

## 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)**

<b>Features of Controls on Capital Transactions</b>	-	<b>Total no. of Countries with this feature</b>
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
 <b><u>Provisions specific to</u></b>		
(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