



# DYNAMICS OF RUPEE CONVERTIBILITY

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## Abstract

*Full convertibility of Indian Rupee involves many complex issues. The approach of Reserve Bank of India in this regard has been cautious. Risks associated with volatile inflow of foreign fund justify the precautionary approach followed so far. Capital Account Convertibility will promote greater financial efficiency, specialisation and innovation by exposing the domestic financial sector to global competition.*

Convertibility of Rupee is a much talked about subject. It is in the early 1990s that the issue gathered a lot of importance for the first time. Initiation of economic reforms in the early nineties brought out the need to reform external sector. It is in 1993 that the Report of the High Level Committee on Balance of Payments set a broad agenda for market determined exchange rate regime, liberalization of current account transactions, a move from debt creating inflows of capital to non debt creating inflows and restrictions on external commercial borrowings in general and especially on short term debt. A gradual and calibrated process was followed in

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respect of achieving full convertibility on current account. This task has already been completed and Indian Rupee is fully convertible so far as current account transactions are concerned. Simultaneously, the country has also been considering liberalization of capital account transactions although the process has been gradual.

## Meaning of Full Convertibility

A currency is said to be fully convertible if its holder can convert it at any time, into gold or any other generally acceptable foreign currency at a predetermined fixed rate, without any restriction from the monetary authority. In such a situation currency is convertible both for payment against the current account transactions and capital account transactions and the monetary authority fixes buying and selling prices for gold and other generally acceptable foreign currencies.

## Approaches to Full Convertibility

There are two approaches to the issue of full convertibility. The first one is the big bang approach that argues for a rapid implementation of full convertibility without waiting for the preconditions to materialise. The market will decide for itself and the invisible hands will operate in the economy to bring in equilibrium. The second is a conservative approach going for a gradual and cautious implementation of full convertibility. It is interesting to note that RBI is neither with the radicals nor with the conservatives. When we introspect, we find that full convertibility has already been achieved in current account transactions of BOP whereas it is partially implemented in capital account transactions of BOP.

## Capital Account Convertibility

The Tarapore Committee, 1997, defined Capital Account Convertibility (CAC) as "the freedom to convert local financial assets into foreign financial assets and vice versa at market determined rates of exchange." In general terms, this would amount to citizens of a country enjoying the freedom to freely converting domestic currency into any foreign currency and vice versa for personal, business and investment purposes inside the country and abroad. It is desirable to state that this facility is theoretically considered advantageous as it is supposed to promote greater financial efficiency, specialisation and innovation by exposing the domestic financial sector to global competition. The other advantages claimed are: it will allocate global savings efficiently and it will exert pressures to discipline domestic macro economic and financial environment.

Full convertibility on current account is already achieved in India through Liberalised Exchange Rate Management Scheme (LERMS) in 1992. India accepted the IMF Article VIII in 1994, which makes a member country mandatory to have no inward or outward restrictions on current account and trade-related transactions. With respect to capital account convertibility, there are several complex issues.

## Policy Issues

While economists do perceive the benefits of CAC, we need to examine two issues before taking a final decision. One important issue is: Are we today ready for rupee convertibility? Indeed, current account convertibility is full as of now with some minor restrictions. To some extent CAC also prevails in so far as resident Indians and listed companies are permitted to invest in some overseas companies; NRIs are allowed to purchase and sell financial instruments and to repatriate assets in India and move their other incomes; resident Indians can open resident foreign currency accounts in India and remit foreign exchange for acquiring foreign securities and so on. Therefore, the issue now is: Can we go in for full capital account convertibility of rupee? The second issue is: What will be the likely impact of CAC on the Indian economy especially on its development process and macro economic stability?

On the first issue, the experience of Latin American and South East Asian Countries with their premature currency convertibility suggests that we should cautiously tread the path of full convertibility. Recognising the danger involved in treading such a path, the Tarapore Committee laid down the following pre-conditions before India chose to adopt full convertibility of rupee on capital account:

- a) Reduction in fiscal deficit to 3.5% of GDP.
- b) Reaching an inflation rate of 3-5%.
- c) Strengthening the financial system by reducing CRR to 3%, reducing NPAs from 13.7% to 5%, and deregulating the interest rates.
- d) Strengthening the external sector by reaching 15% level of current receipt/GDP rates, reducing debt service ratio to 20% and accumulating adequate forex reserves, say, at least of the order of not less than 6 months imports.

Eruption of the Asian crisis in 1997 indicated that economic shocks could bring about disruptions resulting in re-imposition of controls in case a country does not have a cautious approach towards liberalization of capital account. Perhaps, the immediate outcome of the experience with the Asian crisis was the realization that

each country would need to decide on its own path of capital account liberalization especially with regard to their readiness, timing and sequence. While India could be more flexible on liberalization of current account transactions experience of emerging economies indicates that there are several parameters which need consideration before India decides to go in for capital account convertibility.

## Initiatives in Indian Context

Indian rupee is fully convertible on current account at present. Both the Government and the RBI are currently on a liberalization spree so far as the Capital Account transactions are concerned. This could be seen from the developments on this front during the last couple of years, which include:

- Extensive freedom granted to resident entities to make investments abroad.
- Efforts taken to help the corporate entities access the Euro commercial segment of the market through liberalisation.
- Extensive changes introduced in the Foreign Direct Investment Policy with a view to encouraging investment in manufacturing and infrastructure.
- Freedom given to foreign institutional investors registered with SEBI and Non resident Indians to purchase shares, bonds and convertible debentures under the Portfolio Investment Scheme.
- Freedom available to corporate entities to access foreign currency resources abroad through the issuance of ADRs and GDRs.
- Significant changes brought about in the policy framework for non-resident Indian deposits held by the Indian banking system.
- Provision made for hassle free remittance facilities to resident individuals, on a declaration basis up to US\$25000 per annum for any permitted purpose both under current and capital account or combination of both.

While these are some of the major policy initiatives, there is enough evidence to show that the liberalization process that has been underway for sometime has created a more competitive environment for Indian industry and it has contributed in a big way towards the integration process of India's financial and real sectors with the global markets.

The initiation towards capital account convertibility has been a calibrated and well thought out process in the Indian context. It has however been possible to accelerate the process of liberalization on this count on account of improved macro economic

fundamentals of Indian economy in general and the strength garnered by its external sector, in particular. This could be observed from the fact that:

- Indian economy has come out the "licence raj" and it has opened up on larger scale to the global economy in the recent past than before.
- With its US \$600 billion in size, Indian economy is 12<sup>th</sup> largest in the world.
- India's overall GDP growth rate currently is 6 to 6.5 per cent and inflation rate is at moderate 5 per cent.
- India's export growth is robust and its capital flows are much encouraging than before.
- India's foreign exchange reserves are at a whopping US \$140 billion, the increase being of the order of US 28 billion during the current fiscal year so far. This is against the position of India having a mere \$800 million as reserves in 1991 which enabled it to import its requirements of just 15 days.
- India's foreign exchange reserves can provide about 18 months' cover for its imports.
- India holds 6<sup>th</sup> largest position in accumulation of foreign exchange reserves and it accounts for as much as 20 per cent of its GDP in 2004.
- With its large amount of foreign exchange reserves on hand, the country can repay all its external debt, which stood at \$112 billion as at end March 2004.
- The ratio of India's external debt to GDP has dropped from the high level of 30.8 per cent in 1995 to 17.4 percent in 2004.
- India is currently a creditor to the IMF and it has been included in IMF's Financial Transactions Plan for rendering assistance to countries which are facing balance of payments problems.
- India has started prepaying its high cost debt and during 2003 and 2004 and it has already prepaid about \$7 billion apart from the fact that it redeemed Resurgent India Bonds involving a large sum of \$5 billion. It is also expected to redeem India Millennium Deposits during September 2005.
- India's short-term debt to foreign exchange reserves declined from 146.5 per cent at end March 1991 to 4.2 per cent as at end March 2004 whereas the ratio of volatile capital flows (defined to include cumulative portfolio inflows and short term debt) to reserves declined from 146.6 per cent to 36 per cent during the same period.

## Advantages of CAC

Availability of a larger capital stock to supplement domestic resources and thereby a higher growth rate and reduction in the cost of capital – interest, and improved access to international financial markets are major advantages envisaged by capital account convertibility. Capital account convertibility allows the resident to hold an internationally diversified portfolio, which reduces vulnerability of income streams and wealth compared to domestic real and financial stocks. CAC lowers funding costs to borrowers and creates prospects of higher yields to savers. Dynamic gains from financial integration through improved allocation efficiency; stimulation of innovation and better productivity would be associated gains of CAC. Indian tax regime has to rationalize to converge into international tax structures. This will reduce the scope of tax evasion and capital flight.

## Precautions

The Tarapore committee has made certain cautions prior to implementation of full convertibility. The reduction of interest rate and fiscal deficit, the structural reforms of the Indian financial system are the most important criteria. The higher interest rate of 6.5% and fiscal deficit of 6 - 8% are huge hurdles for implementing the full convertibility. A highly efficient management information system is sine-qua-non for an effective risk management system, to avoid wealth depletion of asset holders and minimization of volatility in investments.

Rupee convertibility without meeting the problems of diminished global importance of India in trade and finance will only cause rampant speculation and further depreciation of rupee's value. We need to have a national policy of making Indian economy a global player. For a start, it could be increasing India's share in world trade through policies, which promote exports. In turn, this will increase demand for rupee.

A sound financial and banking system should be in place along with an autonomous central bank which will give investors confidence in holding rupee denominated assets. Once India makes progress on aforesaid issues, confidence in the rupee and our financial system will be restored. After this capital account convertibility-freely floating rupee – shall be our reach.

Since 1966, when the first devaluation of the rupee was announced, the Indian currency has fallen nearly by 670% vis-à-vis the US dollar (from Rs 7/- in 1966 to over Rs. 43/- today). The primary cause of the weakness of the Rupee has been

India's diminishing importance in world Trade. In 1947, India accounted for 5% of the world trade compared to 0.5% today, decline of nearly tenfold. When a country ceases to be a major player in international market, demand for its currency also drops.

The goal of full convertibility by year 2010 should be preceded by the implementation of norms in the financial and banking sector, and a bigger presence in the international market.

## Fiscal Deficit and External Balance

While a moderate government deficit corresponding to a sustainable current account gap may be desirable in building up domestic capital formation, a persistently large fiscal gap however, may turn the external payment situation unsustainable. Persistent high levels of current account deficit pose a short-term risk and a long-term problem. To the extent that it generates an unfavourable market sentiment, the adverse effects on interest rate and exchange rate could turn the domestic policy unsustainable. The long-term problem manifest through increased debt service payments, erosion in the long run investment prospects and a sustained loss of confidence in the economy. It is in this context that the measures to reduce domestic absorption and improve public saving constitute important policy ingredients of the adjustment towards creating a sustainable balance of payment environment.

Fiscal deficits increase the aggregate demand level in the economy and may influence output (in the absence of supply constraints), disposable income, consumption and investment, thus raising the import demand at each stage of transition (C Rangarajan, M.S Mohanty, 2003). Given the availability of borrowed resources from non-monetary and external sources, a part of the deficit is financed by resorting to borrowing from central bank. The stock of money therefore evolves endogenously through the feedback from reserve money, which varies with the changes in fiscal deficit. The money stock along with output determines the price level in the economy, which in turn determines the relative prices of imports and exports. To the extent that nominal exchange rate deviates from its full purchasing parity level, given the domestic and world price levels, fiscal deficit financed by money creation leads to appreciation of real exchange rate, leading to a rise in imports and decline in competitiveness of exports. The resulting current account deficit creates a financing need and increases the stock of external debt and interest payment, enforcing the initial deterioration in the current account balance.

## Current Position of Foreign Exchange Reserves

Foreign exchange reserve of India is bulging. There is continuous increase in inflow of foreign currency resources since the globalisation and opening up of the economy in 1991. India has the sixth largest dollar reserve in the world.

**Table 1. Foreign Exchange Reserve Position of India**

Date	Foreign exchange reserve (In billions of US \$)
March 31, 1991	5.8
March 31, 2002	54.1
May 31, 2002	55.6
December 1, 2003	97.5
February 6, 2004	106.6
August 30 2004	126.6
February 28, 2005	142

Source: Compilation by the author from multiple sources.

What to conclude from the above facts? India no longer required living a hand to mouth existence, frantically finding out ways to pay for imports or to pay the short-term debts. There are some significant observations with respect to Indian Forex. Much of the increase in forex reserve occurred during the past two years. IMF and World Bank have been pressurizing for more capital market liberalization - free markets and market liberalization in India. With acceleration of capital flows, and integration of financial markets domestically and globally, India could build up a vast chest of foreign currency. The argument is for making rupee fully convertible on current account and capital accounts of BOP, simultaneously liberalising the capital market in order to attract foreign capital, especially FDI.

## Arguments against Full Convertibility

Some economists argue, in order to attract FDI, capital market liberalisation is not necessary. For instance, China became a destination of huge sum of FDI even without capital market liberalisation. Given the high savings rate of India, the country hardly needs additional funds. The task for India is to canalize the flow of savings in desired lines of investment. Savings in India pile up with banks pushing the rate of interest downwards. FDI itself is a vehicle of economic drain: foreign companies overrun local ones. Investment flourishes because of special privileges



**Table 2. Foreign Exchange Reserves Compositing of India.**

	Foreign Currency		Gold		SDRs			Reserver tranche Position of IMF		Total	
	Rupees Crore	in millions of US\$	Rupees Crore	in millions of US\$	in millions of SDRs	Rupees Crore	in millions of US\$	Rupees Crore	in millions of US\$	Rupees Crore	in millions of US\$
1	2	3	4	5	6	7	8	9	10	11	12
2002-03	341476	71890	16785	3534	3	19	4	3190	672	361470	76100
2003-04	466215	107448	18216	4198	2	10	2	5688	1311	490129	112059
2004-05	593121	135571	19686	4500	3	20	5	6289	1438	619116	141514

Note: Gold is valued at average London market price during the month.

Conversion of SDRs into US\$ is done at exchange rates released by the IMF.

Conversion of foreign currency assets into US\$ is done at week end and month end New York closing exchange rates.

Foreign exchange holdings are converted in foreign exchange reserves from April 2, 2004 to match the best practices.

**Table 3. FDI Share in India's GDP (Rs. Crores)**

Year	GDP	FDI	FDI as % of GDP
1997-98	1376943	16143	1.17
1998-99	1583159	14280	0.90
1999-00	1746407	15210	0.87
2000-01	1885713	20591	1.09
2001-02	2078871	21498	1.63
2002-03	2230272	17768	0.79
2003-04	2497691	16409	0.65

Source: Central Statistical Organisation

extracted from the government- such privileges are the results of corruption, bribery and bureaucratic norms. The inflow of capital leads to appreciation of country's currency, making imports cheaper and exports dearer. Removal of exchange and capital controls makes room for the influx of hot money into and out of country. Today's developed countries earlier till 1970's did not attempt rapid capital market liberalisation. Indian banking system is not so matured. Joseph Stiglitz points out, "Setting them off on a voyage on a rough sea, before the holes in their hulls have been repaired, before the captain has received training, before life belts have been put on board." The risk is that when foreign lenders or investors pull their money out at the first sign of trouble- exacerbating the economic downturn as indicated by south East Asian Currency Crisis in 1997.

## FDI Outflows

Going by current growth trends, annual foreign direct investment (FDI) outflows from India could exceed FDI inflows into the country by 2008-09. In the past five years, both inflows and outflows grew at the same rate. Since 2002-01, overseas investment outflows fuelled by aggressive cross-border acquisition by Indian companies have grown at a compounded annual growth rate (CAGR) of 35%. In comparison, during the same period FDI inflows into the country has grown by just 8%.

FDI inflows into the country could grow at a faster rate if the retail sector is opened up. If outward FDI flows from India do outpace inflows, as many believe it is likely, it will mark a significant milestone in the growth of both the Indian economy and the corporate sector.

“Indian investment in UK is already greater than UK’s investment in India. Growing overseas investment from India shows the growing maturity of Indian businesses as they seek to access foreign markets and technology” (Rajiv Kumar, Chief Economist, CII).

The fact that FDI outflows could outpace inflows shows that India has been an underachiever when it comes to attracting FDI. Even with a liberal FDI definition, India remains well short of the \$10 billion FDI target set by NDA government a few years ago. While greater FDI outflows could result in lower or even negative net FDI inflows. Analysts believe higher export earnings and improved corporate performance will provide a cushion to the BOP situations (Vidhika Sehgal and Javed Sayed, Economic Times, 13 September 2005).

In the world of perfect capital mobility, domestic savings and investment would flow between countries in search of the highest real rates of returns. Capital mobility affects the potency of fiscal, monetary and exchange rate policies (Hague and Montiel, 1991; Montiel, 1994). For this reasons, many developing countries try to impose controls on capital movements. In spite of the strict financial controls, majority of developing countries experience high capital flight (Hague and Montiel, 1991). This constitutes BOP difficulties.

China started to introduce capitalist business model in 1978 and privatization of some public sector undertaking began in 1984. China is the fourth largest economy in the world with a constant growth rate of 7% per annum. It is sixth largest exporter; the amount of annual FDI remains \$50 billion and foreign exchange reserve of \$250 billion. Factors like labour force, government policy and economic and political stability make China a destination in attracting FDI (M Janardhana Rao, 2003).

## Risks in Volatile Capital Inflow

The capital that has entered into our economy is highly volatile. NRI bank deposits, FII funds in stock market, outstanding commercial borrowings, suppliers credit and all short-term loans together come to two-third of the total forex reserves. FII were negligible in 2002, but they exploded in the second half of the 2003. The rise in the secondary market prices of shares was caused mostly by steep fall in interest rates on bank deposits. FII portfolio investment crossed 10 billion\$ in 2003 which was clearly aimed at reaping huge gain out of rising prices of shares in secondary markets. It causes an appreciation of Rupee. NRI deposits in deposits are aimed at taking advantage of the appreciation of rupee. Another significant factor in the

increased foreign exchange reserves in 2002-2003 was the banking capital. Banks borrowed abroad at low rates and lent at home at higher rates.

The caution of former RBI Governor Bimal Jalan in this respect is worth remembering: "With full convertibility, the residents may transfer their deposits abroad. In that event, \$290 billion equivalent of Indian bank deposits - roughly more than two times the foreign exchange reserves - may leave the country in search of greener pastures, precipitating a crisis far bigger in dimension than that in Argentina in 2001. Even if a fraction of these deposits are slashed away or simply transferred to a foreign territory, it will be enough to destabilize the BOP." Bulging foreign exchange is a threat to BOP stability posed by the appreciation of the rupee caused by massive inflow of foreign funds. The appreciation of rupee has made its impact on current account. Exports have become non-competitive and imports have started growing. Invisible receipts are likely to fall if BPO is checked by governments. Rupee value will then depreciate. Inflow of capital may dry out and reversal of capital inflow will take place. In that event the collapse of Argentina may be rehearsed in India- remember Argentina's forex reserves of US\$82 billion disappeared in a single day under the impact of speculative capital transfer.

While a comfortable level of foreign exchange reserves provides the confidence and flexibility to go ahead with liberalization of capital controls, a question, which is being often asked, is how much of reserves would be needed to have full convertibility on capital account. Adequate level of foreign exchange reserves is necessary to meet import requirements, unforeseen contingencies and liquidity risks associated with different inflows. Adequacy of reserves also needs to be seen from the angle of "Liquidity at Risk" or "worst case liquidity needs" that a country could face. Under the latter scenario foreign exchange liquidity need is estimated for different simulated scenarios, using a variety of parameters, including exchange rates, commodity prices, credit spreads etc.

At present, the de facto full capital account convertibility for non-residents is supported by the calibrated liberalisation of transactions undertaken for capital account purposes in the case of residents. The achievement on this front has to be recognized against the plethora of not so positive developments, which have taken place either internationally or domestically. These include a series of financial crisis in Asia, Brazil and Russia and the September 11 terrorist attacks in the US apart from the border tensions, sanctions imposed in the aftermath of nuclear tests and political uncertainties India has been facing from time to time.

First of all, we need to examine whether total capital account convertibility is desirable at this juncture and should we have it in one stroke? In other words should we liberalize all the remaining capital controls in one go? As far as the future is

concerned, in the first place, the "Impossible Trinity Factor" (Peter J Montiel, 2003) is already visible so far as India is concerned. Central banks, the world over has not been able to keep a check on interest rate, exchange rate and inflation at a time, together. If there is large inflow of capital across borders interest rate could either plummet or go high depending on the directions of such flows. If the rates go down it could encourage, in the case of governments of emerging economies like India, to borrow more. If the interest rates go up it may adversely affect creditors who would need finance from banks and financial institutions. So also, if there is large capital inflows or outflows domestic currency is expected to appreciate or depreciate as the case may be. If the economy is flush with liquidity there is the possibility of an inflationary spiral and if there is a liquidity crunch, the position could be vice versa. The issues become more complex when one does not really know what an enduring capital inflow is and what is not.

Secondly, financial markets are unpredictable. It is in the habit of throwing traders off track. Despite all out efforts by Greenspan, to cut down the twin deficits, the breadth and depth of US currency's slide over the last couple of years give an impression that US dollar is facing a terminal decline. Coupled with this, the efforts of some of the Asian countries, which sit on piles of forex reserves to diversify their foreign assets into other currencies, could bring about dramatic changes on the international financial scene. While no unidirectional or unrestricted rise or fall of major currencies on a long term and continuous basis can be expected on account of alertness of central banks, even small changes in either way can set in motion movement of large volumes which can adversely affect economies which permit unrestricted capital flows. Accordingly, before we consider full convertibility of rupee on capital account, it would be appropriate to weigh the pros and cons of the decision in some depth.

Thirdly, the oil import factor continues to play a key role on most emerging economies like India. It is a fact that oil prices are not expected any more to fall like snow flakes and OPEC prices have risen by 28 per cent in 2004 while it is expected to be higher during 2005. Just recently the prices have already touched a record level of \$70 per barrel. The fact that the weak US dollar, in which prices are quoted by OPEC countries need to be compensated for the erosion in the dollar value, makes it imperative on the part of oil producers to keep oil prices higher and fund managers to indulge in currency speculation. The New York Mercantile Exchange which reported an option with a strike price of \$100 a barrel of oil recently give indications that another oil shock can jeopardize finances of emerging economies. The International Energy Agency in a Report released in 2004 has warned that a US \$10 price increase per barrel of oil sustained over one year could trim about 0.8 per cent of Asia's overall economic growth. The effect could be much more severe on emerging economies like India. Estimates for India indicate that effect of sustained

\$10 per barrel increase in oil prices could bring about a 1 per cent fall in real GDP and 2.6 per cent rise in inflation. Finally, even with its foreign exchange reserves of \$140 billion, India could feel the tremor if oil prices shoot up the way it has been in the recent past.

Fourthly, even for the present with limited convertibility on capital account our experience indicates that stock market operations of FII's can result in sudden or large scale reversals in capital flows with a boom bust pattern in asset prices. This, in turn can adversely affect domestic demand for foreign exchange and in turn exchange rate, and entail the risk of an external or financial market crisis. Any proposal on convertibility of Rupee on Capital Account needs to be examined keeping this aspect in view.

Finally, convertibility of rupee could give rise to emergence of an offshore market for rupee. In fact, offshore trading of currencies is now being discouraged by a number of emerging market economies in Asia. This has been done to eliminate the potentially destabilizing influence of offshore currency trading on onshore markets and thus to allow the authorities to implement monetary policy that is conducive to domestic policy objectives without undermining the stability of their exchange rates.

To conclude, for the emerging economies, in my view full convertibility of their currencies would mean further volatility of exchange rates and interest rates due to sudden and large movement of funds across borders seeking arbitrage opportunities. India could be no different. As the economy grows further and the financial markets gather strength to absorb shocks, one could definitely take a different view. For the present we could rather debate and decide on how exactly to sequence further liberalization of capital account rather than jumping into the bandwagon of those who support total convertibility of rupee both on capital and current account, as convertibility on capital account needs to be considered as a process than an event.

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