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Pros and Cons of Capital Account Convertibility – A Review

***Dr.V.Chandra Mohan,**

Associate Professor of Commerce, Govt. First Grade College, Bangarpet.

Abstract

This paper attempts to study how **Convertibility of capital account leads to** – the complete elimination of all capital control through currency conversion **current account convertibility.** Compared to current account convertibility, capital account convertibility is a complex issue because of the peculiar feature of capital account transactions. An important one is the high frequency and volume of international capital movements across borders which may produce many macroeconomic effects in host countries like India. Capital Account Convertibility is not just the currency convertibility freedom, but more than that, it involves the freedom to invest in financial assets of other countries. The Committee on Capital Account Convertibility (1997, Chairman Dr S S Tarapore) in its report has given a working definition for the CAC which is as following. "CAC refers to 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." Capital account convertibility is thus the freedom of foreign investors to purchase Indian financial assets (shares, bonds etc.) and that of the domestic citizens to purchase foreign financial assets. ***Capital Account Convertibility means that the currency of a country can be converted into foreign exchange without any controls or restrictions***. In other words, Indians can convert their Rupees into Dollars or Euros and Vice Versa without any restrictions placed on them. The reason why it is called capital account convertibility is that the conversion of domestic currencies into foreign currencies is allowed in the capital account and not only the current account. **Partially and Fully Convertible Currencies**

Key words: Convertibility of capital account, Capital Account Convertibility, India

Introduction

Partially convertible currencies are those where the currency can be converted in the current account. This means that investors can invest in stock markets and bond markets of the target countries with an option to repatriate their holdings. Further, ordinary citizens can convert their domestic currencies to dollars for expenses like going abroad for work, tourism, and education. On the other hand, capital account convertibility or fully convertible currencies are those where just about anybody can convert the

local currency for foreign currency without any questions or restrictions placed on such conversions. The key aspect here is that many countries do not allow their currencies to be fully convertible if they do not hold significant foreign exchange reserves. This is also the reason why capital controls are imposed in times of economic crises to prevent a capital flight from these countries. Many Asian countries have learnt from the bitter experience of the Asian financial crisis of 1997 and the Russian Default of 1998 where full convertibility lead to a stampede of foreign investors fleeing the countries in the aftermath of the economic crisis. The other aspect here is that even in the European Union, capital controls are being planned to contain flight of capital to other countries as the Eurozone crisis deepens.

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

To attract foreign investment, many developing countries went in for CAC in the 1980s, not realising that free mobility of capital leaves countries open to both sudden and huge inflows and outflows, both of which can be potentially destabilising. More important, unless you have the institutions, particularly financial institutions capable of dealing with such huge flows, countries may not be able to cope as was demonstrated by the East Asian crisis of the late 90s. The lessons from the East Asian and other financial crises of 1990s have brought about a marked shift in the approach towards capital account liberalisation, particularly among developing countries. Countries are less confident today of the conventional wisdom which maintained that trade flows were the key determinants of exchange rate movements. The longstanding assumption that the case for liberalising capital account transactions is analogous to that for liberalising trade is being increasingly called into question (Bhagwati, 1998). In more recent times, with the tail of mobile capital accounts wagging the dog of the balance of payments, the importance of capital flows in determining the exchange rate movements has increased considerably, rendering some of the earlier guideposts of monetary policy formulation possibly anachronistic (Mohan, 2003).

On a day-to-day basis, it is capital flows rather than trade flows which influence the exchange rate and interest rate arithmetic of the financial markets. Thus, instead of the real factors underlying trade competitiveness, it is expectations and reactions to news which drive capital flows and exchange rates, often out of alignment with fundamentals. Unregulated capital flows in some instances have been subject to destabilising speculation, thereby imposing a burden on the real economy. It is well recognised now that although global capital flows have a potential for improving efficiency and growth prospects, they also can trigger instability, due to a variety of reasons (Reddy, 2000a). The East Asian crisis of 1997 amply demonstrated the need to proceed with caution in opening the capital account. It provides rights for firms and residents to freely buy into overseas assets such as equity, bonds, property and acquire ownership of overseas firms besides free repatriation of proceeds by foreign investors.

Not surprisingly, the pace and content of opening up of the capital account has slowed down in many EMEs with a view to limiting their vulnerability to crises. It has been recognised that capital account liberalisation needs to be undertaken as an integral part of macroeconomic and structural reforms and be synchronised with appropriate macroeconomic, exchange rate and financial sector policies. The issue relates as much to the sequence of reforms as to their speed. It is argued that a combination of sound macroeconomic policies, a well-regulated financial system and restrictions on short-term speculative flows is likely to create a system wherein the benefits of external capital could be reaped without its adverse effects (Jadhav, 1999; Rangarajan and Prasad, 1999). 8.4 In India, capital account liberalisation is treated as a process rather than an event (Reddy, 2000a). India

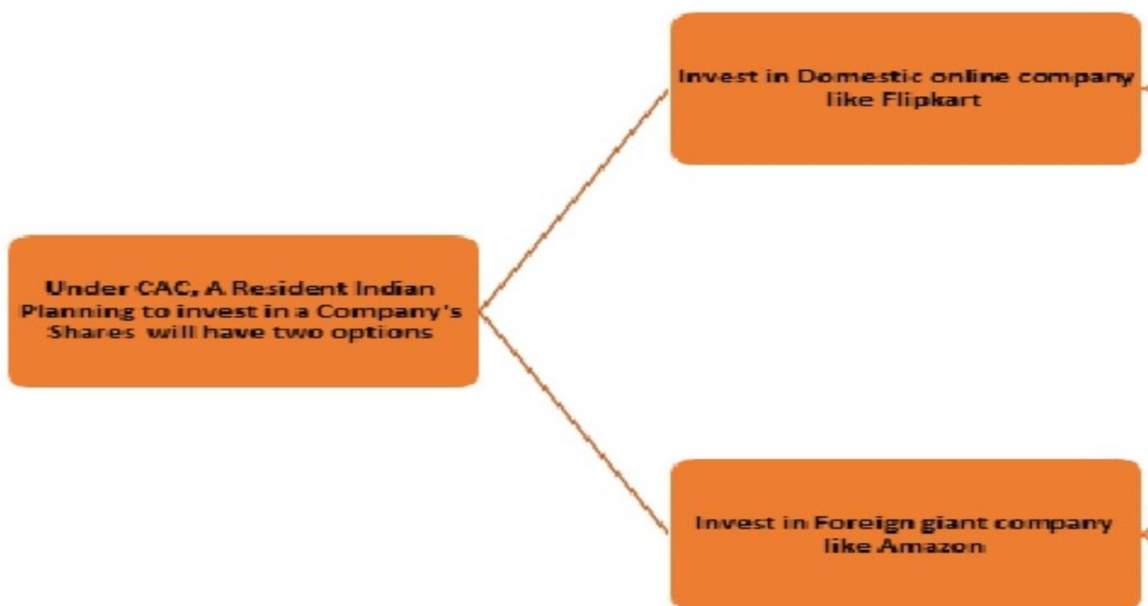
adopted a cautious approach while initiating a process of gradual capital account liberalisation in the early 1990s. The Report of the Committee on Capital Account Convertibility (Chairman: S.S. Tarapore) provided the framework for liberalisation of capital account and served as the basis for undertaking further liberalisation during the late 1990s. Initial reform measures on the heels of the balance of payments crisis in 1991 were predominantly directed at current account convertibility leading to acceptance of obligations under Article VIII of the International Monetary Fund's (IMF) Articles of Agreement by August 1994. Subsequently, policies in regard to foreign direct investment (FDI), portfolio investment and long-term commercial borrowings were progressively liberalised. With growing consolidation of the external sector, restrictions on outflows have also been liberalised over time. There are, however, two areas, where extreme caution is advocated, viz., (i) unlimited access to short-term external commercial borrowing for meeting working capital and other domestic requirements; and (ii) unrestricted freedom to domestic residents to convert their domestic bank deposits and idle assets (such as, real estate) in response to market developments or exchange rate expectations (Jalan, 2003). The policy challenges for India arising from the opening of the capital account broadly fall under two categories: (i) management of the surges in capital flows; and (ii) entrenchment of preconditions that could create room for further liberalisation of the capital account (Jadhav, 2003).

Objective:

This paper intends to explore and analyze market rate of exchange, for the purpose of transactions on trade, invisible (bilateral) **current accounts and capital accounts in India**

Present Situation in India

In India, the Tarapore committee had laid down a three-year road-map, ending 1999-2000, for CAC. It also cautioned that this time-frame could be speeded up, or delayed, depending on the success achieved in establishing the pre-conditions primarily fiscal consolidation, strengthening of the financial system and low rate of inflation. With the exception of the last, the other two preconditions have not been achieved. The Capital Account Convertibility in India will depend on how fast the country meets the preconditions put forward by Tarapore Committee such as fiscal consolidation, inflation control, low level of Non-Performing Assets, low Current account deficit and strengthen financial markets. Sound policies, robust regulatory framework promoting a strong and efficient financial sector, and effective systems and procedures for controlling capital flow greatly enhanced the chances of ensuring that such flows fostered sustainable growth and did not lead to disruption and crisis.



- Current Account Convertibility: Current account is today fully convertible (operationalized on August 19, 1994). It means that the full amount of the foreign exchange required by someone for current purposes will be made available to him at the official exchange rate and there could be an unprohibited outflow of foreign exchange (earlier it was partially convertible). India was obliged to do so as per Article VIII of the IMF which prohibits any exchange restrictions on current international transactions (keep in mind that India was under pre-conditions of the IMF since 1991).
- Capital Account Convertibility: After the recommendations of the S.S. Tarapore Committee (1997) on Capital Account Convertibility, India has been moving in the direction of allowing full convertibility in this account, but with required precautions. India is still a country of partial convertibility (40:60) in the capital account, but inside this overall policy, enough reforms have been made, and to certain levels of foreign exchange requirements, it is an economy allowing full capital account convertibility. Following steps have been taken in the direction of capital account convertibility.

1. Indian corporate is allowed full convertibility in the automatic route up to $ 500 million overseas ventures (investment by Ltd. companies in foreign countries allowed).
2. Indian corporate is allowed to prepay their external commercial borrowings (ECBs) via automatic route if the loan is above $ 500 million.
3. Individuals are allowed to invest in foreign assets, shares, etc., up to the level of $ 2,50,000 per annum.
4. Unlimited amount of gold is allowed to be imported (this is equal to allowing full convertibility in the capital account via current account route, but not feasible for everybody) which is not allowed now.

The Second Committee on the Capital Account Convertibility (CAC)— again chaired by S.S. Tarapore— handed over its report in September 2006 on which the RBI/the government is having consultations.

Pros and cons of Capital account Convertibility

Advantages	Disadvantages
Availability of large funds by improved access to international financial markets.	Market determined exchange rates being higher than officially fixed exchange rates can raise import prices and cause Cost-push inflation.
Reduction in cost of capital.	Improper management of CAC can lead to currency depreciation and affect trade and capital flows.
The incentive for Indians to acquire and hold international securities and assets.	The advantages have been found to be short lived as per studies, and also International financial institutions are skeptical about CAC post-2008 crisis.
Greater financial competitiveness.	Speculative activity can lead to capital flight from the country as in case of some South East Asian economies during 1997-98.
Will help Indian corporate to use External commercial borrowing route without RBI or Govt approval.	Imposing control would become difficult in a globalized environment once CAC is introduced.
Indian residents can hold and transact foreign currency denominated deposits with Indian banks.	
A Certain class of financial institutions and later NBFCs can access global financial market.	
Banks and financial institutions can trade in Gold globally and issue loans.	

Impact on Countries

The previous sections discussed the difference between fully convertible and partially convertible currencies. The impact of convertibility on economies is felt in the way assets held in the domestic country can be repatriated with ease or partially. For instance, in India where the currency is partially convertible, investors cannot liquidate their assets and leave the country without approval. On the other hand, they can repatriate the money that they have invested in the stock market, as was the case in recent months. The effect of this is that many foreign companies do not hold assets like buildings, premises, and other items that fall in the capital account. They also tie up with local companies because in times of crisis, they can exit the joint venture easily and

get back their monies invested in the merged entity. As for other countries in South East Asia that were fully convertible, the Asian financial crisis of 1997 was a wakeup call for them as investors fled the country and capital flight accelerated leading to a near collapse of the economies in the region with the exception of Singapore. **Capital account refers to expenditures and investments in hard assets, physical premises, and factories as well as investments in land and other capital-intensive items**. Current account on the other hand, refers to investments that are short term in duration and hence, they fall under the current account head. As we shall discuss later, there is a significant difference between capital and current accounts as they are different in the period of holding and the kind of investments made. A precondition for many countries to get IMF (International Monetary Fund) or World Bank assistance is to make their currencies capital account convertible so that foreign investors have the exit option quickly and without hassles in times of economic crises. Current Account Convertibility allows free inflows and outflows of foreign currency for all purpose including resident Indians buying foreign goods and services (imports), Indians selling foreign goods and services (exports), Indians receiving and sending remittances, accessing foreign currency for travel, study abroad, medical tourism purpose etc.

Conclusion

The debate assumes a critical dimension in respect of developing countries and emerging market economies (EMEs). While these economies can potentially benefit enormously from larger volumes of capital inflows, their relatively shallow and underdeveloped institutions render them more vulnerable to crises as compared with the developed economies. Having considered the pros and cons of the issue, it must be said that emerging market economies must consider the kind of convertibility after taking into account the various factors that are internal to their functioning and must not make their currencies convertible because of external pressures. The decade of the 1990s witnessed a spate of financial crises in several countries across the world with risks emanating mainly from the capital account of balance of payments. Consequently, the capital account has come to receive increasing attention in policymaking. The crises of the 1990s underscored the inadequacy of erstwhile theories in explaining the sharp volatility in capital flows. The benefits and costs of an open capital account appear more ambiguous now than what many researchers and policy makers had perceived earlier. Moreover, the international financial community is hard put to provide a conclusive set of prescriptions for containing the ill-effects of such capital movements, particularly during episodes of sudden reversal in flows.

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