

Salient Features of Current Account Convertibility of Indian Rupee - An Economic Analysis

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ABSTRACT:

In this paper author seeks to present salient features of current account and convertibility of Indian Rupee. Current account convertibility means freedom to convert domestic currency into foreign currency and vice versa for trade in goods and invisibles (services, transfers or income from investment). Individuals and entities can convert currencies in the foreign exchange market. Exporters, importers, foreign investors, domestic investors investing abroad, residents and corporate etc., would like to convert domestic currency into foreign currency and vice versa to meet their international engagements. Current account convertibility refers to the freedom in payments and transfers in the current account international transactions. Article VIII, section 2, section 3 and section 4 of the International Monetary Fund (IMF) puts an obligation on the member countries for restoring the current account convertibility of their currencies. It puts obligation for removing the restrictions on current payments, avoiding any kind of discriminatory currency practices such as multiple exchange rates etc. However, capital account restrictions are allowed.

Key Words: *Capital account, Current Account, Movement, Foreign exchange, convertibility, present scenario.*

INTRODUCTION:

The government can put restrictions on foreign exchange convertibility which can lead to low currency convertibility. Easy convertibility of currency is necessary for achieving rapid economic growth and ensuring improvement in the living standards of the people. Earlier, fixed exchange rate system was followed by various countries under the Bretton Woods system. For maintaining the exchange rate in terms of gold or US dollar, countries imposed various controls on currency convertibility. In 1971, the Bretton Woods system collapsed and many countries switched over to the floating exchange rate system from the fixed exchange rate system. The floating exchange rate system allows the exchange rates determined by the market demand and supply of that currency. However, many countries still imposed restrictions on free currency convertibility due to the difficult balance of payment position.

REVIEW OF LITERATURE:

Rangarajan Committee Report on the BOP (1993) observes that in India, the role of capital account was minimal and restricted to the financing of the current account deficit in the pre-liberalization period till 1991. All private transactions were heavily regulated. The official flows dominated capital account together with ECBs and NRI deposits in this period. By 1991, however, India became one of the heavily-indebted countries in the world. In addition to the external debt problem, as a result of several adverse domestic and international developments as well as the macro-economic imbalances created by the inward-looking regime that spilled over to the BOP, a liquidity crisis in BOP occurred in 1991. The capital account collapsed with the drying up of external finances as a result of loss in investor confidence

Rakesh (2009) remarks that the Global Financial Crisis, influenced Indian outside division in 2008, is viewed as the most recent in the arrangement of the monetary emergency to antagonistically influence world economies. In contrast to the previous couple of emergencies, the current emergency has not saved any of the nations or market segments and has crushed economies that were customarily solid. It is expressed that an exorbitantly free money related approach during the 1990s in major formed economies changed into worldwide imbalances and an out and out budgetary and monetary emergency for every one of the economies of the world

OBJECTIVE OF THE STUDY:

✓ To present a perspective of account convertibility in India, present scenario, merits and challenges

CURRENT ACCOUNT CONVERTIBILITY:

Salient features of Current account convertibility of Indian rupee

- After the collapse of the Bretton Woods system in 1971, many countries switched over to the system of free currency convertibility on current account. By 1991 around 80 countries had introduced currency convertibility on current account.
- In India, after the economic reforms of 1991, the rupee was made partially convertible under the liberalised exchange rate management scheme from March 1992 onwards. Under this scheme, 60% of all receipts on current account was to be freely converted into rupees whereas 40% was on the basis of official exchange rate fixed by the RBI. India acquired the article VIII status of IMF in 1994.
- The 40% of fixed exchange rate convertibility was meant for fulfilling the government's exclusive requirements for the import of essential commodities. In March 1993, the foreign exchange budget was abolished and the exchange rate was unified, and transactions on the trade account were made free from the exchange control. The exchange rate of rupee was now left to be determined by the market forces of demand and supply.
- In August 1994 rupee was made fully convertible on the current account. In January 1997, the RBI announced some major relaxation in the currency exchange control. The RBI removed the monetary

ceilings prescribed for remittances of foreign exchange for various purposes. The authorised dealers could not allow remittances without having to take prior clearance from the Reserve Bank of India.

- Indian rupee is now fully convertible in any foreign currency for the current account transactions. However, some restrictions from the Foreign Exchange Management Act, 1999 (FEMA) is still applicable. These restrictions include non-convertibility for activities such as betting, gambling and on prohibited items.
- Different limits have been imposed on convertibility in the current account for traveling to other countries, sending gifts, educational purposes, employment, and medical treatment etc.

CAPITAL ACCOUNT CONVERTIBILITY:

Capital Account Convertibility means the freedom to convert rupee into any foreign currency (Euro, Dollar, Yen, Renminbi etc.) and foreign currency back into rupee for capital account transactions. In very simple terms, it means, Indian's having the freedom to convert their local financial assets into foreign ones at market determined exchange rate. Capital Account Convertibility will lead to a free exchange of currency at a lower rate and an unrestricted movement of capital.

Salient features of Capital account convertibility:

- Capital account convertibility refers to the ease and freedom in converting a country's currency into any other foreign currency (such as US dollar, pound sterling, Euro etc) and vice versa for the capital account transactions. Full capital account convertibility would ultimately lead to unrestricted movement of capital.
- Full capital account convertibility of Indian rupee was not introduced because the prevailing conditions were not in its favour as India was facing a large current account deficit. The government wanted to ensure the availability of foreign exchange at lower prices for the input of essential goods and commodities.
- India adopted a cautious approach in the full capital account convertibility of rupee in the view of the Mexican crisis. The subsequent East Asian crisis justified the approach of partial capital account convertibility. Earlier also partial capital account convertibility was allowed under certain conditions.
- Complete capital account convertibility can increase the inflow of capital in the country but if the conditions become unfavourable there is a great risk of the outflow of capital from the home country. This can lead to higher volatility in the exchange rates and can even create a crisis like situation as happened during the East Asian crisis.

DISTINCTION BETWEEN CURRENT ACCOUNT CONVERTIBILITY & CAPITAL ACCOUNT CONVERTIBILITY:

Current Account Convertibility allows free inflows and outflows of foreign currency for all purpose including resident Indians buying foreign goods and services (imports), Indians selling foreign goods and services (exports), Indians receiving and sending remittances, accessing foreign currency for travel, study abroad, medical tourism purpose etc.

On the other hand, Capital Account Convertibility is widely regarded as the hallmark of developed countries. It is also seen as the major comfort factor for foreign investors since it allows them to reconvert local currency back into their own currency and move out from India.

To attract foreign investment, many developing countries went in for CAC in the 1980s, not realising that free mobility of capital leaves countries open to both sudden and huge inflows and outflows, both of which can be potentially destabilising. More important, unless you have the institutions, particularly financial institutions capable of dealing with such huge flows, countries may not be able to cope as was demonstrated by the East Asian crisis of the late 90s.

PRESENT SITUATION IN INDIA

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 the pre-conditions primarily fiscal consolidation, strengthening of the financial system and low rate of inflation. With the exception of the last, the other two preconditions have not been achieved. The Capital Account Convertibility in India will depend on how fast the country meets the preconditions put forward by Tarapore Committee such as fiscal consolidation, inflation control, low level of Non-Performing Assets, low Current account deficit and strengthen financial markets. Sound policies, robust regulatory framework promoting a strong and efficient financial sector, and effective systems and procedures for controlling capital flow greatly enhanced the chances of ensuring that such flows fostered sustainable growth and did not lead to disruption and crisis.

- **Current Account Convertibility:** Current account is today fully convertible (operationalized on August 19, 1994). It means that the full amount of the foreign exchange required by someone for current purposes will be made available to him at the official exchange rate and there could be an unprohibited outflow of foreign exchange (earlier it was partially convertible). India was obliged to do so as per Article VIII of the IMF which prohibits any exchange restrictions on current international transactions (keep in mind that India was under pre-conditions of the IMF since 1991).

- **Capital Account Convertibility:** After the recommendations of the S.S. Tarapore Committee (1997) on Capital Account Convertibility, India has been moving in the direction of allowing full convertibility in this account, but with required precautions. India is still a country of partial convertibility (40:60) in the capital account, but inside this overall policy, enough reforms have been made, and to certain levels of foreign exchange requirements, it is an economy allowing full capital account convertibility. Following steps have been taken in the direction of capital account convertibility.
- Indian corporate is allowed full convertibility in the automatic route up to \$ 500 million overseas ventures (investment by Ltd. companies in foreign countries allowed).
- Indian corporate is allowed to prepay their external commercial borrowings (ECBs) via automatic route if the loan is above \$ 500 million.
- Individuals are allowed to invest in foreign assets, shares, etc., up to the level of \$ 2,50,000 per annum.
- Unlimited amount of gold is allowed to be imported (this is equal to allowing full convertibility in the capital account via current account route, but not feasible for everybody) which is not allowed now.

TARAPORE COMMITTEE ON CAPITAL ACCOUNT CONVERTIBILITY

In 1997, RBI appointed a committee on the capital account convertibility under the chairmanship of Mr. S.S. Tarapore, the former Deputy Governor of The Reserve Bank of India. As per the committee, capital account convertibility refers to the freedom to convert the foreign financial assets with the local financial assets and vice versa at the exchange rate determined by the market forces of demand and supply. The ultimate aim of capital account convertibility is to allow foreign investors to easily move in and move out of the Indian market and to make it clear to the foreign investors that India has sufficient Foreign Exchange Reserves for meeting any outflow of capital from India to any extent.

Full capital account convertibility would ensure availability of large funds for promoting the economic growth of India. It would provide the Indian economy easy access to the international financial markets and can reduce the cost of capital. It would incentivize the Indian investors for acquiring the international assets and securities which would ultimately improve India's position in the global competition.

CONDITIONS TO BE FULFILLED BEFORE FULL CAPITAL ACCOUNT CONVERTIBILITY

Tarapore committee gave the following conditions to be fulfilled before adopting full capital account convertibility in India.

- The government should reduce the fiscal deficit to 3.5 percent of the GDP. The committee recommended for setting up the Consolidated Sinking Fund (CSF) for the reduction of government debt.
- It recommended for mandated inflation targeting between 3% to 5%. The RBI was to be given full freedom for using monetary policy tools for achieving this inflation target.

- The committee recommended for strengthening the financial sector by deregulating the interest rates, reducing the non-performing assets to 5 , and the cash reserve ratio to 3%. It recommended for either the liquidation of weak banks or their merger with other strong banks.
- The current account deficit should be brought down to manageable limits and the debt service ratio to be reduced to 20 % from the present 25% of the export earnings.
- The Reserve Bank of India should have the exchange rate band of 5 of the real effective exchange rate. The RBI should intervene in the exchange rate market only when the real effective exchange rate is outside this band.
- To have adequate foreign exchange reserves in the range between \$22 billion and \$32 billion for meeting the import and debt service payments.
- The restrictions on the movement of gold need to be removed completely by the government.

FEATURES UNDER FULL CAPITAL ACCOUNT CONVERTIBILITY PROPOSED BY THE TARAPORE COMMITTEE

- The Indian corporate sector to be allowed to issue the foreign currency denominated bonds to the domestic investors, to issue the Global depository receipts, to invest in such securities and deposits, and to go for external commercial borrowings with certain limitations without the approval of the Reserve Bank of India.
- Allowing Indian residents to have foreign currency denominated deposits with Indian banks, allowing capital transfer to other countries with certain limitations etc.
- To allow the Indian banks to borrow from the foreign markets for short term and long term within certain limits, to accept and extend loans denominated in any foreign currency, and allowing them to invest in the foreign money markets etc.
- All India Financial Institutions which fulfill the specified prudential and regulatory requirements would be allowed to participate in the forex market with the authorized dealers.
- The banks and financial Institutions which would be allowed to participate in the international markets would also be allowed to freely purchase and sell gold and offer the gold denominated deposits and loans.

The committee had given a period of 3 years to achieve targets like current account convertibility etc which was too short to meet the preconditions and the macroeconomic indicators. Further, the political instability and the East Asian financial crisis did not allow the recommendations of the Tarapore committee to be implemented completely at that time.

SECOND TARAPORE COMMITTEE

In 2006, the RBI constituted the second Tarapore committee on the fuller capital account convertibility. The committee submitted its report in September 2006 and had drawn roadmap for 2011 for full capital convertibility of Indian rupee. At that time, Indian economy was having certain strong fundamentals such as forex reserves of \$165 billion, liberalised foreign exchange system, a prudent financial system for dealing with external capital flows etc.

However, certain economic events such as the global financial crisis of 2007-09 etc could not allow the RBI to go for full capital account convertibility. The partial capital account convertibility had helped India to cope up with the extreme capital outflows which could have taken place during 2008-09.

ADVANTAGES OF CAPITAL ACCOUNT CONVERTIBILITY

- Availability of large funds by improved access to international financial markets.
- Reduction in cost of capital.
- The incentive for Indians to acquire and hold international securities and assets.
- Greater financial competitiveness.
- Will help Indian corporate to use External commercial borrowing route without RBI or Govt approval.
- A Certain class of financial institutions and later NBFCs can access global financial market.
- Banks and financial institutions can trade in Gold globally and issue loans.
- Indian residents can hold and transact foreign currency denominated deposits with Indian banks.

DISADVANTAGES OF CAPITAL ACOOUNT CONVERTIBILITY:

- Market determined exchange rates being higher than officially fixed exchange rates can raise import prices and cause Cost-push inflation.
- Improper management of CAC can lead to currency depreciation and affect trade and capital flows.
- The advantages have been found to be short lived as per studies, and also International financial institutions are skeptical about CAC post-2008 crisis.
- Speculative activity can lead to capital flight from the country as in case of some South East Asian economies during 1997-98.
- Imposing control would become difficult in a globalized environment once CAC is introduced.

MERITS OF FULL CURRENCY CONVERTIBILITY

- The full currency convertibility will give the true value of rupee against the foreign currencies. If the market foreign exchange rate is higher than the previous officially fixed exchange rate, the profitability of Indian exports would increase.
- Higher market determined exchange rate would also promote import substitution as imports would become more expensive which would ultimately encourage the domestic industries.
- Higher market determined exchange rate would provide more incentives to the Indian workers living abroad and NRI to send remittances of foreign exchange. It would make illegal remittances such as Hawala money etc unattractive and the remittances would take place through proper channel.
- It would lead to greater integration of the domestic economy with the global economy. It would also allow Indians to invest globally, and hold an internationally diversified investment portfolio.

DEMERITS OF FULL CONVERTIBILITY OF RUPEE

- Full currency convertibility can lead to the appreciation of rupee which can cause a reduction in the Indian exports overseas. Appreciation of rupee would also increase imports which can have negative impacts on the balance of payment deficit.
- Full currency convertibility may also lead to the depreciation of rupee which would ultimately increase the prices of imports. Imports like oil etc cannot be substituted for domestic production which could ultimately intensify the inflationary pressures.
- Full currency convertibility would lead to the exchange rate of rupee being based on the market forces of demand and supply. This can strengthen the speculative tendencies in the market which could lead to instability in the financial system.

CONCLUSION:

Full currency convertibility provides a self balancing mechanism. If a country is facing balance of payment (BoP) deficit due to the overvalued exchange rate, full currency convertibility would depreciate the exchange rate which would ultimately boost exports and discourage imports. This will allow the BoP to get automatically corrected without the intervention of the central bank. The opposite would happen in the case of surplus BoP due to the undervalued exchange rate. In 2015, former deputy governor of the RBI, HR Khan had said that India is not yet ready for full capital account convertibility of rupee. This is because the Indian economy is expanding and it needs stability on the external front. According to him, India needs an eclectic combination of some capital account openness and some flexibility in the exchange rate. However, the former RBI governor Raghuram Rajan in April 2015, had said that India may have full capital

account convertibility in a short number of years. Therefore, it is expected that India would gradually move towards full capital account convertibility.

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