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.