Operationalising capital account liberalisation: the Indian experience

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1. Introduction

Increasing globalisation in the past few decades has seen more and more countries, especially emerging market countries, open up their capital accounts either partially or totally to avail themselves of the benefits of burgeoning international capital flows. India has also recognised that the move towards complete integration with the international economy is inevitable, and this has led to a cautious but sustained move towards capital account convertibility.

After Independence, the policy adopted by India was one of inward orientation and self-reliance in which dependence on the external sector was discouraged on both the current and capital account. Investments were financed largely through domestic savings, with capital flows restricted to a bare minimum. The capital account was important only as a financing function, with external financing being limited to external assistance from mainly official sources, ie bilateral and multilateral agencies. External assistance accounted for 80% of total financing requirements. Restrictions were, however, imposed on private capital flows at this time.

In the 1980s, however, this form of external financing dwindled, and as financing needs exceeded external financing it became necessary to find other sources of capital. Furthermore, the repayments to be made to the IMF for the Extended Fund Facility drawings of the early 1980s added to the requirement for fresh sources of foreign capital funds. Hence, recourse was taken to external debt on commercial terms. Syndicated loans, external commercial borrowings, etc were accessed on a modest scale during this time. Capital inflows were also obtained through two non-resident Indian (NRI) deposit schemes: the non-resident external rupee account NR(E)RA scheme and the foreign currency non-resident account FCNR(A) scheme.

2. Reforms in the 1990s

However, more substantive, albeit gradual, progress towards capital account convertibility started only in 1991. The outline for reforms in the external sector was provided in the report of the High Level Committee on Balance of Payments headed by Dr C Rangarajan. While the Committee recommended complete current account convertibility, it suggested a very gradual approach towards capital account liberalisation. The report emphasised the need to shift away from debt creating to non-debt creating inflows, with emphasis on more stable long-term inflows in the form of foreign direct investment (FDI) and portfolio investment. It also advocated a very gradual liberalisation of capital outflows from India.

Foreign institutional investments

Based on the recommendations of the Committee, many steps have been taken since 1991 to promote non-debt creating flows and reduce reliance on debt creating flows. Foreign institutional investors (FIIs) were allowed to invest in Indian equity and debt markets in 1992. The following year foreign brokerage firms were also allowed to operate in India. Prior to the reforms, NRIs and overseas corporate bodies (OCBs) were allowed to hold about 1% individually and 5% jointly of the paid-up capital of Indian companies. In 1992, this ceiling was raised to 24%, and subsequently to 40% in 1998.

[1] The author thanks ICICI Bank Limited and in particular Ms Madhur Jha for her assistance in preparing this paper. The views presented in this paper do not reflect the views of the Reserve Bank of India.

These limits have been raised even further since then. At present, investment by FIIs is allowed in different sectors up to the sectoral limits set for FDI investments. Since 2001, FIIs have also been allowed to invest in equity derivatives in India.

Currently, there are about 500 FIIs registered with the Securities and Exchange Board of India (SEBI) from around 28 different countries. In terms of market capitalisation, the share of FIIs had also increased to almost 12% of total market capitalisation of the Bombay Stock Exchange by August 2002. In FY02 portfolio investments accounted for nearly 40% of total foreign investments in India and in FY01 for 90% of the current account deficit. A major chunk of these portfolio investments came in the form FII investments.

Indian companies were also encouraged to issue American depositary receipts and global depositary receipts (ADRs and GDRs) to raise foreign equity in 1992 subject to the rules governing the repatriation and end use of funds. These rules were further relaxed in 1996 after being tightened in 1995 following a spurt in such issues. The requirement of a three-year track record was removed for investments in infrastructure projects, restrictions on the number of issues per year were lifted and end use requirements were relaxed. At present, ADRs, GDRs and foreign currency convertible bonds can be raised through the automatic route without any restrictions.

Foreign direct investment

FDI norms have been liberalised and more and more sectors have been opened up for foreign investment. Investment was initially allowed up to 51% through the automatic route in 35 priority sectors. The approval criteria for FDI in other sectors were also relaxed and broadened. In 1997, the list of sectors in which FDI could be permitted was expanded further with foreign investment allowed up to 74% in about nine sectors. The areas covered under the automatic route have been expanding ever since 1991. This can be seen from the fact that while till 1992 inflows through the automatic route accounted for only 7% of total FDI inflows, this proportion has increased steadily with investments via the automatic route accounting for about 25% of total FDI inflows in India in 2001.

Table 1

Foreign investments

(in USD millions)

	FDI	**Portfolio**
1990-91	97	6
1991-92	129	4
1992-93	315	244
1993-94	586	3,567
1994-95	1,314	3,824
1995-96	2,144	2,748
1996-97	2,821	3,312
1997-98	3,557	1,828
1998-99	2,462	–61
1999-00	2,155	3,026
2000-01	2,339	2,760
2001-02	3,904	2,021

Source: *Handbook of Statistics on Indian Economy,* 2001.

Today, FDI is usually permitted through the automatic route unless otherwise specified and is allowed in non-bank financial activities and insurance. There are an increasing number of fields where 100%

foreign investment has been allowed, such as special economic zones (SEZs) and telecommunications. Recently a decision has been taken to allow FDI in the print media. Thus, today, FDI is allowed in almost all sectors except defence, information and broadcasting, agriculture and plantations, and atomic energy.

The FDI policy followed by the Indian authorities has been to encourage investment in infrastructure and the development of telecommunications and basic industries. This can be inferred from the fact that, in the first three months of 2002, maximum inflows were directed into the fuel and power generation industry followed by telecommunications, transportation and the automobile industry. The source countries for these flows are very diversified, with maximum inflows from Mauritius, the United States and Japan; the leading Asian countries are Korea, Singapore and Hong Kong. A list of reforms in this area during the last two years is provided in the Annex.

External commercial borrowings

Management of the capital account is also operationalised through policies on external commercial borrowings (ECBs) and non-resident deposits. There were some modifications to the limits for raising ECBs in 1991 to avoid excessive dependence on borrowings, which was instrumental in the 1991 balance of payments crises. In March 1997, the list of sectors allowed to raise ECBs was expanded; limits for individual borrowers were raised while interest rate limits were relaxed and restrictions on the end use of the borrowings largely eliminated. However the rule of thumb that was followed was to discourage the raising of short-term debt.

In 2000, the Indian government permitted the raising of fresh ECBs for an amount up to USD 50 million and refinancing of all existing ECBs through the automatic route. Corporates no longer had to seek prior approval from the Ministry of Finance for fresh ECBs of up to USD 50 million or for refinancing of prevailing ECBs. The Indian government further delegated powers to the Reserve Bank of India (RBI) in respect of ECB approvals by increasing the limit for the ECB approvals that could be given by the RBI to USD 100 million under all windows. The ECB limit for equity investment in infrastructure projects was raised to USD 200 million.

End use restrictions were also relaxed further, with ECBs being permitted for all purposes except investment in real estate and capital markets. Other incentives were also provided, with export-oriented units (EOUs) being permitted to have a foreign currency exposure up to 60% of the project cost. The RBI was also delegated the power to approve prepayments as per existing guidelines, even for ECBs that had been approved earlier by the Ministry of Finance. In order to discourage a bunching-up of flows depending on market conditions, prepayment of loans is generally discouraged. Recently, given the comfortable forex reserve position, prepayment of ECBs has been allowed to the extent of foreign currency balances with corporates in the exchange earners' foreign currency account.

NRI deposits

Non-resident deposits were first accessed in the 1980s. There were basically two kinds of deposit schemes available: deposits denominated in Indian rupees, which did not have any exchange guarantee, and foreign currency denominated deposits.

Rupee-denominated deposit schemes were of two types: NR(E)RA and NR(NR)RD. The non-resident external rupee account (NR(E)RA) scheme was introduced in February 1970 and could be opened only by non-residents of Indian origin and by overseas corporate bodies. It allowed the repatriation of both principal and interest payments. The other scheme, NR(NR)RD, ie the non-resident, non-repatriable rupee deposit scheme, was introduced in June 1992 and permitted the opening of accounts by all non-residents, including foreign citizens. It provided for the repatriation of interest payments only.

Different types of foreign currency denominated non-resident deposit schemes were introduced over time. The foreign currency non-resident account (FCNR(A)) scheme came in in 1975. This scheme was open only for non-residents of Indian origin and OCBs. In this scheme the foreign exchange risk was borne by the RBI and subsequently by the Indian government. The scheme was withdrawn with effect from August 1994. The FCNR(B), or foreign currency non-resident (banks) account scheme, was introduced in May 1993, with the foreign exchange risk borne by banks. The external payments crisis of 1990-91 led to the introduction of the foreign currency (banks and others) deposit (FC(B&O)D) scheme. This scheme was open not only to NRIs/OCBs but also to foreign citizens and banks and other institutions. Withdrawals before maturity were not possible in this scheme, and it was terminated in July 1993. Another scheme which was terminated was the foreign currency (ordinary non-repatriable) scheme since it did not receive a positive response from investors. Finally, an account was started as late as April 1999 to simplify the procedures applicable to the operation of bank accounts and financial transactions for persons who would voluntarily undertake not to seek repatriation of funds held in this account and/or the income/interest accrued thereon. Since the beginning of the 1990s, the inflows on account of NRI deposits have been rising steadily. The total annual net inflows rose from INR 14.12 billion in 1991-92 to INR 105.85 billion in 2001. At the end of March 2002, balances in the non-resident deposit schemes stood at USD 25.15 billion.

Since 1991, there have been major changes even with respect to inflows on account of NRI deposits. In the 1990s, steps were taken to rationalise the structure of non-resident deposits. The flight out of India of such capital during the 1991 crises led to the view that these deposits were an expensive and very volatile component of the capital account. Keeping this in mind, spreads between the regulated rates paid on these deposits and international rates were reduced to make these deposits less attractive. While relaxations were introduced with respect to the types of schemes that could be offered, banks were also allowed to provide differential rates of interest on these deposits. Steps have also been taken to bring the statutory liquidity ratio (SLR) and cash reserve requirement (CRR) on such deposits into line with those on other deposits. As a further move towards full capital convertibility, NRI deposits were made fully convertible as of 1 April 2002.

Committee on Capital Account Convertibility (Tarapore Committee)

Seeing the benefits that other countries were reaping from a more open capital account and greater integration with the international markets, a Committee on Capital Account Convertibility was set up under the chairmanship of Dr Tarapore. It submitted its report in May 1997. The report acknowledged the need to move towards full capital account convertibility and suggested a roadmap for achieving it. Bearing in mind the dangers of greater capital flows in terms of volatility and the impact on the domestic financial system, the report, however, suggested certain preconditions that needed to be met before full capital account convertibility could be attained.

The Committee put forward three basic preconditions in this connection. First, a reduction in the fiscal deficit to gross GDP ratio to 3.5%; second, an inflation target of 3-5%; and lastly, measures to strengthen the financial sector, and especially the banking sector. The ratio of gross non-performing assets (NPAs) to advances was to be reduced to 5% and the CRR to 3%. All these measures, it was hoped, would be achieved by 1999-2000. At the same time, the Committee called for a reduction in the external debt service ratio to about 20% and the prescription of a net foreign assets to currency ratio of 40%.

While most of these targeted recommendations are in place at the moment, the fiscal deficit to GDP ratio and ratio of non-performing assets to total advances are still at levels higher than that envisaged in the recommendations. The country has not, however, implemented capital account convertibility as per the schedule envisaged in the report. It was also felt that greater caution had to be exercised after the Asian currency crisis of 1997, which saw the economies of many of the Southeast Asian countries that had embraced capital account convertibility crumble as the contagion spread. However, the spread of the crisis did not imply a complete reversal of the liberalisation trend or a halt in the move towards capital account convertibility. The process of liberalisation has continued at a cautious but sustained pace.

Today many of the recommendations suggested by the Tarapore Committee's report have been implemented. Thus, while the inflows from abroad have been freed to a large extent, outflows associated with these inflows, such as interest, profits, sale proceeds and dividends, are completely free of any restriction. All current earnings of NRIs in the form of dividends, rent, etc have been made fully repatriable.

In line with the recommendations of the report, convertibility in terms of outflows from residents, however, remains more restricted. Residents are not allowed to hold assets abroad. However, direct investment abroad is permissible through joint ventures and wholly owned subsidiaries. This is encouraged since it helps India to earn foreign exchange through earnings such as dividends, royalties and fees for the transfer of technical know-how. Such ventures also encourage the export of Indian goods and technology to the rest of the world and lead to the dissemination of Indian technical know-how.

An Indian entity can make investments in overseas joint ventures and wholly owned subsidiaries in the order of USD 100 million during one financial year via the automatic route. At the same time, investments in Nepal and Bhutan are allowed in the order of INR 3.5 billion in one financial year. Units located in SEZs can invest out of their balances in the foreign currency account. Such investments are, however, subject to an overall annual cap of USD 500 million.

Indian companies are also permitted to make direct investments without any limit out of funds raised through ADRs/GDRs. Indian entities engaged in health services, information technology and entertainment software services, chartered accountancy and legal and other related activities, etc are allowed to invest in overseas ventures of a similar nature subject to a limit of USD 1 million for a given financial year. Recently, mutual funds have been allowed to invest in rated securities of countries with convertible currencies within existing limits.

3. Banking sector reforms

A strong and robust banking system is a prerequisite for attempting capital account liberalisation. One major reason why India was able to ward off the crippling effects of the Southeast Asian crisis and manage its external sector so well is that the external sector reforms have been enmeshed with financial sector, and especially banking sector, reforms. When the first set of reforms in the external sector were introduced in 1991, the Narasimhan Committee was also constitued to provide guidelines for banking sector reforms.

The financial system from the nationalisation of banks in 1969 to the early 1990s was characterised by financial repression, with the system primarily acting as an instrument of public finance. Banks had been nationalised in the hope of spreading their reach to rural and backward areas and providing institutional sources of credit to the priority and neglected sectors of the economy. There was control of deposit and lending rates and amounts. Credit was made available to the government and priority sectors at below market rates; competition in the financial sector between different players was limited, with the public sector being predominant.

However, these policies led to banks becoming plagued by inefficiency and growing non-performing assets, a lack of transparency in operations and diminishing confidence in the health of the banking sector. The increasing dependence of the government on the banking sector to finance its deficits through the SLR meant that funds left for credit to the corporate sector were minimal. The government’s appropriation through the CRR and SLR was as high as 63.5% on an incremental basis by 1990-91. This implied that, for every rupee invested in the form of deposits, it left only about a third to be lent to the commercial sector. The presence of non-price allocation mechanisms also led to the inefficient use of whatever funds were allocated to the commercial sector.

Thus was the background against which the Narasimhan Committee was set up and presented its Report on the Financial System. Since then, several of the Committee’s recommendations have been incorporated with a view to strengthening the Indian banking system and making it more transparent and market-determined. The primary thrust of these reforms has been to improve the competitiveness and efficiency of the banking system. The major reforms can be broadly categorised into three main categories; the removal or relaxation of external constraints; the introduction of prudential norms; and institutional strengthening. In line with the best practices followed in developed countries, banking sector reforms were introduced. The main objective of these reforms was to bring in transparency in banks’ operations with more disclosures, capital restructuring, asset classification and provisioning norms, and valuation of securities based on market rates. Banks were also required to cut down costs and bring in profit orientation.

As part of the reforms, the interest rate structure was liberalised, with banks being free to fix their own deposit rates for different maturities. There has been a rapid reduction in the CRR and SLR to 5% and 25%, respectively. Competition has been increasingly encouraged in the financial sector, with the setting-up of nine new private banks since 1994 and 21 new foreign banks by FY01.

4. Exchange market reforms and management

Sodhani Committee report

In 1993, the exchange rate was made market-determined. Further, recognising the importance of the development of the foreign exchange market, in a country opting for globalisation, an Expert Group on Foreign Exchange (the Sodhani Committee) was set up in 1994 to recommend measures to develop and deepen the forex markets, improve risk management techniques and introduce new products to enhance market efficiency.

The Committee made wide-ranging recommendations to liberalise the market and to enable the introduction of sophisticated risk management products. Most of the Committee's recommendations have been implemented in stages. Although certain restrictions were reimposed in the wake of the Asian crisis, most of these measures have since been withdrawn.

The Sodhani Committee's recommendations can be said to be the basis for the development of a fairly active foreign exchange market in India. Today, with a daily turnover of around USD 3.5 billion and ample liquidity up to one year, the Indian foreign exchange market is the largest in southern Asia. Corporates today have a broad menu of risk management products such as options, swaps and forward rate agreements for managing of interest rates and exchange risk. Corporates are also permitted selectively to hedge the commodity price risk in the international commodities exchanges.

Gold market

Internationally, gold is deemed on a par with a currency or any other investment asset. It is therefore presumed that any liberalisation measures on the capital account would have to be accompanied by a contemporaneous liberalisation of gold. In India, gold continues to be treated as a commodity for its traditional values. Severe restrictions were placed on the import of gold into the country up to 1990 but, along with the economic reforms of the 1990s, India brought about a sea change in its gold import policy. First, gold was allowed to be brought into country by non-resident Indians up to a specified amount on payment of import duty. Subsequently, in 1997, select commercial banks were authorised to import gold freely for sale in the domestic market. The tariff structure on gold was also reviewed simultaneously to ensure that the differential between international and domestic gold prices was kept to a minimum. Over a period of time the agenda is to create a deep and vibrant gold market in the country which would enable investors to look at gold more as an investment asset rather than a mere store of value.

Managing exchange markets

The authorities have not only undertaken a concerted and balanced approach towards reforms, with a careful mix of external sector and financial sector reforms, but have also used monetary and exchange rate policies efficiently to control any volatility in the exchange markets. These policy decisions along with the sustained rise in foreign exchange reserves and declining short-term debts have increased the confidence of investors in the Indian markets. The prudent mix of monetary and exchange rate policies to obtain foreign exchange market stability can be seen from two brief episodes since 1991 where currency market volatility was reduced through various measures.

Exchange market volatility in 1995-96

In the financial year 1995-96, there was an overall balance of payments deficit caused by a steep rise in the current account deficit to 1.7% of GDP from 0.9% for the previous year (Table 2). The simultaneous slowing-down of FII flows into the country implied that this rise in the deficit could not be covered by capital flows. A sharp rise in imports by about 26.9% over the previous year caused the trade deficit to almost double, although exports registered a rise of 20.8% powered mainly by a jump in agricultural exports.

Table 2

External sector indicators

(in USD millions)

	1994-95	1995-96	Percentage change (year on year)
Exports	26,331	31,797	20.76
Oil imports	5,928	7,526	26.96
Non-oil imports	22,727	29,151	28.27
Trade balance	–2,324	–4,881	110.03
Current account	–3,396	–5,899	73.70
Capital account	9,156	4,678	–48.91
FCNR(A)	7,051	4,255	–39.65
FCNR(B)	3,063	5,720	86.75
FDI	1,314	2,133	62.33
FII	1,503	2,009	33.67

Source: RBI, *Annual Report,* 1995-96.

Net capital flows, declining sharply and for the first time since 1992-93, were unable to cover the current account deficit. Both external assistance and external commercial borrowings saw declines and were able to meet only about one sixth of financial requirements. Net commercial borrowings almost halved in the year, as did net drawings under short-term credit.

There was a spurt in FDI flows in the order of USD 2.13 billion (Table 2) to financial companies, engineering and electronics companies, etc, reflecting the strong performance of the industrial sector in the country. There was a completely different picture on the portfolio investment front, however. Portfolio flows fell from USD 3.62 billion in 1994-95 to USD 2.21 billion. Flows to emerging markets had slowed down in this period, with investors already wary on the back of the Mexican currency crisis in 1994 and rising rates of interest in the United States attracting funds. Inflows into India also saw a decline, as there was a slump in inflows on account of GDRs of Indian corporates in the euromarkets.

The initial weakening of the Indian rupee came about in October 1995 with a rise in the value of the US dollar against all other major currencies. The pressure for depreciation mounted as importers covered positions and exporters held back remittances, causing a continuous mismatch between the demand for and supply of dollars.

In response, the RBI withdrew liquidity totalling INR 2.78 billion from the system to contain the money supply imbalance in October 1995. This exchange market operation led to a steep rise in the call rates. The burgeoning demand for investment credit called for an easing of reserve requirements and an injection of liquidity into the system via reverse repo auctions.

To deal with the growing demand for credit, the CRR for scheduled commercial banks were cut systematically from 15% in November 1995 to 12% in July 1996. CRR for non-resident deposit schemes were also systematically reduced from November 1995. Furthermore, the SLR on outstanding liabilities under the NR(E)RA scheme was lowered from 30% to 25% in April 1996. These measures were undertaken to attract funds into the foreign exchange market by encouraging banks to mobilise foreign exchange deposits.

Simultaneously, the RBI took measures to reinforce the exchange market intervention, by encouraging the remittance of export proceeds and arresting the pace of import payments. Effective from October 1995, the interest rate surcharge of 15% was imposed on outstandings under the import credit limit. The USD/INR exchange rate regained some stability at around INR 35.00 till January 1996, when it jumped to INR 37.95.

The RBI again moved in to control the volatility in the foreign exchange market. The interest surcharge on import finance was hiked from 15% to 25% to discourage the overuse of credit for financing imports. It also discontinued the scheme of post-shipment export credit denominated in foreign currency in February 1996 to prevent exporters from earning a positive differential over the cost of funds simply by drawing credit and retaining the forward premia. The rule under which exporters not realising export proceeds within six months of the shipment of goods were liable to face punitive action was enforced more vigorously. The RBI also made mandatory the reporting of any cancellation of forward contracts booked by banks for amounts of USD 100,000 and above on a weekly basis.

On the interest rate front, scheduled commercial banks were allowed to set the interest rates on domestic term deposits with a maturity of over two years from October 1995. This was extended to domestic term deposits with a maturity of more than a year. This move was also intended to provide banks with greater funds for credit disbursal purposes. Further, the minimum period for term deposits was reduced from 46 to 30 days.

To realign the interest rate on domestic deposits and that on non-resident external rupee term deposits, the latter was raised by 400 bp. Some banks reduced their prime lending rate, which had climbed from 14% in October 1994 to 16.5% in November 1995, to 16%. All these measures ensured that the instability in the foreign exchange market was controlled and the USD/INR exchange rate stabilised at around INR 35.80.

The FCNR(A) scheme was discontinued in 1994 and so all net inflows were on account of the recouping of maturing deposits. Banks had a problem attracting deposits under the FCNR(B) scheme given the prohibitive costs implied by the high rates of forward premia in the foreign exchange market. However, the systematic easing of the CRR on the FCNR(B) scheme from 14.5% to 7.5% in November 1995 and the further exemption from the CRR of 7.5% for the deposits outstanding on 24 November 1995 helped banks to mobilise funds in the last quarter of the year and deposits grew by about 85% over the previous year.

Exchange market volatility in 1998-99

1998-99 again saw a period of volatility in the foreign exchange markets. The REER was overvalued by about 2% in this period. On the balance of payments front, the current account deficit fell to 1.1% of GDP in 1998-99 from 1.3% of GDP in 1997-98, mainly on account of a fall in import payments and good inflows via invisible receipts (Table 3). Imports fell largely due to easing oil prices, whereas inflows on account of software exports, wage remittances, etc boosted invisible receipts. Exports were sluggish following a slowdown in both the domestic and international markets after the Asian currency crisis.

Table 3

External sector indicators

(in USD millions)

	1997-98	**1998-99**	**Percentage change (year on year)**
Exports	35,006	33,219	–5.10
Oil imports	6,399	10,482	63.81
Non-oil imports	33,321	35,990	8.01
Trade balance	–6,478	–7,068	9.11
Current account	–5,500	–4,308	–21.67
Capital account	9,844	8,565	–12.99
FCNR(A)	–	–	–
FCNR(B)	8,467	8,323	–1.7
FDI	3,557	2,462	–30.78
FII	5,385	2,401	–55.41

Source: RBI, *Annual Report,* 1998-99.

The capital account, on the other hand, saw a lot of volatility. Net capital inflows fell from USD 9.8 billion in 1997-98 to USD 8.6 billion in 1998-99. This fall was basically caused by outflows on the portfolio account in the order of USD 68 million, as compared to an inflow of USD 1.83 billion for the previous year. The general slowdown of the Indian economy from 6.3% in 1997-98 to 4.6% in 1998-99 together with wariness to invest in Asian markets following the currency crisis in 1997 were the major reasons for these outflows. The imposition of economic sanctions on India following the nuclear tests in May 1998 led to further outflows.

The overall balance of payments showed a surplus of about USD 4.2 billion. However, inflows of around USD 4.3 billion on account of the Resurgent India Bond scheme accounted for a major portion of the surplus.

There was general pressure on the USD/INR exchange rate to depreciate as the USD strengthened against other Asian currencies in the wake of the crisis in 1997. With the imposition of economic sanctions following the nuclear tests and the ensuing flight of capital, there was a situation of excess demand for dollars in the economy. This led to a sharp weakening of the Indian currency from about INR 39.7 per USD in May 1998 to about INR 42.4 in June 1998.

Although the foreign exchange market had seen some volatility towards the third quarter of the financial year 1998, there was overall stability in the market in the last quarter of FY98. Given this stability on the external front and in order to provide a fillip to the lagging domestic industry, the RBI had reduced the bank rate (the key policy rate) by 1.5 percentage points in April. This measure was intended to encourage investments and boost industrial growth. Other interest rates linked to the bank rate were also lowered. Public sector banks reduced their prime lending rates and deposit rates. The repo rate was reduced by 100 bp on three successive occasions to reach a level of 5% by June 1998.

The response of the RBI in this period is a classic example of the way in which any apex bank uses monetary policy to impact the economy. The RBI alternated between an easy and a tight monetary policy in the same financial year depending upon the situation prevalent in the economy.

Initially, in June 1998, the RBI announced its readiness to sell foreign exchange in the markets to rebalance the demand and supply of funds. It also allowed the FIIs to manage their exchange risk exposure by undertaking foreign exchange cover on their incremental equity investment from June 1998 onwards.

Banks and authorised dealers of foreign exchanges were allowed to directly approach the RBI for foreign exchange purchases and all domestic financial institutions were allowed to buy back their own debt paper or other Indian paper from international markets. Banks were also cautioned against using a spread of more than 1.5 percentage points above Libor on export credit in foreign currency, down from the 2 to 2.5 percentage points allowed earlier. The rupee stabilised reasonably on the back of these measures.

The rupee, however, came under pressure again in August 1998 as the crisis spread to Russia and there were concerns of Chinese renminbi devaluation. To prevent speculative forces from causing violent movements in the rupee, the RBI took various measures to tighten monetary policy. It raised the CRR from 10% to 11% and the repo rate from 5% to 8%. These measures were essentially short-term measures, which left the deposit and lending rates of the banks unchanged. They were intended to prevent excess funds from the domestic market spilling over to the foreign exchange market.

The Reserve Bank enhanced the forward cover facilities for FIIs and withdrew the facility to rebook the forward contracts cancelled for imports and splitting the forward and spot legs for a commitment. It also allowed flexibility in the exchange earner foreign currency accounts but made it mandatory to remit export proceeds within the specified time period except under exceptional circumstances.

These measures were accompanied by the introduction of the Resurgent India Bond scheme aimed at attracting foreign exchange flows into India after the imposition of sanctions and the subsequent downgrading of the country. The scheme attracted flows worth USD 4.23 billion and, together with the measures taken by the central bank, led to the re-establishment of stability in the foreign exchange market.

The RBI, while explicitly not targeting any level of the exchange rate, moves in to support the USD/INR exchange rate whenever it foresees volatile movements in the currency. For this, it usually follows a policy of changing its foreign exchange reserve position, drawing down the reserves when there is excess demand for dollars in the market and augmenting them when there is an excess supply. In this way it ensures that all corrections to the USD/INR exchange rate take place very smoothly and without causing any panic in the exchange markets.

5. Benefits of capital account convertibility

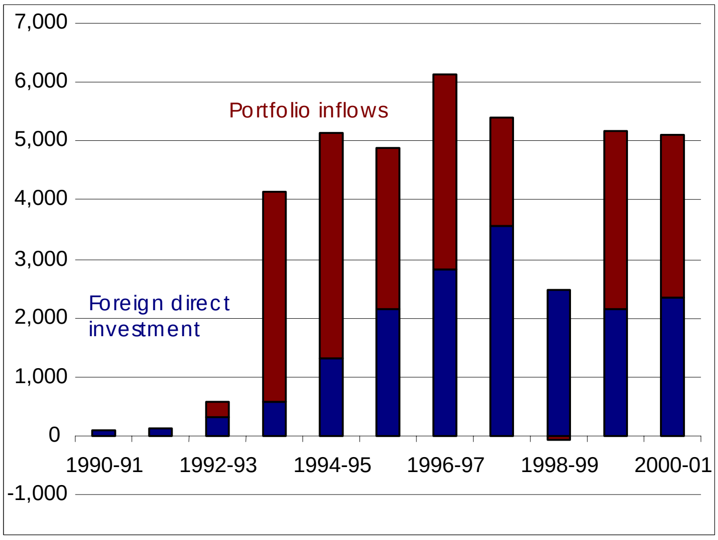
Economic growth, efficiency and productivity increase

A transition towards capital account convertibility is most beneficial for a developing country such as India since the country may be constrained in its ability to provide resources to finance its own growth. The savings-investment gap of such a country is usually very wide and is reflected in a burgeoning current account deficit. Capital inflows help finance this current account deficit. Since the time that India liberalised the capital account to some extent, capital inflows have exceeded the deficit on the current account in all but a few years and net private capital inflows have exceeded inflows on the official account. This is reflected in the rapid accretion in reserves, from USD 4.89 billion in April 1991 to USD 60.15 billion on 2 August 2002.

An increasing number of countries have encouraged foreign investments in order to bolster their economic growth through efficient utilisation of untapped resources. Furthermore, foreign investment, especially FDI, is accompanied by a transfer of state of the art technology and better management and operational practices, which enhance the productivity of the sectors obtaining the investment. The experience of India so far has borne out this fact. Since the introduction of partial capital account convertibility in India, total foreign investment inflows (foreign direct plus portfolio) rose from USD 0.13 billion in 1991-92 to USD 4.15 billion in 1994-95 and have averaged around USD 5 billion per annum since then (Graph 1).

Graph 1

Foreign portfolio and direct investment inflows

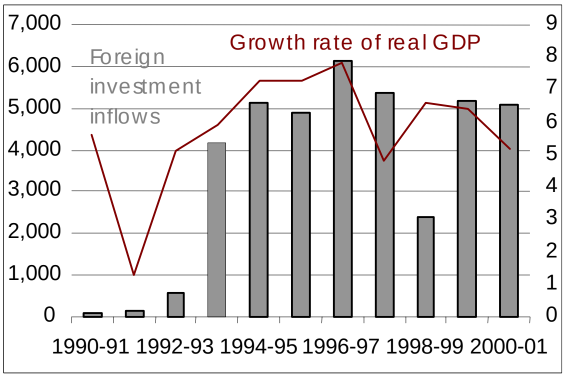


Source: *Handbook of Statistics on Indian Economy*, 2001.

India's real GDP growth rate showed a perceptible increase from 5.1% per annum in 1992-93 to 7.3% per annum in 1994-95, when foreign investment flows into India actually picked up, since when it has maintained a respectable average of over 6% (Graph 2). At the same time, the fact that capital flows are financing the wider savings-investment gap caused by domestic absorption exceeding GNP can be seen from the rise in the rate of investment in the economy. The rate of real gross domestic capital formation increased from 22.9% in 1992-93 to 26.4% in 1994-95 and has hovered around those levels since then (Graph 3).

Graph 2

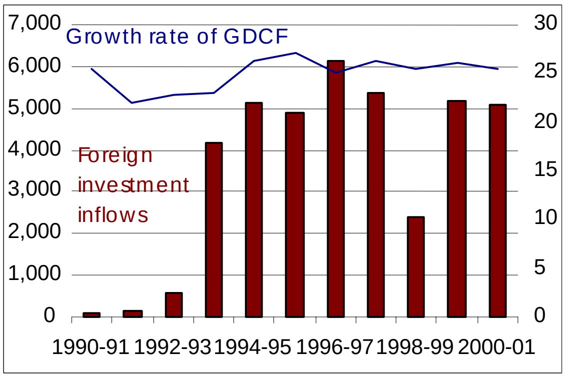
Foreign investment inflows and GDP growth



Source: *Handbook of Statistics on Indian Economy*, 2001.

Graph 3

Foreign investment flows and capital formation



Source: *Handbook of Statistics on Indian Economy*, 2001.

In a falling international interest rate regime, allowing corporates and other institutions to raise commercial borrowings abroad helps reduce the cost of funds and improves the prospects of profitability for the entity raising the resources. Competition from foreign firms also increases the efficiency of domestic firms.

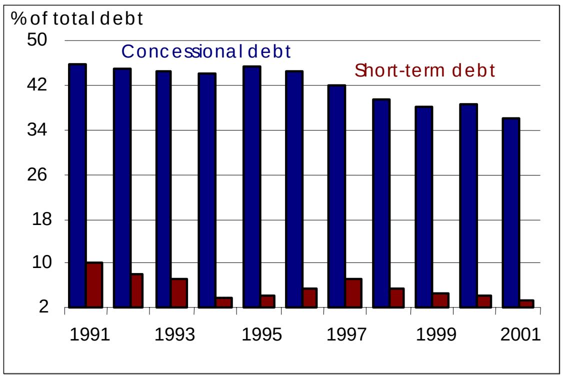
Reduction in external debt

Managing India's external debt position assumed importance for the country after the 1991 crisis. Capital inflows from sources other than debt, such as FDI and NRI deposits, along with prudent management thereof by the authorities have helped in improving India's external debt position (Graph 4). The balance of payments crisis of 1991 was largely attributable to India running up a very high proportion of short-term debt, as witnessed by a short-term debt to foreign currency asset ratio of 382.1%. At the same time, the proportion of short-term debt to total debt stood at 10% in 1991.

Accessing other sources of capital has helped India to drastically reduce these figures. At end-March 2001 the ratio of short-term debt to foreign exchange reserves stood at 8.2% while the short-term debt to total debt ratio was just 2.8%.

Graph 4

India's external debts



Source: *Handbook of Statistics on Indian Economy*, 2001

Management of foreign exchange reserves

The general policy with regard to managing foreign exchange reserves has been to ensure a comfortable level of reserves in order to instill confidence in the ability of the authorities to tide the market over through any adverse situation and quell all speculative attacks on the currency. India believes that an orderly market is a prerequisite for maintaining investor confidence. There has been a sustained increase in India's foreign exchange reserves from the low of USD 4.62 billion in 1991 to some USD 60 billion in August 2002. Reserves have grown not only in absolute terms but also in terms of their sufficiency if we look at the import cover that they provide, ie the number of months that imports can be sustained on the basis of foreign reserves. While this number stood at a low of just two and a half months during 1990-91, it has grown steadily over the years. While it averaged about six to eight months in the past few years, FY02 has again seen a jump in the import cover provided by forex reserves to about 12 months.

An analysis of India's vulnerable liabilities including its external debt with a residual maturity of less than one year (Table 4), shows that the country is at present comfortably placed to allow for greater capital account freedom.

Table 4

Vulnerable liabilities

(in USD billions, 2001)

FII investments	13.40
NRI deposits	15.43
Short-term debt	3.46
Trade credit	5.84

Source: CMIE, *Monthly Review of the Indian Economy*, September 2002.

A more cross-sectional comparison of various indicators of reserve sustainability across countries (Table 5) also shows that India had a relatively more comfortable reserve position than most other countries even by end-2000. However, a look at the ratio of total debt to reserves shows that the total external debt stands at a little more than double the reserves of our country. Nevertheless, most of this debt is long-term, which would not threaten the reserve position in the short term. In fact, the ongoing debate in India is whether the strengthening of the Indian rupee and comfortable reserve position present a golden opportunity to prepay some of the high-cost debts.

Table 5

Various indicators of reserve sustainability across a selection of countries

(expressed as percentages)

	External debt/GDP	Debt service/exports	Interest payments/GDP	Reserves/GDP	Debt/reserves
India	22.00	12.70	0.80	9.25	237.80
China	13.90	13.90	0.70	15.95	87.15
Korea	29.40	23.00	0.90	21.04	139.73
Indonesia	92.50	25.40	4.70	19.17	482.42
Argentina	51.40	85.50	3.50	9.29	553.52
Pakistan	52.10	26.10	1.40	2.61	1,998.36
Thailand	65.80	14.90	2.60	26.79	245.58
Malaysia	49.70	4.70	2.50	33.31	149.20
Philippines	69.40	13.70	3.30	19.96	347.70
Mexico	26.90	32.70	2.00	5.85	460.01

Note: Data as of 2000.
Source: World Bank site.

6. Why gradual liberalisation?

There are two basic approaches to capital account convertibility: the first is the big bang approach, in which the economy is opened on the capital account very rapidly; the other is the more gradualistic approach in which the liberalisation is undertaken slowly and over a period of time. India has followed the latter approach towards capital account convertibility.

Given the various benefits of capital account convertibility, why has India not opted for a more aggressive opening-up of the capital account? The reason lies in the fact that while a move towards complete capital account convertibility would bring in its wake several benefits, the attendant risks are also many. The authorities have realised that rapid and unplanned liberalisation of the capital account can imply more harm than benefit to an economy that is not equipped with sound macroeconomic fundamentals as indicated by the fiscal deficit and inflation levels and a strong financial sector.

The caution seems to have been validated by the experience of the East Asian countries which saw rapid growth rates and tremendous improvements in living standards comparable to those of the developed countries after opening up their economies to capital inflows. The export-led strategies followed by these countries, based on a high degree of import intensity, resulted in rising current account deficits. Opening the capital account led to massive private capital inflows, which financed these current account deficits, and domestic investment booms reflected in 40-50% investment growth rates. Implicit government guarantees to banks and fixed exchange rates encouraged excessive risk-taking by banks and led to a deterioration in loan quality. When export growth declined in 1996, investors' exuberance also faded simultaneously.

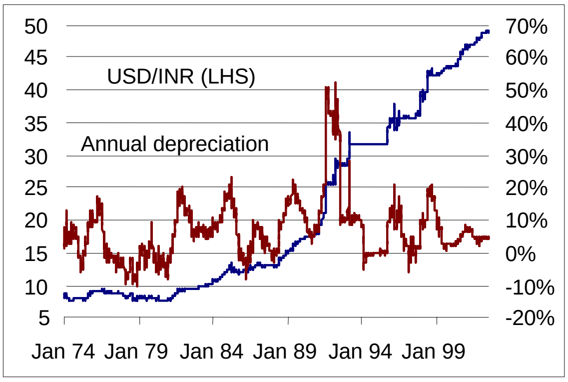
Capital outflows put sharp downward pressure on the exchange rates and the contagion effects saw the collapse of stock markets and even greater pressure on exchange rates. In this situation debt servicing became increasingly difficult, adding to the liquidity constraints. There was a burgeoning of non-performing loans and increasing debt-equity ratios for corporates as the foreign debt component increased in local currency terms. The end result was a crippling destabilisation of the financial and exchange rate markets.

The Indian authorities have recognised the pitfalls of unrestrained capital account convertibility and the fact that domestic autonomy in terms of monetary authority becomes untenable in a situation of free capital flows. This comes out most clearly in the case of the "impossible trinity" of fixed exchange rates, free capital flows and domestic autonomy, as can be seen from the Southeast Asian and Latin American crises. The fact that India emerged relatively unscathed from the contagion that gripped Southeast Asia has been a testimony to the prudence of following a policy of gradual opening-up of the capital account.

The Indian authorities have been quite successful in combining a gradual opening-up of the capital account with getting domestic monetary and exchange rate stabilisation policies to spur and enhance one another. While Southeast Asian currencies saw their values fall by 30-40% in terms of the REER, the Indian authorities have succeeded in reducing exchange rate volatility since the 1990s, which has imparted a certain sense of confidence to foreign investors. At the same time, robust capital inflows have helped keep the balance of payments position comfortable in most years and contributed to maintaining exchange rate stability (Graph 5).

Graph 5

The USD/INR exchange rate and its rate of depreciation



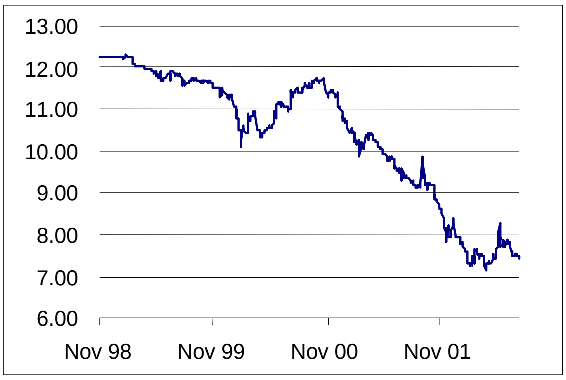
Source: Reuters.

The interest rate policy followed by the central bank has also enhanced the country's ability to attract capital inflows. Although interest rates have been falling in India, they are at higher levels than in some other countries (Graph 6). This has helped to attract capital inflows, especially in terms of NRI deposits. Good capital flows have also meant that domestic liquidity management can be used to lower interest rates and bolster domestic economic activity by reducing the cost of raising capital for investment (government securities).

Graph 6

Ten-year government bond yields

(in percentages)



Source: Reuters.

7. Further reforms: the road ahead

While perceptible liberalisation has taken place since the 1990s, full capital account convertibility would require further steps on all fronts. Liberalisation so far has occurred in line with the broad reforms being undertaken elsewhere in the economy, such as the export-import, banking sector and financial reforms. Further liberalisation and its pace would depend on how quickly reforms are implemented in other areas, the health of the economy, especially the banking sector, and the level of foreign exchange reserves.

The sectoral limits for FDI can be raised to 100% for most areas except sensitive sectors. Furthermore, the range of sectors in which investment is allowed via the automatic route could be expanded to cover almost all areas. However, the experience of other countries also indicates that, maybe, the current restrictions on foreign investment in real estate should continue even in the future in order to minimise risks of a currency crisis.

On the external commercial borrowings front, corporates could be allowed to raise loans through the automatic route in most cases and the minimum maturity guidelines can be relaxed further. Limits for such automatic route approvals may be raised fom the current USD 50 million level. Furthermore, prepayments of ECBs could be further liberalised and the need for withholding tax reviewed. Similarly, NRIs could be allowed to repatriate the proceeds from the sale of assets without any limits.

What is also essential to achieving full capital account convertibility is the freeing-up of capital outflows for residents. The limits on outward foreign direct investment by companies should be raised from the current level of USD 100 million per financial year. Furthermore, Indian residents could be allowed to hold assets abroad and invest their money in equity and debt markets through approved investment vehicles such as mutual funds. This would enable them to have a diversified and hence lower risk portfolio as well as enhance their wealth holdings.

8. Conclusion

Any debate on capital account liberalisation and convertibility always reaches a consensus about the central importance of financial sector reform, prudential norms and effective regulatory supervision. One more issue that would have to be added for a country like India where, for decades, the central bank monetised the deficit of the government is the need for fiscal discipline. These areas are gravely deficient in several developing economies, leading as they do to a worsening of the situation and in turn a crisis following capital account liberalisation.

As evident from the foregoing discussion, India has been consistently attempting discernible improvement in each of the above areas before becoming fully convertible in the capital account. The sequencing of reforms was carefully thought out. Although the Asian crisis slowed down the move to capital account convertibility, the move is still very much on. So far, the stated stance of the authorities has been that the freedom of resident individuals is of least priority while sequencing reforms. Although even this stance is undergoing review at present, the country still firmly believes that unless we are fully equipped, we should not rush into convertibility only to regret it at leisure.

In order to prepare the country for capital account convertibility, the Indian government has recently taken a very important step in setting up SEZs based on the Chinese model. The banking sector in the country is undergoing a transformation. Public sector banks, which account for about 80% of business, are being privatised in stages. Banking conglomerates are emerging on account of mergers and acquisitions. Risk management systems and accounting standards are being revamped for both banks and corporates to put them on a par with international standards.

The NPAs of the Indian banking system continue to be above acceptable levels although the position is continuously improving. Legal changes have been effected to improve the recovery process.

Most importantly, the Indian government has been making conscious efforts to improve its finances. The Fiscal Responsibility Act is in the offing. The above changes have hastened India's march towards full capital account convertibility. China, as seen from the various reports, is more or less in the same position. In the years to come, these two large economies, it is hoped, will lead world growth.

Annex:
Major initiatives to attract FDI during 2000-01 and 2001-02

- In pursuit of its commitment to further facilitate Indian industry's unhindered engagement in various activities, the Indian government has permitted, except for a small negative list, access to the automatic route for FDI, whereby foreign investors only need to inform the Reserve Bank of India (RBI) within 30 days of bringing in their investment, and again within 30 days of issuing any shares.
- Non-banking finance companies (NBFCs) may hold foreign equity up to 100% if they are holding companies.
- Foreign investors can set up 100% operating subsidiaries (without any restriction on the number of subsidiaries) without the condition of disinvesting a minimum of 25% of their equity to Indian entities, subject to bringing in USD 50 million, of which USD 7.5 million to be brought up front and the balance in 24 months. Joint venture operating NBFCs that have 75% or less than 75% foreign investment will also be allowed to set up subsidiaries for undertaking other NBFC activities, subject to the subsidiaries also complying with the applicable minimum capital inflow.
- FDI up to 49% from all sources is permitted in the private banking sector on the automatic route subject to conformity with RBI guidelines.
- In the process of liberalising FDI policy, the following policy changes have been made:
    1. 100% FDI permitted for B2B e-commerce.
    2. The condition of dividend balancing (a condition that foreign exchange invested should be matched through dividends over a specified numbers of years) on 22 consumer items removed forthwith.
    3. Removal of cap on foreign investment in the power sector.
    4. 100% FDI permitted for oil refining.
- The automatic route is available for proposals in the information technology sector, even when the applicant company has a previous joint venture or technology transfer agreement in the same field. The automatic route for FDI up to 100% is allowed in all manufacturing activities in special economic zones (SEZs), except for the following:
    1. Arms and ammunition, explosives and allied items of defence equipment, defence aircraft and warships.
    2. Atomic substances.
    3. Narcotics and psychotropic substances and hazardous chemicals.
    4. Distillation and brewing of alcoholic drinks.
    5. Cigarettes/cigars and manufactured tobacco substitutes.
- FDI up to 100% is allowed with some conditions for the following categories in the telecoms sector:
    1. Internet service providers not providing gateways (for both satellite and submarine cables).
    2. Infrastructure providers providing dark fibre (IP category I).
    3. Electronic mail.
    4. Voice mail.

- FDI up to 74% is permitted for the following telecom services subject to licensing and security requirements (proposals with FDI over 49% require prior government approval):
  1. Internet service providers with gateways.
  2. Radio paging.
  3. End-to-end bandwidth.
- Payment of royalty up to 2% on exports and 1% on domestic sales is allowed under the automatic route for the use of trademarks and the brand name of the foreign collaborator without technology transfer. Payment of royalty up to 8% on exports and 5% on domestic sales by wholly owned subsidiaries to offshore parent companies is allowed under the automatic route without any restriction on the duration of royalty payments.
- Offshore venture capital funds/companies are allowed to invest in domestic venture capital undertakings as well as other companies through the automatic route, subject only to Securities and Exchange Board of India (SEBI) regulations and sector-specific caps on FDI.
- FDI up to 26% is eligible under the automatic route in the insurance sector, as prescribed in the Insurance Act, 1999, subject to the procurement of a licence from the Insurance Regulatory and Development Authority.
- FDI up to 100% is permitted for airports, with FDI above 74% requiring the prior approval of the Indian government. FDI up to 100% is permitted with the prior approval of the Indian government in courier services subject to existing laws and the exclusion of activities relating to the distribution of letters. FDI up to 100% is permitted with the prior approval of the Indian government for the development of integrated townships, including housing, commercial premises, hotels, resorts, city and regional level urban infrastructure facilities such as roads and bridges, mass rapid transit systems and the manufacture of building materials for all metros, including associated commercial development of real estate. Development of land and provision of allied infrastructure will form an integral part of township development.
- FDI up to 100% is permitted on the automatic route in the hotel and tourism sector and for mass rapid transport systems in all metropolitan cities, including associated commercial development of real estate. FDI up to 100% in drugs and pharmaceuticals (excluding those which attract compulsory licensing or are produced by recombinant DNA technology and specific cell/tissue-targeted formulations) placed on the automatic route.
- The defence industry sector is opened up to 100% for Indian private sector participants with FDI permitted up to 26%, both subject to licensing.
- International financial institutions such as the Asian Development Bank, IFC, CDC and German Investment and Development Company are allowed to invest in domestic companies through the automatic route, subject to SEBI and RBI guidelines and sector-specific caps on FDI.
- Decision taken to allow FDI in print media.

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