

# [Capital account convertibility essay](https://assignbuster.com/capital-account-convertibility-essay/)

This report has been prepared to discuss the issue of Capital Account Convertibility (CAC) and India’s experience with it. The concept of CAC and its history and its implications has been discussed. The recommendations of the Tarapore Committee (the committee set up for looking into the issue of CAC) have been presented. Lastly, the progress made towards CAC in India and its implications have been discussed.

SUMMARYContinuing on the way of economic liberalization and economic reforms and against the pressure by left and democratic parties, the prime minister announced on March 18, 2006 his government’s resolve to move towards full capital account convertibility of Indian rupee ignoring even the advice of his pro-liberal friends. In order to operationalise this, a committee named as Tarapore II under the leadership of S. S. Tarapore, ex-deputy governor, RBI was constituted by the RBI which commenced its work from May 1, 2006 and has since submitted its report on August 31, 2006 to RBI.

This new report has generated a fresh debate on the fuller capital account convertibility (FCAC) and its real implications, particularly for countries like India. This is more so as the new Tarapore Committee II, have themselves admitted in their report that various countries including European Union still continue with several restrictions on FCAC. Even IMF, which has mooted the idea of changing its Charter to include FCAC in its mandate, has shelved the idea in view of its possible dangers. Moreover, the link between FCAC and growth is yet to be firmly established by any stretch of empirical evidence. First of all, we should try to gather the meaning of full capital account convertibility, as distinct from partial capital account convertibility or convertibility of current account. WHAT DO YOU MEAN BY CAPITAL ACCOUNT CONVERTIBILITY? By “ Capital Account Convertibility” (or CAC in short), we mean “ the freedom to convert the local financial assets into foreign financial assets and vice-versa at market determined rates of exchange.

It is associated with the 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. ” (Report of the Committee on Capital Account Convertibility, RBI, 1997). It is sometimes also known as Capital Asset Liberation. In simple language what this means is that CAC allows anyone to freely move from local currency into foreign currency and back. It is basically a policy that allows the easy exchange of local currency (cash) for foreign currency at low rates so that local merchants can easily conduct transnational business without needing foreign currency exchanges to handle small transactions. CAC is mostly a guideline to changes of ownership in foreign or domestic financial assets and liabilities.

Tangentially, it covers and extends the framework of the creation and liquidation of claims on, or by the rest of the world, on local asset and currency markets. It is different from CURRENT ACCOUNT CONVERTIBILITY which allows free inflows and outflows for all purposes other than for capital purposes such as investments and loans. In other words, it allows residents to make and receive trade-related payments — receive other foreign currency for export of goods and services and pays dollars for import of goods and services make sundry remittances, access foreign currency for travel, studies abroad, medical treatment and gifts etc. As of now, we all are probably aware that the convertibility of Indian rupee into foreign currencies and vice versa is almost wholly free for current account transactions like trade, tourism, travel, education abroad and in India, and remittances into and out of India for purchasing health-care products. In contrast, the principal focus of capital account convertibility is on assets, both financial and real.

Today, we have limited capital account convertibility. An Indian individual or institution is allowed, subject to certain conditions, to invest in foreign assets. Foreigners too are similarly allowed to invest in India. Considering the example of scenario in India, the foreign exchange transactions (transactions in dollars, pounds, or any other currency) are broadly classified into these two accounts: current account transactions and capital account transactions. If an Indian citizen needs foreign exchange of smaller amounts, say $3, 000, for travelling abroad or for educational purposes, she/he can obtain the same from a bank or a money-changer. This is a “ current account transaction”.

But, if someone wants to import plant and machinery or invest abroad, and needs a large amount of foreign exchange, say $1 million, the importer will have to first obtain the permission of the Reserve Bank of India (RBI). If approved, this becomes a “ capital account transaction”. This means that any domestic or foreign investor has to seek the permission from a regulatory authority, like the RBI, before carrying out any financial transactions or change of ownership of assets that comes under the capital account. Of course there are a whole range of financial transactions on the capital account that may be freed form such restrictions, as is the case in India today. But this is still not the same as full capital account convertibility.

Complete capital account convertibility of the rupee would mean almost no restrictions and no questions for free flow of foreign currencies and rupee in and out of India. PROBLEMS ASSOCIATED WITH CAC Many economists are of the view that allowing full capital account convertibility will have adverse effects on the economy of the nation and can led to serious consequences. Some of the reasons for that are: • During the good years of the economy, it might experience huge inflows of foreign capital, but during the bad times there will be an enormous outflow of capital under “ herd behavior” (refers to a phenomenon where investors acts as “ herds”, i. e. if one moves out, others follow immediately). For example, the South East Asian countries received US$ 94 billion in 1996 and another US$ 70 billion in the first half of 1997. However, under the threat of the crisis, US$ 102 billion flowed out from the region in the second half of 1997, thereby accentuating the crisis. This has serious impact on the economy as a whole, and can even lead to an economic crisis as in South-East Asia. • There arises the possibility of misallocation of capital inflows. Such capital inflows may fund low-quality domestic investments, like investments in the stock markets or real estates, and desist from investing in building up industries and factories, which leads to more capacity creation and utilization, and increased level of employment.

This also reduces the potential of the country to increase exports and thus creates external imbalances. An open capital account can lead to “ the export of domestic savings” (the rich can convert their savings into dollars or pounds in foreign banks or even assets in foreign countries), which for capital scarce developing countries would curb domestic investment. Moreover, under the threat of a crisis, the domestic savings too might leave the country along with the foreign ‘ investments’, thereby rendering the government helpless to counter the threat. • Entry of foreign banks can create an unequal playing field, whereby foreign banks “ cherry-pick” the most creditworthy borrowers and depositors. This aggravates the problem of the farmers and the small-scale industrialists, who are not considered to be credit-worthy by these banks.

In order to remain competitive, the domestic banks too refuse to lend to these sectors, or demand to raise interest rates to more “ competitive” levels from the ‘ subsidized’ rates usually followed. • International finance capital today is “ highly volatile”, i. e. it shifts from country to country in search of higher speculative returns. In this process, it has led to economic crisis in numerous developing countries.

Such finance capital is referred to as “ hot money” in today’s context. Full capital account convertibility exposes an economy to extreme volatility on account of “ hot money” flows. According to Joseph Stiglitz, the former Chief Economist at the World Bank and a Nobel Laureate in 2001, “ Capital market liberalization entails stripping away the regulations intended to control the flow of hot money in and out of the country- short term loans and contracts that are usually no more than bets on exchange rate movements. This speculative money cannot be used to build factories or create jobs-companies don’t make long term investments using money that can be pulled out on a moment’s notice- and indeed, the risk that such hot money brings with it makes long-term investments in a developing country even less attractive. ”- (Globalization and its’ Discontents, 2002. ) Finally, CAC puts new pressures upon macroeconomic management of the economy, in the sense that poor macroeconomic policies will swiftly generate large outflows of funds, and price volatility.

Financial markets will constantly monitor economic policy; this will constrain the behavior of policymakers, and diminish the likelihood of irresponsible policy choices. CAC also brings up the specter of a significant macroeconomic crisis if irresponsible policies are adopted. Why then is the government interested in introducing Capital Account Convertibility? Instead of having so many dangers there are reasons due to which the governments are willing to introduce Capital Account Convertibility. One of the reasons for that might be that the UPA government, since its inception, had has been pursuing the policies of liberalization and privatization, and the government is unwilling to change course and is in essence pursuing the same policies. A policy like Capital Account Convertibility is a reflection of this. Such policies solely benefit the rich business houses, investors in the stock markets and those who control the international finance markets.

The prime minister and the finance minister are seems to be more than eager to serve the vested interests of these classes. Dani Rodrik, an eminent Harvard economist, has argued that “ The greatest concern I have about canonizing capital-account convertibility is that it will leave economic policy in the typical “ emerging market” hostage to the whims and fancies of two dozen or so thirty-something country analysts in London, Frankfurt, and New York. A finance minister whose top priority is to keep foreign investors happy will be one who pays less attention to developmental goals. We would have to have blind faith in the efficiency and rationality of international capital markets to believe that these two sets of priorities will regularly coincide. — (“ Who Needs Capital Account Convertibility? ” February 1998).

But even with this there are many perceived benefits that Capital Account Convertibility can bring to the nation. BENEFITS FROM CAC According to the article appeared in Economic Times in June 1997, the various benefits of allowing fuller capital account convertibility could be: • Rates of return on debt and equity in India were high by world standards. With convertibility, foreign money will come into India to arbitrage this differential away and reduce these rates of return: i. e. the cost of capital faced by the companies of India in equity and debt financing will drop. At a lower cost of capital, more investment projects would be viable, which would generate a faster pace of investment and growth in the economy.

• With convertibility, Indians would be able to diversify their portfolios internationally. Instead of being constrained to only hold Indian real estate, equity and debt, we will reduce our risk by diversifying internationally. This means that in a bad year in India, when Indian financial assets generate a poor return, foreign assets owned by Indians would continue to generate good returns. This reduction in the variability of returns would make Indians happier since they face less risk, and help stabilize India’s macro economy. • Convertibility means that the households and firms of India are not forced to meet each other through India’s financial system.

The GDR market is one example of the alternative: here Indian firms chose to meet with foreign investors through the markets outside India. This market arose in response to weaknesses of existing markets in India. With convertibility, it will be possible for Indian firms to interact with Indian households in (say) the markets of Singapore. This would provide alternatives for India’s households and firms, generate competition for India’s financial industry, and elevate the urgency of reforms in the financial sector. For example, if derivatives on the dollar–rupee start trading in Singapore or Chicago, convertibility means that we in India would be able to use them. Convertibility would generate massive flows of funds into and out of India, as Indians and foreigners modify their portfolios to reflect new investment possibilities.

Even if all policies in terms of financial regulation are correctly orchestrated, volatility in the dollar-rupee will innately increase. But given the tradition of government controls in India, we are all used to expecting low volatility of the rupee-dollar. This raises the urgency of developing futures and options on the dollar-rupee, which would give people a method for managing these risks. The foreign exchange market will especially be in the spotlight, since all these increased flows of funds will have to go through the dollar-rupee market. An illiquid dollar-rupee market will display spurious volatility under such pressures. Hence, institutional development of India’s foreign exchange market should precede convertibility.

The two key approaches for this are (a) transition of the spot market away from the inter-bank market to modern screen-based trading that is widely accessible all over the country, and (b) transition away from the inter-bank dollar-rupee forward market to a modern dollar-rupee futures market without entry barriers. These approaches would transform the quality of the foreign exchange market. CAC also has important ramifications for taxation. Convertibility opens up new avenues for a narrowing of the tax base, and hence upgrades the priority of a harmonization of taxation in India with international standards. Who exactly are expected to be benefitted from CAC? The class which benefits from the CAC primarily compromises the big business houses and the finance capitalists, who invest in the stock market for speculations. The policies like CAC are pursued mainly to gain the confidence of the speculators and punters in the Stock Markets, and do not have any beneficial effects on the real sector of the economy, like increasing the employment level, eliminating poverty and decreasing the inequality gap.

However, the irony is that under a crisis, the burden is borne primarily by the common masses. This may come in the form of a sharper reduction in subsidies, less investment for social welfare projects by the government and an increase in the privatisation process. The foreign speculators and the domestic players may walk out of the market (by converting their assets to foreign currency) and insulate themselves from any damage. HISTORY Till 1934, countries all over the world followed the fully convertible currency system.

People from various countries were free to trade with one another without any barriers. People from one country could exchange currency with those of another country on mutually agreed terms. Exchange controls were non existing. However in 1934 Hitler’s finance minister introduced the system of import licensing and exchange controls.

From then on various control systems have dominated world trade. However during the late 60’s and early 70’s countries of the world did express their desire to move back to the fully convertible system. According to the IMF almost 80 countries had already made their currency convertible at least with regard to the current account. There was a widespread belief that free capital market was an important part of liberal market. This feeling was so strong in 1997 that IMF was on verge of extending its remit to include supervision on control on international capital flows to help its member countries to move to a situation where there were no restrictions on movement of capital. The main pressure that time for liberalization of capital flows was from US treasury.

When countries wanted to negotiate bilateral trade agreement with US, they found that treasury was demanding that the partner country should never in future reinforce any such capital controls. Given that government, like markets, typically take a rather short-term view of costs and benefits, and that the countries could not see the prospects of a crisis at the time when negotiations were taking place, the US treasury got it way. However, before the formalization of CAC, there were problems with the theory. Free flow of assets was required to work in both directions.

Although CAC freely enabled investment in the country, it also enabled quick liquidation and removal of capital assets from the country, both domestic and foreign. It also exposed domestic creditors to overseas credit risks, fluctuations in fiscal policy, and manipulation. As a result, there were severe disruptions that helped to contribute to the East Asian crisis of the mid 90’s. In Malaysia, for example, there were heavy losses in overseas investments of at least one bank, in the magnitude of hundreds of millions of dollars. These were not realized and identified until a reform system strengthened regulatory and accounting controls.

This led to the Tarapore Committee meeting which formalized CAC as utilizing a mixture of free asset allocation and stringent controls. BACKGROUND OF CAC IN INDIA In India the need for making the rupee fully convertible was first felt in 1990 at the meeting of the national development council. A noted economist of the 60’s also said that only if India were to make its rupee fully convertible will she be able to attain her full potentialities. Before the reform of the 90’s strict capital controls existed. The major reasons for this are listed below: • The British Rule: It is a known fact that the British came to India as traders and became rulers. Since gaining independence in 1947, India has looked at foreign trade suspiciously.

It was a common belief that the other countries will come to India as traders and consequently become rulers. Hence the government of India was never open to foreign trade. • Balance of Payment Crisis: As a natural consequence there are concerns about capital outflows also, reinforced by repeated stress on balance of payment often due to droughts, wars and supply shock mainly oil. • Belief that India could be self reliant: It has also been felt that the domestic economy was endowed with a reasonable base of human skills, institutional social and physical infrastructure and diversified industrial base so that the country could successfully launch on the path of self reliance with relatively low level of dependence on the external world.

• Restriction on world trade: Till the eighties influential assessment among policy makers was that world trade was not open enough to promote strong export led growth of a large economy like India. Usually it was argued that strong protectionism would be put in place by industrial countries if India attempted a thousand Singapore’s. Similarly it was felt that, given the level of capital flows which was mainly on official account, India’s large needs may not be met in any single way. In other words possible quantities of capital inflow to India in that view did not justify the risk of opening the economy. By August 1994, India was forced to adopt full current account convertibility under the obligations of IMF’s article of agreement (Article No. VII).

The committee on Capital Account Convertibility, under Dr S. S. Tarapore’s chairmanship, submitted its report in May 1997 and observed that international experience showed that a more open capital account could impose tremendous pressures on the financial system. Hence, the committee recommended certain signposts or preconditions for Capital Account Convertibility in India.

However, the agenda of Capital Account Convertibility was put on hold following the South-East Asian crisis. Even the finance minister acknowledged this point that “… the idea of Capital Account Convertibility was floated in 1997 by the Tarapore Committee, but could not be implemented as the Asian Crisis cropped up”. (The Hindu, March 25, 2006).

The RBI over a period of time has accepted the point that the South East Asian crisis was a bad example for Capital Account Convertibility and that India had been insulated from the crisis because it had not allowed Capital Account Convertibility. The growing global macroeconomic imbalance – as evidenced by the large and sustained current account deficit of the US – suggests that markets may at times allocate global saving differently from what is perceived by the policy makers as appropriate and sustainable in the long-run. Like the effect on resource allocation, the beneficial effects of capital account liberalization on growth are ambiguous. ” – (Report on Currency and Finance 2002-03, RBI. ) But at the same time, the RBI had started talking about Capital Account relaxations, under pressure from the business classes in India. However, given the obvious pitfalls of CAC policies, the RBI talked about a cautious approach to CAC.

“ In India, it is recognized that the pace of liberalization of the capital account would depend on both domestic factors (especially progress in the financial sector reform), and the evolving international financial architecture. The regulatory framework is being used in several combinations to address problems of excessive inflows and pressures towards outflows. In this regard, an integrated view of the state of development of activities in financial markets needs to be taken. – (Report on Currency and Finance 2002-03, RBI. ) It is interesting to note here that there already exists a great amount of freedom in transacting foreign currencies today: • Indian residents and companies (listed in the share markets) can invest in foreign companies, provided a) the foreign company has 10 per cent share holding in some Indian company and b) the domestic country does not invest an amount more than 25 per cent of the company’s total valuation.

However, if an Indian company has a “ proven track record” it can invest an amount up to 100 per cent of its total valuation in a foreign entity engaged in a “ bonafide” business activity. • There is no monetary limit on such aforesaid investments by individuals. • Indian banks can invest their “ unutilized” FCNR(B) funds (Foreign Currency (Non-Resident) Accounts (Banks)- accounts in which NRI’s and PIO’s can deposit in any Indian bank) abroad in only long term fixed income securities which have some minimum ratings (read credibility) internationally. An Indian exporter can give “ loans” out of its foreign earnings to foreign importers without any limit; i. e. the foreign exchange earned need not necessarily be deposited in the country.

• Indians can have Residents Foreign Currency (domestic) Accounts in which they can hold their savings in foreign currency without any limit. They can also remit these foreign currencies to acquire foreign securities (from foreign stock markets) under Employees Stock Option Plan (ESOP) without any limits. NRI, PIO and non residents can take up to US$1 million per year out of the country from balances held in Non Resident Ordinary (NRO) accounts/ sales of Indian assets. Such assets may include those acquired through inheritance/legacy. Any further relaxations would render the Indian economy susceptible to the kind of crisis faced by the other developing countries.

Now let’s see why there was pressure in 1997 for India to allow full Capital Account Convertibility when the first Tarapore committee was appointed. There were mainly two reasons for that: Firstly because that was the spirit of the age,(before the Asian crisis), as manifest in the pressures on the IMF as discussed earlier in this report • Secondly and more importantly because of the desire for cheaper credit on the part of Indian business, which looked with envy at the relatively low dollar interest rates prevailing in the outside world and contrasted them with the high rupee interest rates then prevalent in India. Indian business wanted to be able to access cheap external credit without having to ask permission of the Reserve Bank of India. The desire was understandable, but the cost of giving in to it would have been to expose India to the danger of contagion similar to that which laid the whole of East Asia low when Thailand had a balance of payments problem. For there is no serious doubt that the countries that suffered crises in 1997 were those that had accepted a large volume of short-term capital and not those that were particularly corrupt. Like China, India was not among them, not because there is no corruption in China or India, but because they did not have an open capital account and therefore had not imported a lot of capital that could flee when investors panicked.

Now let study the details about first Tarapore committee which was setup by RBI in 1997-98 to look and give report on the implications of Capital Account Convertibility and about the Asian crisis which has completely changed the understanding and scenario of Capital Account Convertibility. TARAPORE COMMITTEE I The Union Finance Minister, Shri P. Chidambaram, in his Budget Speech for 1997-98 had indicated that the regulations governing foreign exchange transactions need to be modernized and replaced by a new law consistent with the objective of progressively liberalizing capital account transactions. To quote:” I also believe that the time has come for preparatory work towards capital account convertibility. This is a cherished goal.

It is also a matter of great sensitivity. Hence, I shall not make any commitment. For the present, I am asking RBI to appoint a group of experts to lay out the road map towards capital account convertibility, prescribe the economic parameters which have to be achieved at each milestone and work out a detailed time table for achieving the goal. I believe the appointment of such a group will send a powerful signal to the world about our determination to join the ranks of frontline nations”. Dr. C.

Rangarajan, Governor, Reserve Bank of India, on February 28, 1997 appointed a Committee on Capital Account Convertibility consisting of the following: • Shri S. S. Tarapore, Chairman • Dr. SurJit S.

Bhalla, Member • Shri M. G. Bhide, Member • Dr. Kirit Parikh, Member The Definition of CAC as given in the Committee Report The Committee recommended a pragmatic working definition for purposes of its report.

“ CAC refers to the freedom to convert local assets into financial assets and vice versa at market determined rates of exchange. ” Benefits of an open capital account as seen by the Committee The committee is of the view that there are several benefits of a more open capital account. They are: 1. Availability of a large capital stock to supplement domestic resources. 2.

Reduction in the cost of capital and improved access to international financial markets. 3. CAC allows residents to hold an internationally diversified portfolio. 4. The quality of financial assets improves as a result of greater liquidity and deeper markets.

Efficiency gains are created by specialization in financial services. Allocative efficiency improves as a result. 5. CAC provides the impetus to domestic tax regimes to rationalize and converge to international tax structures.

6. CAC has a disciplinary influence on domestic policies. Furthermore, CAC enhances the effectiveness of fiscal policy by firstly, reducing real interest rates applicable to public sector borrowings, secondly, by bringing about an optimal combination of taxes through a reduction of the inflation tax and in the rates of other taxes to international levels with beneficial effects for tax revenues and lastly, reducing crowding out effects in the access of funds. Preconditions for Capital Account ConvertibilityThe Committee recommended that the implementation of CAC be spread over a three year period. It stressed that the implementation of measures towards CAC should be sequenced along with the authorities making an assessment of the progress towards the attainment of the pre-conditions/signposts stipulated and depending on the assessment the implementation of measures could be accelerated or decelerated.

Let’s look into the pre-conditions for CAC in India: a) Fiscal Consolidation: The most important precondition for CAC is a stable macroeconomy including a sustainable fiscal deficit. The Committee recommended a reduction in the GFD/GDP ratio from a budgeted 4. 5% to 3. 5% in the three years. The reduction in the Center’s GFD should be accompanied by a reduction in the States’ deficit. The RBI should totally eschew from participating in the primary issues of Government borrowing.

Moreover, transparent and internationally comparable procedures for fiscal accounting should be adopted so as not to blur the true magnitude of GFD/GDP ratio and the constituents of the budget as a whole. b) Mandated Inflation Rate: In the context of the move towards CAC effective measures should be taken to evolve a more specific commitment on the inflation rate. There should be a medium term inflation mandate approved by Parliament and only Parliament should alter that mandate. The Committee recommended that the mandated rate of inflation for the three year period should be an average 3- 5%.

c) Consolidation in the Financial Sector: This concerns an entire range of issues. The banking system which faced very huge reserve requirements relative to international standards should be brought to international standards. It would be necessary to reduce the tax on the banking system by developing other instruments of monetary policy such as open market operations and interest rates. The committee further recommended that the interest rates should be fully deregulated in 1997-98 and there should be total transparency to ensure that there is no formal or informal interest rate controls. The Committee recommended the sequencing and time frame for signposts which should be in relation to Cash Reserve Ratio (CRR) from 9.

3% to 3% and Non Performing Assets (NPAs) from 13. 7% to 5%, as part of a progressive move towards CAC. Besides the above signposts considered, the Committee also recommended that it is important to monitor certain important indicators such as the Exchange Rate Policy, the Current Account Balance and the Adequacy of the Foreign Exchange Reserves, with a view to assessing the viability of the country’s external sector. The Exchange Rate Policy in the context of the CAC assumes a role quite different in both content and character. With large capital inflows the exchange rate would appreciate in both nominal and real terms, which would hurt India’s competitiveness. An excessively overvalued exchange rate may trigger capital flight resulting in a crisis.

It would be desirable to evolve a system under which any corrections of the Real Effective Exchange Rate (REER) which may be necessary are brought about smoothly to avoid any sudden volatility in the exchange market. The RBI should have a Monitoring Exchange Rate Band of +/- 5. 0% around the neutral REER. The RBI should ordinarily intervene as and when the REER is outside this band. However, it can use its judgment to intervene within the band to obviate speculative forces and unwarranted volatility. A function of degree of openness of the economy can be defined in terms of the ratio of the Current Receipts (CR) to GDP.

Accordingly the Committee recommended that as a broad rule of thumb over the three year period the external sector policies should be designed to ensure a rising trend in the CR-GDP ratio from the 1997 level of 15 % and the endeavor should be to reduce the debt service ratio gradually from 25% to 20%. The Capital Account Deficit as a percentage of GDP should also need to be consistent with the above parameters. The Committee also provided four indicators to be used in the Indian context for evaluating the adequacy of reserves. The Committee presented its report on June 3, 1997, which was just few months before the beginning of the South East Asian Currency Crisis.

This crisis meant that the issue of Capital Account Convertibility was pushed to the back burner and also signaled in some sense the end of discussion on CAC. SOUTH EAST ASIAN CURRENCY CRISIS This was a very important event without which discussion about Capital Account Convertibility is not complete. The five Asian tigers viz. Japan, South Korea, Hong Kong, Singapore and Taiwan were involved in it.

This crisis was an outcome of unlimited liberalization of the capital account. Situation before crisis The crisis in East Asia followed after a sustained high growth for two and half decades. Until that time the growth rate of per capita real GNP of those countries i. e. Japan, South Korea, Hong Kong, Singapore and Taiwan was more than 5 per cent per annum. In fact in the period of 1960-85 the per capita income of Japan increased more than 4 times and that of other countries doubled.

The World Bank, which had initially subscribed to the laissez-faire principle of these countries, afterwards came out with the deeper analysis and some new policies. The policy interventions took place in many forms: Subsidized credits and inputs, financial repression, import substitution in general and for specific industries, public investment in economic and social infrastructure and social industries, and strategic trade and growth interventions. But, in spite of all these favorable conditions they still faced some problems, which led to crisis. Problems There was an over ambition of growth possibility and consequent over investment. It had reached a very high capital base and so the law of diminishing marginal returns began to operate.

The markets were saturated with goods and so there was no scope for new production to enter. When capital was decontrolled large numbers of foreign investors were attracted. Due to this the domestic investment rates increased to 50-60 %. This led to the Keynesian type problem of effective demand. These countries followed free trade and open economy policies. So, a tight control was retained on domestic financial system, resulting in financial repression.

There was a nexus between politicians and large business houses that took undue advantage of this financial repression due to which the efficiency of resource allocation and utilization was affected. Eventually when some of the inefficient business houses collapsed the financial system also suffered. Many banks sanctioned excessive loans against property speculation violating the basic principles of credit. When property market collapsed the financial system also became bankrupt. A major cause of this was opening up of capital market. Due to some greedy foreign investors the local currency was devalued.

While foreign direct investment was welcomed portfolio investment was discouraged. When portfolio capital was liberalized the volume went up from $6 billion to $ 30 billion. As there was no market and the companies were not doing something new a collapse was inevitable. As these Asian economies were highly integrated with the rest of the world, the crisis has had its impact on the world economy as a whole. The high foreign trade to GDP ratio of these nations (varying between 50 and 120%) is one indication of their global integration. Equally important were the inward and the outward capital flows.

The impact of the crisis on India was marginal (growth rate of exports fell to 55 compared to 18-20% in the previous year). The main reason for this was that in 1997 foreign investment, FDI and portfolio, was equivalent to only over 1& of GDP in India as compared to about 15% in the South Asian countries. PROGRESS MADE IN INDIAN ECONOMIC ENVIRONMENTIn the nine years since it last considered capital account liberalization, India has made important progress in two of the three areas specified by the first Tarapore Committee as preconditions, and in liberalizing trade. Inflation has fallen from over 7 per cent in 1997 to under 4 per cent in 2005, and the RBI has been told to pursue an inflation target. The percentage of advances classified as non-performing – which is the best single measure of the health of the banking system – has fallen from 13. 7 per cent in March 1997 to 5.

2 per cent in March 2005. And while Indian trade is still far from completely free, it is now far less restricted than it then was: in particular, the quotas on imports of consumer goods have now been phased out. Unfortunately that still leaves one important area in which India has not made progress, which concerns fiscal discipline: the total size of the public sector deficit has actually risen from 7. 3 per cent of GDP in 1997-98 to an estimated 7. 7 per cent of GDP in 2005-06 (with even higher figures in between), while the ratio of public debt to GDP has increased from under 65 percent to over 83 per cent.

So even on the conditions suggested by the first Tarapore Committee, a quick move to capital account convertibility would be premature. Although some of these preconditions have been almost attained, it seems difficult to realize some others, such as a legislatively determined inflation target, especially in the light of globally volatile crude prices. The purpose of these conditions was obviously to make India’s macroeconomic situation stable enough to meet the vulnerabilities endemic to a free forex regime, which CAC implies. While conservative fiscal targets per se make sense, it does not seem particularly clear how fiscal performance and capital account flexibility are interrelated. The US, for instance, has a higher than normal fiscal deficit, but has capital account convertibility. What seems more relevant is that the Government should not be borrowing in the external markets nor lend its support to domestic banks and other financial entities raising short-term funds abroad beyond a prescribed limit.

The sizeable forex reserves that India now has are well above the Tarapore Committee’s indicated limit of $22 billion. On another basis, reflecting the debt service payments, the same report mentioned a figure of $24 billion. On yet another basis, relating the required level of reserves to the level of short-term debt stock and portfolio investments, the Committee mentioned a figure of $31 billion. These are among the number of alternative formulations used by the Committee to define the adequacy of forex reserves the country should have to meet the possible risks from CAC.

Fortunately, India today has a level of reserves well in excess of all these recommendations of the Tarapore Committee. Let us now look at the current account deficit. The Tarapore Committee had introduced a slightly different concept, namely the ratio of current receipts to GDP which, in its view, is more relevant than the ratio of current account deficit to GDP. This downgrading of the importance of current account deficit is puzzling. It is, in fact, the size of the current account deficit that determines how much, in the form of debt or non-debt liabilities, the country has to incur to meet the gap. Current receipts may be higher, but if current outgoes, such as imports, are much higher, their rising ratio is irrelevant.

In any event, the Committee seems to have been rather restrained in its estimate of how much India’s current account deficit would rise post-liberalization. On this count, the Committee’s recommendations of a current account deficit of 2-3 per cent as the pre-requirement do not seem to have been met. But it views favorably the decline in the debt service ratio as a necessary concomitant of sustainable balance of payments. This seems to have been improved in recent years. The rising current account deficit does, however, cause concern.

The macroeconomic scene is continually changing and it is time to review it. It is appropriate that the Government has asked the RBI to set up another Committee under Dr S. S. Tarapore’s chairmanship to lay out the roadmap for capital account convertibility. The Committee has its task cut out, especially in the light of the doctrinal debate that followed the East Asian crisis, which was blamed by some observers on the introduction of capital account convertibility at a premature stage.

The Asian crisis gives further cross-country experience to guide the Tarapore Committee (II) in its further deliberations. The Prime Minister’s announcement has raised expectations of a radical change in the financial sector with the coming of CAC, expected to be ushered in following the Tarapore Committee (II)’s roadmap. But we are already well on the way to capital account convertibility with the relaxation of limits on foreign investments by Indian residents in the recent period. TARAPORE COMMITTEE II 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”. 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: • Shri S. S.

TaraporeChairman • Dr. Surjit S. BhallaMember • Shri M. G. BhideMember • Dr.

R. H. Patil Member • Shri A. V. RajwadeMember • Dr.

Ajit RanadeMember 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: ) To review the experience of various measures of capital account liberalization 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 dollarization in India of domestic assets and liabilities and internationalization 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, ) 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.

Important points analyzed and recommended by them: The cross-country experience with capital account liberalization 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. Even in the European Community (EC), which otherwise allows unrestricted movement of capital, the EC Treaty provides for certain restrictions. 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 payment. They have provided a five year roadmap towards fuller rupee convertibility which doesn’t appear optimistic in its timeframe, because some of the key recommendations will challenge the government and may not find favor with the central bank. The road map released outlines a three-phase plan extending to 2010-11 to allow greater movement of capital in and out of the local currency. The panel recommended that before achieving fuller capital account convertibility the central bank needed a more transparent exchange rate policy, the government should lower its stakes in state-run banks and measures should be taken to discourage overly high investment by foreign funds.

The panel also said the government should put its finances in order and start running revenue surpluses after wiping out the revenue deficit by 2009, a uggestion, analysts say, the government will find challenging to meet by 2010-11. There are recommendations that the panel has made which cannot be met in the five-year timeframe and could take longer like: • Public finances. The country runs a revenue deficit and a high fiscal deficit, making it vulnerable to shocks when foreign capital is allowed to enter and leave freely. The combined deficit of the governments was 7. 7% of GDP in 2005-06, one of the highest in the world.

Indian law stipulates fiscal deficit must fall by 0. percentage points a year until 2009 and while it has shrunk recently this is due to high growth than budget discipline. • Rupee has been convertible on current account since 1994, meaning it can be changed freely into foreign currency for purposes like trade-related expenses. But it cannot be converted freely for activities like acquiring overseas assets. Fuller convertibility is expected to facilitate double-digit growth through higher investment and improve efficiency in financial sector through greater competition. But analysts say the panel’s suggestion that government’s share in state-run banks should fall to 33% from 51% will fall foul of the ruling coalition’s communist allies.

The communists, whose main backers are trade unions, fear loss of state control will lead to job cuts. “ It will not happen with communist parties as allies,” said A Balasubramaniam, chief investment officer at Birla Sun Life MF. “ Probably the government would make the state-run banks stronger, may be through mergers, to face competition when fuller convertibility comes in. ROAD TOWARDS FULLER CAC Tarapore Committee has rightly said that the acceptance of capital account convertibility presupposed a pretty flexible exchange rate policy, so that a change in capital flows could be absorbed by a change in the exchange rate rather than a surfeit of reserves or their possible exhaustion. But this seems to be easier for an advanced industrial country to fully accept than it is for an emerging market, in which growth has to be largely export-led.

It does not means that emerging markets benefit themselves by running under-valued exchange rates and continuous export surpluses; real resources are best used for real investment at home, not for buying something like lots of US treasury bills. But it might not be desirable for emerging market to push its exchange rate to an uncompetitive level. Right now the Indian exchange rate is properly balanced and any rapid move to liberalize capital flows can create problems for maintaining that balance. The conditions suggested by the first Tarapore Committee omitted one important consideration.

Specifically, the committee did not acknowledge the fundamental importance of having become completely trusted in international markets. When a mature industrial country gets into trouble and wishes to borrow more in order to tide over bad times, it can always do so, because lenders do not doubt that it will be able and willing to continue servicing its debts. Markets may charge more, or exchange rates may depreciate, but ultimately industrial countries can continue to borrow if they need to and are willing to pay the price. Unfortunately this is not true for emerging markets, even if they have an exemplary past record of debt service.

And the fact that some of them don’t (think of Argentina as the most recent example) does not make it easier for the others. Situations in which markets simply will not lend, on any terms, have continued to recur in recent years, until the cyclical upswing started in 2003 and avoided further crises for the moment. Think of Latin American countries, like Brazil in 2002 or Chile in 1998. Or think of the Asian crisis (a particularly vivid example). Or, to go slightly further back in history, think of India itself in 1991.

This is not to argue that India and other emerging markets never should or will have capital account convertibility. As they grow and as per capita income increases, it is to be expected both that market trust will increase and the efficacy of capital controls will fall. If a country becomes a net creditor to the rest of the world, it can expect greater returns if it allows most of its investments to be made by private investors than if they are all invested by the authorities in US treasury bills or similar low-yielding instruments they like to hold (so as to avoid the charge of losing public money, which they do not expect to be leveled against them as long as the securities do not depreciate in terms of the US dollar). A time will therefore come when it will be entirely appropriate for the state to allow free capital flows.

Judging by the European experience after the Second World War, it takes about 30 years from when a country starts the process of liberalization and financial integration before it makes sense to move to capital account convertibility. Of course, countries do not suffer capital flight when their central banks are sitting on reserves of $ 140 billion odd (approaching 20 per cent of GDP) and a world boom is in progress. But the case for restraint in moving to capital account convertibility does not rest upon a conviction that any short-run danger lurks through such a move. The question is whether when circumstances turn difficult, the country will be in an equally solid position to maintain its growth if in the interim it has taken on a load of short-term debt and given investment banks the right to play games with its money. For example if, as some of us fear is quite likely, the US one day confronts a crisis caused by a collapse of the dollar, the consequence for the rest of the world is likely to be even more traumatic.

Recession in the US will be tempered in the medium run by the shift in expenditure toward American-made goods caused by the dollar depreciation, but in other countries expenditure-switching and expenditure-reduction will reinforce each other in making for recession. Countries whose exchange rates float uncontrollably upwards will suffer the most. All of this does not mean that India should not be willing to play a role as a responsible member of the international community in accepting its fair share of the dollar depreciation, but simply that it would be advantageous to avoid the greater burden that might be thrust upon it by a market in which the free flow of capital dictates how far exchange rates move. And if India sought to maintain spending during a world recession through expansionary macroeconomic policies, it might well find that its reserves got run down even without a strong initial effective appreciation.

At that point, the danger would be the more traditional one of a run out of the rupee. Therefore there are many of reasons for India to take a go-slow approach in moving to liberalize the capital account. That it would be wise to liberalize one day no doubt. That there are some liberalizing measures that should be made early – of FDI, of portfolio investment, of small private transactions. But there are many other liberalizing reforms – from electricity pricing to making the courts work expeditiously to pruning the fiscal deficit – that deserve to be priorities over complete capital account liberalization for the next 10 years (at least).

At this stage full capital account liberalization promises no large benefits, while it increases the risk of things going badly wrong. Opposition to Capital Account Convertibility Continuing with its stated opposition to full capital account convertibility, CPM politburo on Monday asked government not to accept recommendations of the Tarapore Committee that has suggested a roadmap for liberalizing the capital account. Party would also be sending a note on this issue to the government. CPM, which had opposed the idea when the prime minister mooted it, said Tarapore panel’s recommendations went against basic tenets of the common minimum programme of the UPA.

According to them dilution of capital controls will only lead to greater flows of speculative finance capital into the Indian economy. It will also increase the risks of a currency crisis, since along with non-residents like the FIIs, Indian residents would also be able to take large amounts of money out of the economy without any restrictions. They feels that recommendations like bringing down government stakes in public sector banks and doing away with the cap on voting rights in bank boards are meant to promote the interests of private corporate at the cost of public sector banks. The fact that such sweeping recommendations related to fiscal, monetary and banking policies have been made in a backdrop, where farmers are committing suicides in our country due to unbearable indebtedness and the commitments made in the CMP on employment, agriculture, health and education are crying out for more fund allocation, shows how much the Tarapore Committee is out of sync with the current Indian realities,” their statement said. Observing that the committee had “ failed to draw the most important lessons” from the spate of currency crises in several developing countries, it said the common feature of all these economies — from southeast Asia to Brazil, Mexico and Russia — was their liberalized capital account. According to them India could avoid such a predicament precisely because of capital controls, much of which has survived till date despite the recommendations to remove them by the first Tarapore committee of 1997.

George Soros point of view George Soros, the self-styled advocate of ‘ open societies’ and the successful practitioner of hedge funds in global financial markets was asked by an academic if he thinks that developing countries like India should make a move for full convertibility of the capital account and the rupee , George Soros gave the reply with a clear negative. This came as a shock to many. The message can also be a cause of unease for policymakers and their advisors in the current government, who have been active in advocating the full convertibility of the rupee, by removing the restrictions as are still there on transfers of money from the country by resident Indians. Transfers currently legalized are up to $2500 per person over a calendar year, which amounts to $2.

5billion per year if one million Indians take this route of legalized money transfers. Removing the restriction will add to the sum by encouraging more transfers by individuals and corporates, especially when the future worth of the rupee in terms of dollar or other currencies is suspect . Of course what thus remains in India today as remnants of the capital control regime happens to be rather slender, with capital inflows of all varieties enjoying a free play in the economy. Soros, of course, did not go to the specifics of India’s capital account liberalization and its current state when he made this point on the possible dangers to a complete liberalization of capital flows for India. It was more of a broad argument which applies to developing countries in general with India as an example. A position as above on capital account controls (or its opposite, convertibility) as held by Soros, the propagator of ‘ open societies’ of the Popperian variety, however is consistent with his rather candid statement that markets are not supposed to cater to the ethical aspect or the social consequences of its actions and it remains for other institutions (the state? ) to provide the correctives.

It was however, not clear whether his position on the inadvisability of lifting all controls on capital flows originates from his concern for markets or goes beyond! Knowledge relating to the movements in the market is ‘ kaleidoscopic’ as the economist Shackle once described it. It is thus uncertainty which explains the herd behavior instincts of participants in markets, with outcomes close to what Keynes described as a ‘ beauty contest’, one where opinions are shaped by how others view it. There is no role in this scenario for a set of well-defined knowledge on future events as is held in mainstream economics. Dwelling on the capital market and its behavior pattern, a financial boom necessarily dwells on the belief system, one where the participants do not withdraw from the market because they believe that the boom will continue. Once they retreat, the party is over and the belied perceptions of the dissenters (lenders) will erode and depress further the worth of financial assets transacted in the market, thus signaling a sharp turnaround. What lies beyond the fast changing fortunes of participants in the financial markets thus do not necessarily reflect the world of realities in terms of what is often described as the ‘ fundamentals’ , the growth in physical terms and its stability.

George Soros’s warning, delivered in a platform run by private capital in India and on a day when Thai monetary authorities faced the wrath of speculators while trying to restrain short term outflows, leaves a message for the markets and the regulators in developing countries. While financial markets driven by speculation have its own decoy for those who are not risk-averse, nobody can predict its future course. And a crash of the financial market not only wipes off the transitory gains for the participants therein but also spills over to other arenas affecting output and employment among others. Thus the financial and real losses reinforce each other in a crashing market. It is not the responsibility of the market, as clarified by Soros, who made his career in financial markets, to act on the ethical implications and the social consequences of the above possibilities.

It thus remains for the regulators in the state machinery to take on newer responsibilities in these de-regulated financial markets, not only for what may befall to public in general but also to protect capital itself under capitalism. Combined with the demands for minimal survival and its stability in a social democratic set up, as in India, responsibilities of regulating the financial markets for the common good of the country is even more. This is probably the message which comes out from the reservations of George Soros on full convertibility of the rupee and the freeing of capital account transactions in India. CONCLUSION There has been liberalization and deregulations in many areas relating to capital account convertibility in recent past. Currently Rupee is practically fully convertible for most of the business and personal transactions. Further, in cases where specific permission is required for transactions above a monetary ceiling, it is generally received easily.

And all of these deregulation policies are expected to be continued in near future. But still it will not be suggestible to allow: • Give unlimited access to short-term external borrowings, and • Give unrestricted freedom to domestic residents to convert their domestic bank deposits and idle assets in response to market developments or exchange rate expectations. Such liberalization would cause extreme domestic financial vulnerability as the Asian crisis taught us. It should be realized that free mobility of capital has affected many countries, including Mexico, East Asia, Russia and so on. However strong the economic fundamental of developing countries, free flow of global capital inevitably sows the seeds of financial crises.

Excessive inflows of capital results in exchange rate appreciation and thereby affect the competitiveness of the host country in the international goods market, on the one hand, and widens the trade deficit by increasing imports, on the other. The central bank’s intervention to avoid these effects causes problems and affects the independent monetary policy operation. Full capital account convertibility may encourage arbitrage operation. It is so because banks, non-banking financial institutions and individual borrowers will prefer to borrow global capital cheap which would not only increase the external debt burden of the country but also encourage the functioning of the “ black economy” and financial instability because of the heavy investment in physical and financial assets.

Full capital account convertibility often provides wrong signals to the international investors about the host country’s economic fundamentals. Since the international investors are concerned about their profit maximization rather than productive investment, they mobilize their funds for higher returns which may results in moral hazard and adverse selection problems and thereby destabilize the financial system and cause great loss to the host country. Foreign capital is neither necessary nor desirable for India. It is so because the voluntary savings in India generated according to the time preference of the economic agents is mostly sufficient for the gross domestic investment and growth. The high real rates of interest promotes oth financial and total savings and private sector capital formation by facilitating the accumulation of finance necessary for undertaking investments. However, the cumulative net impact of the real rate of interest on investment is positive because its effect operating through financial intermediation and complementarily outweighs its cost effect.

Therefore, any reduction in interest rates affects both savings and investment. The proper utilization of domestic savings at appropriate interest rates structure is sufficient to put the Indian economy on a higher growth path. For this, needed is coordination among such economic agents as households, corporate, banks, and the Government, which, in turn, depends on confidence and expectation about the future economic activity. REFERENCES 1.

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