Rupee Convertibility : Current and Capital Account Convertibility

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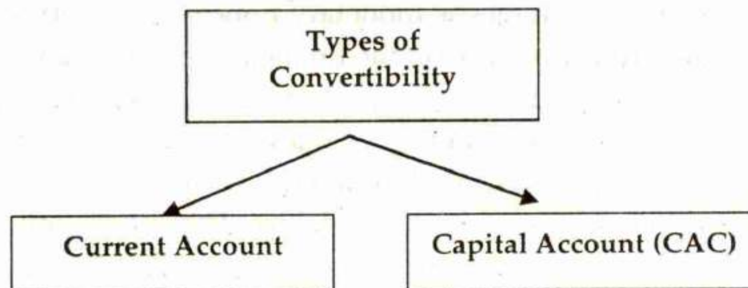
CONVERTIBILITY MEANING

Convertibility of a currency implies that a currency can be converted into another currency without any limitations or any control. A currency is said to be fully convertible, if any currency can be converted into some other currency at the prevailing rate of exchange. Now the issue is why we need to convert one currency in terms of another. This can be explained with the help of a simple example. If a person in India wants to purchase some commodity from the U.S. then he will have to pay the seller in US dollars. Thus, he needs to convert rupee in terms of US dollar.



CURRENT ACCOUNT CONVERTIBILITY -

Current account convertibility allows free inflows and outflows of currency i.e. to make and receive trade related payments.

After the announcement of economic liberalization in 1991, Government of India announced partial convertibility of rupee from

March 1st 1992 in order to integrate Indian economy with the rest of the globe. Under the partial convertibility, 40 % of the earnings were convertible in rupee at official determined rates of exchange by the RBI and the Government and the remaining 60 % of the exchange earnings were convertible e at market determined rates of exchange.

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Now, the government has made the rupee fully convertible on current account. Today, the exporters are allowed to convert their entire foreign exchange earnings on current account transactions at the market rate.

CAPITAL ACCOUNT CONVERTIBILITY -

Capital account includes transactions of financial assets. Its convertibility refers to the freedom to convert local financial assets into foreign assets in any form and vice versa at market-determined rates of exchange. But this allows huge outflow of capital and foreign reserves of a country so a lot of restrictions are placed on it. So every country imposes some capital controls on convertibility of its currency. It normally restricts or prohibits cross-border movement of capital. Thus, controls on capital movements include prohibitions: need for prior approval; authorization and notification; multiple currency practices; discriminatory taxes; and reserve requirements or interest penalties imposed by the authorities that regulate the conclusion or execution of transactions. The coverage of the regulations would apply to receipts as well as payments and to actions initiated by non-residents and residents.

The international experience with CAC shows that liberalization of the capital account induces large capital inflows that can cause appreciation in the exchange rate and erode the effectiveness of domestic monetary policies. Furthermore, an open capital account imposes tremendous pressure on the financial system and weakens the financial system. While it is necessary to recognize that these weaknesses could precipitate systematic hazards irrespective of whether or not CAC is introduced, the move to CAC would demand a strongly disciplined financial system and would warrant early rectification of infirmities in the system. There are distinct benefits of CAC, such as, availability of a larger capital stock at international prices to supplement domestic resources, risk diversification, allocate efficiency and improvement in intermediation of financial resources, development of financial markets and a disciplining influence on macro-economic policies.

India had already adopted current account convertibility in August,1994 by formally ratifying Article VIII of the Articles of Agreement of the (IMF). Furthermore, CAC is already instituted for foreign investors, both direct and portfolio, non-resident depositors and resident corporate houses and institutions.

Controls, however, continue to operate on the ability of resident individuals and corporate entities to send capital abroad as also on inflows and outflows of capital associated with banks and non-bank financial utilities.

To see whether India should allow full capital account convertibility, The Tarapore Committee was set up. Let's see the recommendations made by it.

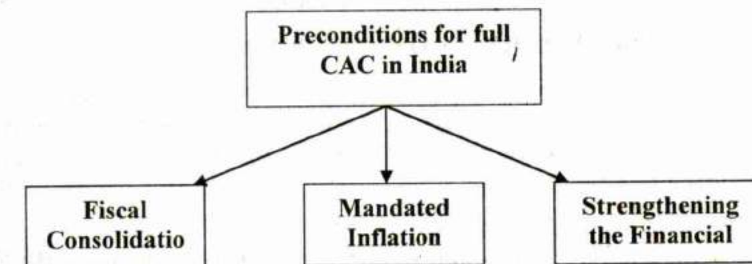
THE TARAPORE COMMITTEE REPORT -

Chaired by its former Deputy Governor, S.S. Tarapore, a Committee was appointed by the Reserve bank of India on February 28, 1997, in pursuance of the commitment made by the Finance Minister Shri P. Chidambaram in his Budget for 1997-98. The RBI had at that time indicated that the Committee will complete its work by May30,1997.

The terms of reference of the committee were to:

1. Review the international experience in relation to capital account convertibility (CAC) and to indicate the preconditions for CAC,
2. Recommend measures for achieving CAC,
3. Specify the sequence and time frame for such measures, and
4. Suggest domestic policy measures and changes in institutional framework. The Committee has recommended a phased implementation of CAC over a three-year period: Phase I (1997-8), Phase II (1998-9) and Phase III (1999-2000).

It also recommended that fiscal consolidation; a mandated inflation target and the strengthening of the financial system should be regarded as crucial preconditions/ signposts for bringing CAC to India. Now let's discuss what can get us the above requirements.



FISCAL CONSOLIDATION -

There should be a reduction in the Centre's Gross Fiscal Deficit to GDP ratio from a budgeted 4.5% in 1997-98 to 4.0% in 1998-9, and further to 3.5% in 1999-2000, accompanied by a reduction in the states' deficit, and also a reduction in the quasi-fiscal deficit. Recognizing that the practice of financing the amortization of government borrowings by borrowing afresh is clearly unsustainable and would inevitably result in a crisis, the Committee has recommended introduction of a Consolidated Sinking Fund (CSF) as part of a more transparent fiscal system. The Committee has urged that any

increase in the profit transfer from the RBI to the Government as well as the proceeds from disinvestments should be used entirely towards building up a CSF.

MANDATED INFLATION RATE -

For the three-year period, the MIR should be, on an average, 3-5%. There should be an early empowering of the RBI on the inflation mandate approved by Parliament, which alone should be able to alter that mandate. Once it is given, the RBI should be free to attain the target, with appropriate guidelines on changing the mandate.

STRENGTHENING THE FINANCIAL SYSTEM -

This was viewed as the most important precondition for changing to CAC, and therefore weaknesses in the financial sector need to be addressed early. Interest rates should be fully deregulated in 1997-8 and there should be no formal or informal interest rate controls. The average effective Cash Reserve Ratio (CRR), 9.3% in April 1997, should be reduced to 8% in 1999-2000. Furthermore, drastic measures should be taken to bring down gross Non-Performing Assets (NPAs) from the tentatively estimated 13.7% of the total advances in March 1997 to 12% in 1997-8, 9% in 1998-9 and 5% in 1999-2000. Concerned that some weak banks are growing at rates faster than the system, the Committee recommended that weak banks should be converted into narrow banks, i.e., those whose incremental resources are invested only in government securities. In extreme cases of weakness, restraints should be applied on liability growth.

ISSUES IN CAPITAL ACCOUNT CONVERTIBILITY -

CAC is widely regarded as one of the hallmarks of a developed economy. It is also seen as a major comfort factor for overseas investors since they know that anytime they change their mind they will be able to re-convert local currency back into foreign currency and take out their money.

In order to attract foreign investment, many developing countries went in for CAC in the 80's not realizing that free mobility of capital leaves countries open to both sudden and huge inflows as well as outflows, both of which can be potentially destabilizing. More important, that unless there is the existence of institutions, particularly financial institutions, capable of dealing with such huge flows countries may just not be able to cope up as was demonstrated by the East Asian crisis of the late nineties. Following the East Asian crisis, even the most ardent votaries of CAC in the World Bank and the IMF realized that the dangers of going in for CAC without adequate preparation could be catastrophic. Since then there has been a slow but cautious move towards CAC with priority being given to fiscal consolidation and financial sector reform above all else.

In India, the Tarapore committee had laid down a three-year road-map ending 1999 2000 for CAC. It also cautioned that this time-frame could be speeded up or delayed depending on the success achieved in establishing certain pre-conditions - primarily fiscal consolidation, strengthening of the financial system and a low rate of inflation. With the exception of the last, the other two pre-conditions have not yet been achieved.

Based on the experience of other countries, the following issues are of concern for India.

<u>*Banking and capital market regulatory system:*</u> Banks intermediate a substantial amount of funds in India - over 64 per cent of the total financial assets in the country belong to banks. However, many Indian banks are undercapitalized, and their balance sheets characterized by large amounts of non-performing assets (NPAs). Unless banking standards are duly brushed up, viable competition introduced and government interference reduced, it would be reckless to go in for full capital account convertibility, which requires flexibility, dynamism and foresight in the country's banking and financial institutions.

<u>*Transparency and discipline in fiscal and financial policies:*</u> The ratio of gross fiscal deficit to GDP increased to 10.4 per cent inc1999-2000 from 6.2 per cent in 1996-97 and 8.5 per cent in 1998-99, and has hovered around the 10 per cent figure since then. Such high fiscal deficits can prove to be unsustainable and frighten away investors there is an immediate need for putting brakes on government expenditure, and until that has been satisfactorily done, opening up the capital account fully would carry with it a big risk of sudden loss of faith of investors and capital flight.

<u>*Flexibility in exchange rate:*</u> To prevent a nominal appreciation because of the capital inflows, the RBI has been adding billions of dollars to its reserves; the foreign exchange reserves with the RBI are a whopping $69 billion. However, intervening foreign currency purchases to stabilise the exchange rate and accumulation of forex reserves have implications for domestic monetary management, which can be seriously impaired by divided short-term monetary responses during a capital surge. On the other hand, the option of a more flexible exchange rate would cause an appreciation in the value of the rupee, which may hurt exports

Hence, the usual macroeconomic trilemma where only two of the three objectives of a fixed exchange rate - capital mobility and an activist monetary policy - can be chosen. Since the government has already liberalised inflows of capital to a large extent, the authorities could attempt to deal with this problem in one of the following ways: It could begin relaxing capital controls, allowing individuals to exchange rupees for dollars.

Indeed, some piecemeal measures in this direction have already been taken. But this, perhaps, is a risky proposition.

POSSIBLE OUTCOMES OF CAC

The experience with liberalization of inward capital flows in India has been similar to the economies of Latin America and East Asia, only the magnitude of these flows has not been large enough to cause serious macro and micro management problems. The Government would do well to focus at present on the fundamental processes of institutional development and policy reform because, in the long run, these would serve the country better than an early move towards full capital account convertibility.

It increases the risk of capital flights both ways, which increases the volatility in exchange rates and financial markets.

(i) It tends to increase unemployment, and reduce output and wages.

(ii) It may accentuate inflationary pressures because foreign goods become available at higher prices.

(iii) It can result in the flooding of the domestic markets with imports, particularly non-essential ones.

(iv) It increases the misuse of foreign exchange not only for luxury and leisure industry but also for smuggling of goods, arms, and for other nefarious activities.

ISSUES IN CAPITAL ACCOUNT CONVERTIBILITY IN DEVELOPING COUNTRIES

1. Capital account convertibility is desirable and inevitable as it is a part of the globalization process.
2. Capital account convertibility is accompanied by some risks. Its benefits are dependent upon the achievement of certain pre-conditions and sequencing patterns and an orderly liberalization procedure.
3. The opening up of the capital account is a more complicated procedure than often thought. It is desirable to opt for a gradual approach so that it can be embedded in the overall reform process.
4. The need to constrain short-term flows in developing countries arises because they do not have sophisticated financial markets to intermediate funds from the short to the long end and cannot therefore bear the risk of financial

intermediation. The need to constrain short-term flows should diminish as financial sector development and sophistication progresses.

5. The porosity of the capital account generally points to the ineffectiveness of capital controls. A distinction is made between different kinds of controls and types of transactions on the capital account.

CONCLUSION:

Full capital account convertibility should only be implemented if all the pre-requisites' for it are fulfilled, otherwise it can have a lot of destructive outcomes, which can push us in a very big financial problem, which would be very difficult to manage. India should keep in mind the outcomes that developing countries like Indonesia, Korea, Thailand, etc. faced by implementing full CAC without taking proper care in adopting it.

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