Economy Insight:
Capital Account Convertibility

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Background

- Capital account convertibility (CAC) is being discussed again in the country. Statements made by two major policy makers with respect to capital account convertibility in the recent times have evoked interest in this topic once again. RBI Governor, Raghuram Rajan mentioned "*We hope to get full capital account convertibility in a short number of years*," in response to a question on the policy stance on foreign investment in India while speaking to students at the Gokhale Institute of Politics and Economics in Pune. While, Jayant Sinha, Minister of State for Finance mentioned, "*If India wants to be a global economy, then capital account convertibility is needed*," at a conference on the National Pension system.
- Currency convertibility refers to the freedom to convert the domestic currency into other internationally accepted currencies and vice versa. Current account convertibility refers to freedom in respect of 'payments and transfers for current international transactions', while capital account convertibility (CAC) refers to freedom of currency conversion in relation to capital transactions in terms of inflows and outflows. Convertibility in that sense is the obverse of controls or restrictions on currency transactions.
- India has current account convertibility for both inflows and outflows by residents and non-residents. The Indian Rupee was made partly convertible on current account from March 1992 under the "Liberalised Exchange Rate Management scheme, and fully convertible on current account in 1994, following the acceptance of the obligations under Article VIII of the IMF's Articles of Agreement in August 1994.
- In 1997, RBI under the chairmanship of S.S.Tarapore set up a Committee to suggest a roadmap for implementing capital account convertibility in India. The committee in its report chalked out three phases to be implemented by 1999-2000. However, in 1997, The East Asian financial crisis happened and countries with full CAC were badly hit. This slowed the progress towards CAC in India. Later in 2006, then Prime Minister, Manmohan Singh spoke about revisiting the topic and the second Tarapore Committee was set up, which in its report drew up a five-year roadmap with three phases to be implemented for full CAC by 2011. Then again, India stepped back in implementing this policy.
- India currently has partial capital account convertibility. The pros and cons of adopting full capital account convertibility are discussed in this paper to understand if India is ready to implement full capital account convertibility.

Tarapore Committee and its recommendations

- The Tarapore Committee defines CAC as – *Capital account convertibility 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.*
- The Tarapore committee had in its report detailed certain preconditions for moving towards full CAC. These include:
  - ***Fiscal consolidation***: one of the most important pre-conditions for capital account convertibility is strong and stable macroeconomic conditions and a sustainable fiscal deficit. Fiscal deficit as a percentage of GDP is desired to be around 3-3.5% of GDP.
  - ***Monetary policy objectives:*** Inflation rates in India need to converge to internationally acceptable lower level and interest rates would broadly need to realign and reflect inflation differentials. The institutional framework for setting monetary policy objectives also needs to be strengthened.
  - ***Strengthening of banking system:*** Implementation of full capital account convertibility requires a strong banking system. Hence, restructuring of the banking system and putting in place appropriate safeguards would be necessary. In addition, capacity-building in the domestic banks would be imperative to enable them to meet the enhanced needs of a financial system with a liberalised capital account.
  - ***Adequacy of reserves:*** With implementation of full CAC, adequacy of reserves would be an important parameter in gauging an economy's ability to absorb external shocks.

Current status

- India currently has partial capital account convertibility. Over the years, India has taken a calibrated approach towards CAC, adopting small and directed steps towards liberalisation after considering the domestic and global economic situation and in line with developmental requirements. The net result being higher degree of openness of the country's capital account and greater integration with the global capital market.
- India has in place an extensive and at times complex system of controls for different types of capital flows. Foreign investors enjoy a high degree of convertibility on most of the transactions, and rules for Indians/ Indian firms investing abroad have also been relaxed over the years.
- Some of the major capital control measures are captured in the table below.

Capital Account Management: Regulatory Framework

Parameter	Inflows	Outflows
Foreign Direct Investment	FDI is allowed under the automatic route without prior approval in most activities/sectors as specified (sectoral caps) in the consolidated FDI Policy, issued by the Government of India from time to time. FDI is prohibited in certain sectors, but these are sectors of social or strategic importance.[1]	Overseas direct investment by an Indian party is permitted up to 400% of their net worth under the automatic route. However, investments in excess of US $ 1 billion or equivalent in a financial year even when it is within the specified limit of 400% of net worth would require prior approval from RBI. In instances, where the investment if made out of balances in the Exchange Earners Foreign Currency Account or out of funds raised through ADR, GDR issues, the ceiling is not applicable. For proprietorship concerns and unregistered partnership concerns, limits are different and certain other criteria also have to be met. [2]
Portfolio Equity Investment	Registered Foreign Portfolio Investor (RFPI) which may include Asset Management Companies, Pension Funds, Mutual Funds, and Investment Trusts as Nominee Companies, Incorporated / Institutional Portfolio Managers or their Power of Attorney holders, University Funds, Endowment Foundations, Charitable Trusts and Charitable Societies are permitted to make investment in India. Investment by RFPIs cannot exceed 10 per cent of the paid up capital of the Indian company. All RFPI/FII/QFI taken together cannot acquire more than 24 per cent of the paid up capital of an Indian Company. Through the Portfolio Investment Scheme (PIS), Foreign Institutional Investors (FIIs), Non-Resident Indians (NRIs), and Persons of Indian Origin (PIOs) can invest/acquire shares and debentures of Indian companies through the primary and secondary capital markets in India. NRIs and PIOs have a 10% ceiling for overall investment, while the ceiling for overall investment for FIIs is 24 % of the paid up capital of the Indian company. The limit is 20 % of the paid up capital in the case of public sector banks, including SBI.	Under the Liberalised Remittance Scheme, all resident individuals, including minors, are permitted to remit up to USD 250,000 per financial year for any permissible current or capital account transaction or a combination of both[3]. Listed Indian companies can invest up to 50 % of their net worth as on the date of the last audited balance sheet in (i) shares and (ii) bonds / fixed income securities, rated not below investment grade by accredited / registered credit rating agencies, issued by listed overseas companies.[4] Indian Mutual funds registered with SEBI are permitted to invest within the overall cap of US $ 7 billion.[3]
Investments in money market	NRIs may invest in money market mutual funds.	Residents may purchase these instruments abroad without RBI approval.
Loans	ECBs are allowed through automatic and approval route. Corporate other than those in the hotel, hospital and software sectors, and corporate in miscellaneous services sector can raise ECB upto USD 750 million or its equivalent during a financial year. Corporates in the services sector allowed to avail of ECB up to USD 200 million or its equivalent in a financial year.	Lending abroad is generally subject to approval, except for certain trade credits and lending to foreign subsidiaries.

[1] Consolidated FDI Policy Circular of 2015, DIPP, Master Circular on Foreign Investment in India
[2] Master Circular on Direct Investment by Residents in Joint Venture (JV) / Wholly Owned Subsidiary (WOS) Abroad Amended upto May 6 2015 – valid till July 1 2015, will be replaced with updated Master circular
[3] Sixth Bi-monthly Monetary Policy Statement – February 3 2015
[4] Master Circular on Direct Investment by Residents in Joint Venture (JV) / Wholly Owned Subsidiary (WOS) Abroad Amended upto May 6 2015

Pros/ Merits of Capital Account Convertibility

- Capital account convertibility is considered as an important feature for a developed economy, as it is considered beneficial for both domestic and foreign investors. It gives domestic investors the opportunity to tap the foreign markets, while at the same time, it not only attracts foreign investors, but also gives them the comfort of re-converting the local currency into foreign currency at their behest.
- Full CAC would mean stronger capital inflows into domestic projects (higher investment) thus supplementing domestic resources and leading to higher economic growth. Indian companies would be able to access overseas funds, while the foreign companies can also easily invest in India.
- Cost of capital would be lower leading to higher competition, thus lowering the spreads and making the financial system more efficient.
- It would provide improved access to international financial markets and opportunities for diversification of investments by residents (freedom to trade in financial assets).
- Incentive for Indians to acquire and hold international securities and assets.
- It could incentivize Indian workers living abroad and NRIs to increase foreign exchange remittances and thus reduce illegal remittances.
- One major agreement in favour of CAC is that free capital mobility would allow the global economy to reap the efficiency gains created by specialisation in the production of financial services.
- Countries with a more open capital account will have, in principle, the ability to finance a larger current account deficit and thus increase the volume of foreign savings. [5]
- CAC would improve efficiency and productivity growth. Countries with fewer restrictions on capital mobility will, with other things given, tend to outperform countries that isolate themselves from global financial markets.
- India would be exposed to the vagaries/volatilities in the International financial market and would force the government to be more disciplined on fiscal matters.
- CAC is also desirable in order to rule out the inefficiencies and leakages associated with capital controls.

[5] Capital Mobility and Growth in the Developing World: An Empirical Investigation – Sumati Varma

Cons/Demerits of Capital Account Convertibility

- India would be exposed to the vagaries/volatilities in the International financial market. The volatility in short term capital movements and risk of massive capital outflows could expose the economy to larger macroeconomic instability.
- It could lead to flight of domestic savings from the country for better investment opportunities overseas, or when situation is unfavourable, thus disrupting the financing of domestic investment. The Asian Financial Crisis of 1997 is one such instance.
- The currency could become more volatile leading to either appreciation or depreciation. For instance in May 2013, with the indication of QE tapering by US Fed, there was a sudden and large capital outflow from India, causing the currency (Rupee) to come under pressure (depreciate). At that time, measures taken by RBI relating to the policy rate, liquidity and forex swap facilities and postponement of QE tapering helped in containing forex volatility and helped the rupee to recover since early-September 2013[6.]
- At the same time, excessive capital inflow can lead to appreciation of the currency leading to worsening of balance of trade.
- Exposure to overseas credit risks. Companies may undertake risks beyond their capabilities due to lack of understanding or awareness of various investment avenues.
- Concerns about irrational investments in sectors such as real estate and others could lead to generation of financial bubbles.
- Companies would have access to unbridled overseas borrowings which could lead to more defaults in repayment.

Experience with Full CAC

- In 1975, Chile, Argentina, and Uruguay dramatically liberalized their domestic and international finances. Following the liberalisation, foreign capital flowed into these countries and in the process expanding credit available through the banking sector. In Chile, the domestic interest rates remained high and volatile and most of the loans were short term loans. International credit was used to finance import of consumer goods, and foreign loans replaced domestic lending leading to a decline in domestic investment and savings. Current account deficit was also widening. As more foreign funds poured into these economies, their vulnerability to change in international economic conditions was also increasing. In 1981, When the US dramatically raised its interest rates, capital flows to Latin America reversed and the increased cost of outstanding loans lead to defaults, bank failures and massive economic contraction. In response in 1982 the capital account was closed and banking sector was renationalised. Argentina and Uruguay also faced similar situations, and their capital accounts were also closed.
- Closer to home, was the Asian Financial crisis of 1997. The boom in East Asian economies attracted a huge amount of capital inflows in the 1990s; however the situation changed in mid-1997. The crisis

[6] RBI Release Feb 11,2014 https://rbi.org.in/scripts/BS_ViewBulletin.aspx?Id=14724

starting in Thailand swept through Indonesia, Malaysia and South Korea and capital which was flowing into these countries, flew out in huge amounts and the situation changed from a state of huge capital inflows to outflows. Huge capital inflows had led to overvalued currencies and higher current account deficits. The capital outflows caused the currencies to collapse and stock prices to crash. To address the situation, the countries tightened the fiscal policy and hiked interest rates to stabilize the currencies. The countries also received financial support from the IMF, World Bank, the Asian Development Bank and others to rebuild.

- IMF, one of the strong votaries of capital account liberalisation, has been extremely cautious on this score in recent years. It has adopted an institutional view in 2012. The institutional view recognizes that full capital account liberalization may not be an appropriate goal for all countries at all times, and that under certain circumstances capital flow management measures can have a place in the macroeconomic policy toolkit.[7]

Key Features of IMF's Institutional View

- Capital flows can have substantial benefits for countries. At the same time, they also carry risks, even for countries that have long been open and drawn benefits from them.
- Capital flow liberalization is generally more beneficial and less risky if countries have reached certain levels or "thresholds" of financial and institutional development.
- Liberalization needs to be well planned, timed, and sequenced in order to ensure that its benefits outweigh the costs.
- Countries with extensive and long-standing measures to limit capital flows are likely to benefit from further liberalization in an orderly manner. There is, however, no presumption that full liberalization is an appropriate goal for all countries at all times.
- Rapid capital inflow surges or disruptive outflows can create policy challenges. Appropriate policy responses involve both countries that are recipients of capital flows and those from which flows originate.
- For countries that have to manage the risks associated with inflow surges or disruptive outflows, a key role needs to be played by macroeconomic policies, as well as by sound financial supervision and regulation, and strong institutions. In certain circumstances, capital flow management measures can be useful. They should not, however, substitute for warranted macroeconomic adjustment.
- Policymakers in all countries, including countries that generate large capital flows, should take into account how their policies may affect global economic and financial stability. Cross-border coordination of policies would help to mitigate the riskiness of capital flows.

[7] http://www.ieo-imf.org/ieo/files/whatsnew/The%20IMFs%20Approach%20to%20Capital%20Account%20Liberalization%20Revisiting%20the%202005%20IEO%20Evaluation3.pdf

India's readiness for Capital Account Convertibility

- The statements made by the policy makers say India will move towards full CAC in some time. Let's try and understand whether India is ready for Full CAC. India is currently delicately poised with respect to the major parameters that are considered important for full CAC.
- India has been suffering deficits – trade, current and fiscal for some time now. Fiscal deficit was at 4.0%[8] of GDP in 2014-15 higher than the recommended range of 3-3.5% of GDP for CAC. Given the current tight fiscal situation, the commitment towards fiscal consolidation has been phased out over a longer time period, with the 3% goal post being shifted (postponed) by a year to 2017-18. The targets for fiscal deficit are now 3.9% in 2015-16, 3.5% in 2016-17, and 3% in 2017-18. Even after this postponement, achievement of 3% target in 2017-18 is a challenging task. High fiscal deficit has implications for inflation as well as interest rates.
- The current account deficit levels in the country have come down, however it still remains vulnerable. India's current account deficit rose to 4.7% of GDP in 2012-13 and fell to 1.7% of GDP in 2013-14 and is expected to be around 1.3% of GDP for 2014-15. The drop in CAD is largely due to curbs on imports of precious metals (gold) and drop in international oil prices rather than increase in exports or a shift in trade balance.
- Inflation rates in the country have come down as compared to year-ago levels and RBI has set an inflation target of under 6% by January 2016. The desired inflation for capital account convertibility is around 3-5% (average of 3 years) as per Tarapore Committee Report I. RBI has been able to get inflation rate (CPI) to 5.0% in May 2015. However, there are certain concerns on upside risks to inflation, on account of forecast of deficit rainfall this year, amongst others.
- Another concern area is India's banking system. The asset quality of the banks is deteriorating thus eroding the capital base of the banking system and is a cause of concern. Gross NPAs of the banking system as a proportion of gross advances were at 4.78% as of December 2014, while gross NPAs of PSU banks were around 5.6%. In March 2015, RBI permitted banks to use up to 50% of their counter-cyclical buffer (up from earlier 33%) to provide for non-performing assets. The loss absorbing buffer of the Indian banking system is 7.9% of risk weighted assets as per IMF, ranking low amongst the emerging markets in terms of loss absorbing capacity.
- India needs to improve the overall macroeconomic situation and sustain the low current account deficit and contain the fiscal deficit to be able to reap benefits of full capital account convertibility.

[8] http://pib.nic.in/newsite/PrintRelease.aspx?relid=121807