import licences.	banks and FIs included under (i) above to be freely allowed to all resident. (iii) Banks to be allowed to offer gold denominated deposits 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)	trading. Both residents and non residents to be allowed to operate in this market.		Under the Gold Deposit Scheme, 1999 certain banks are permitted to accept deposits in gold from residents. Nominated agencies and approved banks are permitted to offer gold loans to residents, for export as well as domestic sale of jewellery. Residents with exposure to gold are permitted to hedge the same by way of forward contracts in gold with approved banks in India. Resident banks can cover/hedge their exposure to gold in the derivative markets overseas. Residents are permitted by buy and sell futures contracts in gold in commodity exchanges in India, regardless of whether there is underlying exposure to gold or not. Securities and Exchange Board of India (SEBI), in consultation with RBI has permitted mutual funds in India to introduce Gold Exchange Traded Funds, with physical gold as the underlying.
5. Participation in international commodity markets.	Not allowed	To be allowed	Same as Phase I	Same as Phase I	**Implemented** Listed resident companies engaged in import and export trade, are allowed to hedge the price risk of commodities (except Gold and silver, petroleum and petroleum products) in the international commodity exchanges/markets through select commercial bank ADs. RBI can consider applications not covered under the delegated authority. (Cir.No.3 dated 23.07.2005)

Summary Status of Implementation by April 2006 of the 1997 CAC Recommendations

Sl. No.	Category	No. of items listed in recommendations	No. of items implemented			Items not implemented	Additional Measures by RBI
			Partly	Fully	Total		
1.	Corporates/Business - Residents	10	4	4	8	2	9
2.	Corporates - Non-Residents	3	2	1	3	0	3
3.	Banks - Residents	6	4	1	5	1	3
4.	Banks - Non-Residents	1	1	-	1	-	-
5.	Non-Banks - Financial Residents	2	-	1	1	1	1
6.	Non-Banks Non-Residents - FIIs	4	1	3	4	0	1
7.	Individuals - Residents	3	2	-	2	1	3
8.	Individuals - Non-Residents	4	1	3	4	0	3
9.	Financial Markets	7	4	2	6	1	-
	Total	**40**	**19**	**15**	**34**	**6**	**23**
	Of which						
	Residents	28	14	8	22	6	16
	Non-Residents	12	5	7	12	Nil	7