<u>**Convertibility Of Rupee**</u>

E- Content for M.A. IV Sem

Paper IV

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In India, some decades back, the exchange rate of foreign currency was controlled by RBI for conversion into Indian rupee and vice-versa, and it was known as administered regime. By virtue of this control all the foreign exchange earned by the Indians abroad was to be sold in the currency market through an authorized dealer and if we want to purchase foreign exchange we have to seek permission of central bank. The main purpose behind this was to utilize the foreign exchange earned by the residents as per the priorities fixed by the government. These controls were necessary at that time as India's exports were limited to agricultural product and raw material and imports were consumable goods.

India has changed its forex policy after 1991, One due to change in world economic scenario secondly due to precarious economic condition in India in 1990-91 and India had to pledge gold to get foreign currency that forced India to introspect its economic policy in general and foreign trade policy in particular. Due to change in foreign trade policy and in order to make its economy as a global economy government had to change its administered regime of foreign exchange policy to market driven exchange rate policy. Convertibility of rupee was one of the major policy decision made by the then Government of India (GoI). GoI has decided to make rupee convertible in phased manner firstly on current account transactions. Capital account convertibility of currency was deferred for a long period of time and full capital account transactions convertibility is still not considered as a safe option for Indian economy.

Currency convertibility is an important part of trade with rest of the world's nation, foreign trade of a nation is dependent on its currency's convertibility. Convertibility of currency means when currency of a country can be freely converted into foreign currency, gold with ease at global exchange rate i.e., an exchange rate determined by demand for and supply of a currency.

For example, convertibility of rupee means that those who have foreign exchange (e.g. US dollars, Pound Sterling etc.) can get them converted into rupees and vice-versa at the globally determined rate of exchange. The convertibility of currency is on two accounts. (1) Capital Account (2) Current Account.

Current account convertibility means freedom to convert domestic currency into foreign currency and vice versa for trade in goods and invisibles (like services etc.). When there is current account convertibility an exporter can sell foreign currency he earned from exporting a commodity at the market determined exchange rate and vice versa.

Capital account convertibility compared to current account convertibility is a more complex phenomenon because of high frequency and volume of international capital movements that may produce many macroeconomic effects. Capital account convertibility is not just the capital flow but it involves the freedom to invest in financial assets of other countries. The Tarapore Committee on Capital Account Convertibility has defined the Capital account Convertibility "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."

Current Account Convertibility of rupee

Current account convertibility means when foreign exchange (e.g. Pound Sterling, U.S.Dollar etc.) received for export of merchandise and services can be freely converted into Indian rupees and vice-versa in case of imports.

In the seventies and eighties many countries switched over to the free convertibility of their currencies into foreign exchange. By 1990, 70 countries of the world had introduced currency convertibility on current account and another 10 countries joined them in 1991.

As a part of new economic reforms initiated in 1991, India also joined the regime and made rupee partly convertible from March 1992 under the "Liberalized Exchange Rate Management scheme (LERMS)". In this scheme, 60 per cent of all receipts on current account (i.e., merchandise exports and invisible receipts) could be converted freely into rupees at market determined exchange rate quoted by authorised dealers while 40 per cent of them were to be surrendered to Reserve Bank of India at the officially fixed exchange rate. These 40 per cent exchange receipts on current account was meant for meeting Government needs for foreign exchange and for financing imports of essential commodities. Thus, partial convertibility of rupee on current account meant a dual exchange rate system. Further, full convertibility of rupees at that stage was considered to be risky in view of large deficit in balance of payments on current account.

As even after partial convertibility of rupee foreign exchange value of rupee remained stable, this laid down a base for the full convertibility on current account. Hence, from March 1993, rupee was made convertible for all trade in merchandise. In March' 1994, even indivisibles and remittances from abroad were allowed to be freely convertible into rupees at market determined exchange rate. But this does not mean that one can get any amount of foreign exchange for meeting one's needs e.g. one cannot convert his savings in the country for investment in foreign exchange as could be done by citizens of developed countries like U.K. and USA. However, on capital account rupee remained non-convertible.

Advantages of Currency Convertibility

A. Encouragement to exports: Market rate remains generally higher than the officially determined exchange rate. This implies that from given exports, exporter can get more rupee against foreign exchange. This will help to increase exports

B. Encourages import substitution: Imports become expensive due to convertibility of rupee. So it discourages imports and boosts import substitution.

C. Incentive to remittances from abroad: Earlier, NRIs used to send money illegally to India such as Hawala money and gold etc. But due to removal of restrictions, NRIs can easily remit money to India. It will help to improve Balance of payment.

D. A self – balancing mechanism: Another important merit of currency convertibility lies in its self-balancing mechanism. When balance of payments is in deficit due to over-valued exchange rate, under currency convertibility, the currency of the country depreciates which gives boost to exports by lowering their prices on the one hand and discourages imports by raising their prices on the other.

In this way, balance of payments get corrected without intervention by the Government or Central bank.

Capital Account Convertibility of Rupee

Capital Account Convertibility (CAC) is the freedom to convert local financial assets into foreign financial assets at market determined exchange rates. Referred to as 'Capital Asset Liberation' in foreign countries, it implies free exchangeability of currency at lower rates and an unrestricted mobility of capital. India, at present has partial capital account convertibility.

In India there are conflicting views regarding whether to move towards full convertibility of capital account or not. At present, there are limits on investment by foreign financial investors and also caps on FDI ceiling in most sectors, for example, 74% in banking and communication, 0% in retail, etc.

Advantages of capital account convertibility

(1) Unrestricted mobility of Capital:

Capital account convertibility allows free mobility of Capital into a country from the foreign investors. It allows converting the foreign exchange brought into as Capital to convert into rupees at market determined rates, which makes the investors encouraging. It allows the foreign investors to easily move in and move out from an economy. This enables the domestic companies to raise funds from abroad.

(2) Ability to invest in abroad easily:

Capital account convertibility allows the individuals of a nation to invest in abroad by easily converting their rupees into foreign exchange at the rates determined by the Market. This enables those potential domestic investors to acquire & own the assets in abroad.

(3) Improved access to global financial markets:

One can easily invest in the equity and debt markets of another economies alongside a reduction in the cost of capital

Disadvantages

(2) Easier access to Hawala money:

As it allows converting any foreign receipt into Indian rupees at market determined rates there may be chance that domestic economy will be flooded with foreign exchange which in long run may damage the financial health of an economy.

(2) High volatility of markets:

During the times when the financial markets of an economy are doing well, a country may receive huge foreign investment. But during the adverse times the reverse scenario may happen. For example when the federal reserve Bank of America gave a sign that they are going increase the interest rates the foreign Institutional investors who invested their dollars in Indian stock market had withdrawn their investment from India which adversely impacted the rupee value.

Tarapore Committee on capital account convertibility

A committee on capital account convertibility was setup by the Reserve Bank of India (RBI) under the chairmanship of former RBI deputy governor S.S. Tarapore to "lay the road map" to capital account convertibility. In 1997, The Tarapore Committee had indicated the preconditions for Capital Account Convertibility. The three crucial preconditions were fiscal consolidation a mandated inflation target and strengthening of the financial system. The five-member committee has recommended a three-year time frame for complete convertibility by 1999-2000. The highlights of the report including the preconditions to be achieved for the full float of money are as follows:-

1. Gross fiscal deficit to GDP ratio has to come down from a budgeted 4.5 per cent in 1997-98 to 3.5% in 1999-2000.

2. A consolidated sinking fund has to be set up to meet government's debt repayment needs; to be financed by increased in RBI's profit transfer to the govt. and disinvestment proceeds.

3. Inflation rate should remain between an average 3-5 per cent for the 3-year period 1997-2000

4. Gross NPAs of the public sector banking system needs to be brought down from the present 13.7% to 5% by 2000. At the same time, average effective CRR needs to be brought down from the current 9.3% to 3%.

5. RBI should have a Monitoring Exchange Rate Band of plus minus 5% around a neutral Real Effective Exchange Rate RBI should be transparent about the changes in REER.

6. External sector policies should be designed to increase current receipts to GDP ratio and bring down the debt servicing ratio from 25% to 20%.

7. Four indicators should be used for evaluating adequacy of foreign exchange reserves to safeguard against any contingency. Plus, a minimum net foreign asset to currency ratio of 40 per cent should be prescribed by law in the RBI Act.

Apart from these essential pre-conditions, the Tarapore Committee also recommended that:

(a) RBI should have a monitoring exchange rate band of 5 per cent around Real Effective Exchange Rate (REER) and should intervene only when the RER is outside the band:

(b) The size of the current account deficit should be within manageable limits and the debt service ratio should be gradually reduced from the present 25 per cent to 20 per cent of the export earnings.

(c) To meet import and debt service payments, forex reserves should be adequate and range between $ 22 billion and $ 32 billion; and

(d) The Government should remove all restrictions on the movement of gold.

The Second Tarapore Committee on Capital Account Convertibility

Reserve Bank of India appointed the second Tarapore committee to set out the framework for fuller Capital Account Convertibility. The committee was established by RBI in consultation with the Government to revisit the subject of fuller capital account convertibility in the context of the progress in economic reforms, the stability of the external and financial sectors, accelerated growth and global integration. The report of this committee was made public by RBI on 1st September 2006 had drawn up a roadmap for 2011 as the target date for fuller capital convertibility of rupee.

In this report, the committee suggested 3 phases of adopting the full convertibility of rupee in capital account.

First Phase in 2006-07

Second phase in 2007-09

Third Phase by 2011.

Following were some important recommendations of this committee:

1. The ceiling for External Commercial Borrowings (ECB) should be raised for automatic approval.

2. NRI should be allowed to invest in capital markets

3. NRI deposits should be given tax benefits.

4. Improvement in banking regulation.

5. FII (Foreign Institutional Investors) should be prohibited from investing fresh money raised to participatory notes.

6. Existing PN holders should be given an exit route to phase out completely the PN notes.

The full capital account convertibility of rupee seemed to be desirable by the end of 2006 when the committee submitted its report. However, economic events, especially global financial crisis of 2007-09, brought about a sea change in the economic situation. It was evident that countries with full capital account convertibility were most affected. The Indian economy would have been greatly affected by the global financial crisis if we had implemented the recommendations of Tarapore Committee recommendation. We could not have coped with the extent of capital outflows that took place during 2008-09.

PRESENT STATUS OF CAPITAL ACCOUNT LIBERALISATION

Government of India (GOI) has revised rules pertaining to FEMA and capital account transactions during different periods of time. In context of large capital flows and the upshots of previous modifications during the last few years, GOI and RBI have recently done some additional amendments.

So in India, there is free regime for current account transactions but still partial convertibility for capital account transactions. Many economics experts are of view that we need full capital account convertibility of currency. Recently RBIs governor Raguram Rajan, in an interview has suggested moving towards full capital account convertibility in short numbers of years. Mr. G Padmanabhan, Executive Director of the Reserve Bank of India (RBI), has suggested that

India should move towards making the rupee more convertible for capital transactions by foreign investors. According to him keeping any restriction for too long could prove self-defying. But he also said that how fast that movement should be would, however, depend on how fast the country could meet the pre-conditions such as fiscal consolidation, inflation control, low level of NPAs (non-performing assets), low and sustainable current account deficit, strengthening of financial markets, prudential supervision of financial institutions etc. otherwise, it may prove very risky.

Suggested Readings:-

1. Indian Economy by Datt and Sundaram.
2. International Economics by Sodersten and Reed
3. Dictionary of Economics, Routledge
4. Indian Economy by Misra and Puri