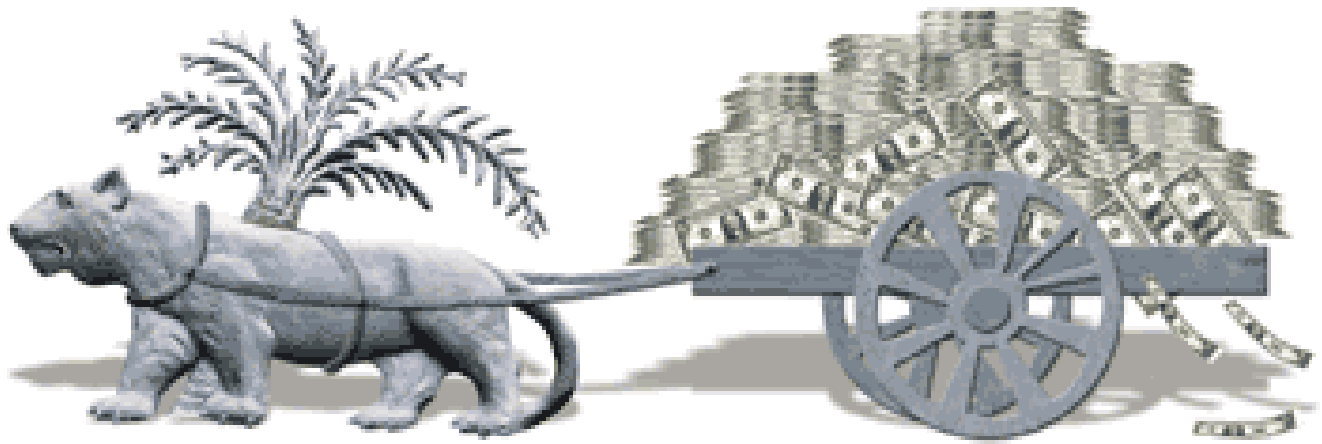


# **Bulging Foreign Exchange Reserves**



**Time for Greater  
Capital Account Convertibility?**

by  
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# **I What is Capital Account Convertibility (CAC)?**

There is no formal internationally accepted *definition* of the term 'Capital Account Convertibility'. However, in India, according to a widely accepted working version, Capital Account Convertibility (CAC) is defined as the freedom to convert local financial assets into foreign financial assets and vice versa at market determined rates of exchange. 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. It also does not preclude the imposition of monetary/fiscal measures relating to foreign exchange transactions which are of a prudential nature.<sup>1</sup>

In other words, CAC means that the home currency can be freely converted into foreign currencies for acquisition of capital assets abroad and vice versa. It implies the absence of any exchange controls or restrictions on those foreign exchange transactions that are linked with international capital movements.

For instance, if an Indian national wishes to purchase stocks of an American company from the New York Stock Exchange; or if an Italian company is willing to set up its subsidiary in Bangalore, India—A 'full capital account convertibility regime' would impose no restrictions whatsoever on conversion of the Indian Rupee into the US Dollar or that of the Italian Lira into the Indian Rupee respectively, for undertaking such operations.

## **II Capital Account Convertibility in India**

India has always followed a gradualist approach to capital account liberalization, and the Indian Rupee is still not fully (freely) convertible on the capital account. While the post-1991 liberalisation process has made a cautious and gradual move towards more capital account openness through the course of the 1990s, a considerable number of obstacles to full convertibility still exist.

India still maintains an extensive capital control regime. These controls have mostly been quantity-based rather than market-based, and have been administratively enforced. They have been oriented towards limiting the country's external debt, particularly acting to reduce excessive exposure to short-term foreign debt through restrictions on External Commercial Borrowings (ECBs). The external exposure of the insurance sector, pension funds and the external assets of banks are closely monitored.

Today, some of the main restrictions which compel India to be labelled as inadmissible to the "full convertibility" bandwagon are:

- Restrictions on External Commercial Borrowings (ECBs)
- Sectoral caps on Foreign Direct Investment (FDI) in Indian industry
- Uniform ceiling at 10% on Foreign Institutional Investment (FII)

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<sup>1</sup> Reserve Bank of India, (1997) Report of the Committee on Capital Account Convertibility, Mumbai, p.4.  
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India's controls have been effective in limiting undesirable capital flows and shifting their composition towards long-term flows. Among other factors such as the economy's limited trade and financial linkages with the global economy, exchange controls reduced our vulnerability and insulated India from the 1997 Asian crisis.

To trace the developments on the capital account front, we look at some of the past events. Soon after independence, a complex web of controls was imposed for all external transactions i.e. all transactions in foreign exchange. Capital account transactions were more or less negligible till the 1980s. Most receipts on capital account were on the Government account. It was only post-1980s that there were significant private capital flows through ECBs and deposits from NRIs. Though piecemeal relaxations were made on the capital account throughout the 1990s, the main thrust came only in 1997-98.

The then Union Finance Minister, Shri P. Chidambaram, in his Budget Speech for 1997-98 indicated that the regulations governing foreign exchange transactions need to be modernised and replaced by a new law consistent with the objective of progressively liberalising capital account transactions. Consequently, the 1997 Tarapore Committee on Capital Account Convertibility was appointed by the RBI to lay out the road map towards capital account convertibility. However, the South East Asian crisis occurred in the same year and dampened the spirits of our government, breaking the speed of reforms and ushering in a rethinking of strategy. Wisely enough, more stable flows such as direct and portfolio investment have been liberalised first, followed by partial liberalisation of debt-creating flows.

Things are different on the current account front. In accord with the obligations imposed by Article VIII (IMF) that India signed in August 1994, there are minimal restrictions on current account transactions and the rupee has become fully convertible on the current account in 1994.

### **III The Case for Greater Capital Account Convertibility**

While there is no discernable disagreement that a partially open capital account is desirable, there has been an ongoing debate about the pros and cons of full capital account convertibility. We still do not have a broad consensus that an open capital account is good for the Indian economy.

One of the most persuasive arguments for capital account liberalisation is that globalisation is here to stay and countries cannot abstain from the growing global financial integration. With increasing financial integration of developing countries with financial markets in the industrialised world, opening the capital account becomes unavoidable, as a country cannot remain isolated. Hence, sooner or later, they will need to liberalise their capital account in order to reap maximum benefits from the existing system. Those remaining aloof have a lot to lose.

*“If countries do not plan for an orderly integration with the world economy, the world will integrate with them in a manner which gives them no control over events. Thus, the question*

*is not whether a country should or should-not move to capital account convertibility, but whether an orderly or a disorderly transition is desired.”<sup>2</sup>*

Following are a few key benefits of greater capital account convertibility:

**1. Less dependence on domestic financial structure:**

Since a fully convertible capital account would allow Indian companies to mobilise resources from well-developed international financial markets, it will help them in overcoming weaknesses in the domestic financial architecture through unhindered access to international capital markets.

**2. Financial sector improvements:**

In the dynamic financial sector, benefits from improved international competition leading to the breaking up of the oligopolistic structure, if any, and a more efficient domestic financial system by intensifying competition between financial intermediaries is seen as another positive outcome of capital account liberalisation.

Hence, CAC provides a huge potential for significant increase in the efficiency and sophistication of the financial services sector. Provided opening up of the capital account is accompanied by free trade in financial services, the competition provided by foreign suppliers of financial products and services will force the domestic banking and other financial institutions to enhance their skills, increase their efficiency and become better financial intermediaries. An open capital account will thus help our financial services sector scale up and become globally competitive.

**3. Wider investment choices, risk diversification and welfare gains:**

CAC offers a wider choice to domestic savers to globally diversify their portfolios and invest in instruments that possess lower risk and/or offer higher returns. Individuals and institutions can actually hedge their risks by investing in a manner that their assets are globally diversified. A Mexican investor, for example, whose portfolio is confined only to Mexican assets runs more risk than one who can diversify internationally.

Also, because the price for bearing risk differs across countries, there are welfare gains in trading in international markets analogous to the trading of commodities. These welfare gains are seen in risk diversification by economic agents i.e. an investment portfolio with a mix of assets with different risk/return profiles. Hence, with a fully convertible capital account, an investor can undertake not only domestic diversification, but cross-border diversification as well, thus expanding his choices.

**4. Increased domestic savings:**

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<sup>2</sup> Tarapore, S. (1998), p. 71.

This is a direct corollary of the aforementioned point. Any expansion in the investment and portfolio choice of domestic savers to include foreign assets would induce residents to save more, thus enhancing the domestic savings level. In other words, greater CAC augments the investible resources in the country through greater access to international capital.

## **IV The Sceptics' Argument**

The 1990s were marked by markets by two major events in international financial markets in the context of emerging market economies. One was the rapid increase in international private capital flows and the other was the occurrence of financial crises, beginning first with Mexico in Dec 1994 and its accompanying contagion effects and the recent contagion effects and the recent crisis in East Asia.

In both these cases, a surge in capital inflows was followed by sudden reversals leading to a financial crisis in the receiving country. Hence, many believe that an open and convertible capital account is an invitation to a foreign exchange crisis and are of the opinion that a closed capital account will avert such a disaster.

Now, there are two counter-arguments to this school of thought.

One, a crisis can occur with a closed as well as an open account and even a cursory view of crises would prove that. A case in point is that of Malaysia and Thailand, both of which had relatively open capital accounts since the 1980s. If capital account liberalisation *per se* was the cause of crisis, it should have happened much earlier. The underlying implication is that it is imperative for economies to put their house in order if a crisis is to be averted. In the case of Malaysia and Thailand, evidence points to the failure of supporting policies (i.e. prudential regulation and monitoring, weaknesses of the financial sector and lack of flexibility in exchange rate policy) as the cause of the crises.

Two, the damage caused by most foreign exchange crises is only short lived, since it is followed by rapid recovery. In fact, strong adverse reaction to open capital account following the Asian crisis has significantly subsided in the light of rapid recovery in the affected countries (except, of course, Indonesia which is a different story). However, this can further lead to the question: why subject the economy to the risk of a systemic crisis even if the probability of its happening is very low, if the incremental benefits are in any case likely to be small?

## **V The Link between Forex Reserves and CAC**

Insofar as capital account convertibility is concerned, the level of foreign exchange reserves becomes a key consideration for policymakers. An adequate level of foreign exchange reserves is essential to withstand cyclical changes in the balance of payments as well as unanticipated shocks which lead up to reversals of capital flows. In the context of CAC, a

high level of reserves also boosts the confidence level of foreign investors planning to park their money in India.

Defining the adequate level of reserves in terms of a quantifiable norm is difficult and necessarily country-specific, depending on structural aspects of the country's balance of payments, the nature of shocks, the degree of flexibility in the exchange rate regime and access to international capital markets. A rule of thumb which has evolved in the context of developing countries with current account deficits is that foreign exchange reserves should be equal to at least three months of imports at any point of time. Measuring the adequacy of reserves exclusively in terms of imports or payments cover is more useful in a situation where capital flows are strictly controlled. In the context of a move towards CAC, since capital flows would have a more significant effect on the balance of payments, the conventional indicator in terms of import cover does not provide a good measure of the adequacy of reserves.<sup>3</sup>

### **Foreign Exchange Reserves in India**

India's central bank, the Reserve Bank of India (RBI), currently (Dec 2003) holds foreign exchange reserves in excess of US \$94 billion. And with millions more pouring in every day, the hoard can very well cross the \$100-billion-mark by the end of this calendar year. The prime reason attributed for our swelling reserves is the 2002-2003 current account surplus of US \$3.7 billion, which was fuelled by a bullish global economy and hence rising exports; and an unprecedented rise in Business Process Outsourcing from India. In addition, there has been a huge upsurge capital flows like Foreign Portfolio Investment due to a good monsoon and interest rate differentials.

Few would dispute that the sizeable build-up of foreign exchange reserves has been the most significant macroeconomic development in the country over the last decade. Reserve accumulation has, in fact, been an enduring phenomenon since the start of the 1990s and there has not been a single year —barring 1995-96— that has not seen an accretion to India's forex kitty. The total forex reserves have risen from US \$3.96 billion in March 1990 to US \$94 billion as on December 2003.

From 1990-91, in the ten years ending 2001-02, the aggregate current account deficit shrank in *absolute* terms to \$34 billion, even as capital inflows, net of repayments, rose to \$82 billion. The absolute lowering of current account deficit levels reduced the draft on capital account surpluses, enabling greater deployment of these inflows for beefing up reserves. The end-result was a reserve accumulation of over \$48 billion during this period.

Hence, there are various other ways to gauge whether current level of reserves is adequate, apart from the conventional parameter of 'import cover'. The two most common sets of

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<sup>3 3</sup> Reserve Bank of India, (1997) Report of the Committee on Capital Account Convertibility, Mumbai.  
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parameters used by economists are whether there is enough foreign exchange to meet sudden withdrawals of short-term capital and reserves as a percentage of select measures of money supply. The table below, based on a research paper by economist Ila Patnaik of Indian Council for Research on International Economic Relations, clearly shows that India's reserves are more than adequate.

<b>How adequate are India's reserves?</b>				
	What it should be	What it is		
		Mar 2001	Mar 2002	Mar 2003
Import cover (months)	>6	8	11.3	14.0
Short-term debt/reserve (%)		8.6	5.1	7.1*
Forex assets/currency in circulation (%)	70	90.4	105.2	125.6
Net forex assets/reserve money (%)		65	78	98.0
Non-debt liabilities + short-term debt/reserve (%)	<60	40.3	33.2	27.2

Source: Data for March 2001, March 2002 and March 2003 from India's policy stance on reserves and the currency by Ila Patnaik, September 2003; Data for non-debt liabilities + short-term debt/reserves for all years from CMIE

Note: What it should be data is according to the recommendations of the Tarapore committee on capital account convertibility \*Data for June 2003

Table 1

Another concern that crops up from various quarters is regarding the sustainability of the current foreign exchange build-up. In other words, if the forex surge reflects only transient factors, there is no basis to infer that it will be sustained over a longer period of time. These transient factors include inflows in the form of portfolio investment or NRI deposits, which are more akin to 'hot money'. They can flow as easily out of the country as into it, and hence they have a 'risk' element attached to them.

A look at what has been behind the growth of forex reserves over the first six months of the year may provide the answer. In the first six months of 2003, the growth in NRI deposits and total portfolio investment as a proportion of the growth in forex reserves was around 42%, much higher than the 20% in the last six months of 2002. Between April and June, forex reserves grew by \$6.6 billion. In the same period, growth in NRI deposits and net portfolio investment into the country was \$3.63 billion. In other words, around 54% of the increase in forex reserves in that period was due to hot money inflows. However, given the 1997 Tarapore Committee recommendation that 'short term debt and portfolio stock should be lowered to 60 per cent of the level of reserves,' the situation does not raise an alarm. The table below illustrates the aforementioned trend.

<b>More reserves, new concern</b>				
Change in	Jul- Sept 02	Oct- Dec 02	Jan- Mar 03	Apr- Jun 03
Forex reserves	<b>4,960</b>	<b>7,331</b>	<b>4,896</b>	<b>6,656</b>
NRI deposits (total)	<b>773</b>	<b>1,024</b>	<b>726</b>	<b>2,238</b>

Bulg.

Table 2

## **VI The Way Ahead for India**

Indian reserves are close to a \$100 billion. The rupee has appreciated for the first time ever, and appreciated by more than 5% in just a matter of months. The call is out for full capital convertibility.

However, if one were to go by the recommendations of the 1997 Tarapore Committee, there was a plethora of pre-conditions to CAC —low inflation, healthy banking and financial system, high growth, high growth of exports, the current account in reasonable balance, foreign debt in control, low short-term debt, confidence of lenders in India, the rupee not weak, low fiscal deficit et cetera— apart from the requirement of a healthy forex reserve base.

While India has scored fairly on most other parameters in the current context, the requirement of sound public finances with low fiscal deficits still remains unfulfilled and draws our attention. There has been little change in the size of fiscal deficit as a proportion of GDP. It continues to hover around 6%. The gross fiscal deficits of the centre and states together is currently over 10 per cent of GDP. This far exceeds the prescribed level of deficit at 7% of GDP (consolidated for centre and states).

A huge fiscal deficit makes capital account liberalisation a slightly risky proposition. This is because a high fiscal deficit will crowd out private investment. Assuming a full CAC regime, this will force private investors to borrow funds from international markets. As a direct result, this will burgeon the debt component as a proportion of our total foreign exchange reserves, which is a highly undesirable situation.

However, some argue that a high fiscal deficit cannot be a constraint on capital account convertibility. The logic is simple. Assuming full convertibility and that the government continued with its excesses on expenditures. Indians, and global investors, will naturally give a thumbs down to such extravagance. We would want to convert the rupee into gold,

or dollars or other foreign assets. The government will find it difficult to borrow, will have to pay a higher yield, and there will be a "check and balance" on its extravagant expenditures. In other words, the deficit will likely reduce.

During the last couple of years, the current account has shown considerable improvement with a surplus in 2002-03, and the NPAs of the banking system appear to have declined significantly to about 5.5% of net advances (for scheduled commercial banks). Therefore, we can safely say that overall the macro-factors are favourable to further opening up of the capital account.

Hence, in conclusion, we can say that like a long-distance runner who puts on added speed during the last lap, the time has come to significantly accelerate the pace of moving towards the goal of an open capital account.

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