

Unit 9

Capital Account Convertibility: Benefits, Costs and Challenges

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ABSTRACT

With the wake of globalization and liberalization, Capital Account Convertibility (CAC) regime has been widely induced by both developed as well as developing countries of the world. CAC has pros and cons. The theory of CAC spells that the primary aim to move towards CAC regime is to help countries to acquire the advantages of improved risk sharing and thereby lowering the volatility in the macro economic aggregates, and enhancing welfare mingling the national economy with the world economy. It is suggested that the developing countries could move towards CAC through correctifying and improving macro economic variables via prudential policies. Nepal could move towards CAC regime via gradualist approach as having done by India in 1990s decade. Nepal moved through CAC regime from the beginning of 1990s decade. Followingly, Foreign Direct Investment (FDI) policy, trade policy and exchange policy were amended, correctified and were formulated backing liberalized economic philosophy. Prevailing inflation, trade deficit and Non-Performing Assets (NPA) level are the hurdles to speed up towards CAC regime for Nepal. Gradual approach would be viable for Nepal to move towards meaningful CAC regime. Nepal could learn much from India's process of CAC and could use its selective devices so as to move towards CAC regime.

INTRODUCTION

No formal definition of CAC exists. The capital account is understood to be fully open when there are no restrictions on capital flows. A country is said to have attained full convertibility of its currency when residents and nonresidents are allowed to convert the currency, at prevailing exchange rates, into foreign currencies and to use the latter freely for international transactions. A working definition of CAC is "the freedom to convert local financial assets into foreign financial assets and vice versa at market determined rates of exchange. It is associated with changes of ownership in foreign/domestic financial assets and liabilities and embodies the creation and liquidation of claims on, or by the rest of the world. CAC can be, and is, coexistent with restrictions other than on external payments. It also does not preclude the imposition of monetary/fiscal measures relating to foreign exchange transactions which are of a prudential nature."¹

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During the 1990s, the financial crises in Brazil, East Asia, Mexico, and Russia highlighted one of the most important concerns for Emerging Market Economies (EMEs) - that CAC carries the potential for currency crises. In the context of the East Asian financial crisis, although country circumstances varied, they largely reflected extant fundamental structural problems, financial sector weaknesses, and poor corporate governance. It became clear that sound macroeconomic policies, an adequate institutional framework, internationally comparable prudential regulation and supervision standards, and improved quality and disclosure of information were all prerequisites for mitigating such recurrences. It was realized that partial and flawed reforms could render financial systems more fragile and more vulnerable to a rapid reversal of capital flows. As a result, EMEs, particularly in East Asia, became more attentive to harmonizing capital account liberalization with appropriate macroeconomic, exchange rate, and financial sector policies. Moreover, in both advanced economies and EMEs, studies have shown that an open capital account does not have to mean unfettered capital account liberalization, and in practice some capital controls and significant prudential regulations are consistent with capital account convertibility.

BENEFITS AND COSTS

With the wave of financial globalization, capital account has been the center of attention for researchers and policy makers. Most developing countries have begun dismantling the restrictions on capital account transactions with the objective of achieving the traditional benefits of CAC identified in the literature. Since most developing countries still have some kind of restrictions on capital account transactions, capital account openness is a matter of degree.² In terms of theory, one of the primary aims of increasing the degree of capital account openness is to help countries to obtain the advantages of improved risk sharing and thereby lowering the volatility in macroeconomic aggregates like output, consumption and investment, which will, in turn, has welfare enhancing effects. Developing countries, in particular, appear to have benefited most from risk sharing owing to their highly volatile nature of income and consumption dynamics. However, contrary to the expectations, the volatility of these aggregates has increased in the aftermath of CAC leading to crises in many countries at the end of the 1990s. This led to a widespread debate regarding the costs and benefits of CAC.

Though countries have fears about plunging into CAC, there exist a host of distinct advantages: a) there would be more and more capital available to the country, and the cost of capital would decline; b) just as there are gains from trade, there are advantages to the free movement of capital, which is, in a way, the freedom to trade in financial assets; c) the spreads of banks and nonbank financial institutions would come down due to growing competition, rendering the financial system more efficient; d) tax levels would move closer to international levels thereby reducing evasion and capital flight; e) the cost of government borrowing would fall in response to lower interest rates, thus lowering the fiscal deficit; and f) it would become quite difficult for a country to follow unwise macroeconomic policies, because, under CAC, markets would preemptorily punish imprudence.

Critics have also spelled out a number of costs associated with CAC. In the first place, an open capital account could lead to the export of domestic savings, which for capital scarce developing countries would disrupt the financing of domestic investment. Secondly, CAC could expose the economy to larger macroeconomic instability emanating from the volatility of short-term capital movements and the risk of massive capital outflows. Thirdly, premature liberalisation (that is, if the speed and sequencing of reforms are not appropriate) could initially stimulate capital inflows that would lead to appreciation of real exchange rate and thereby destabilise an economy undergoing the fragile process of transition and structural reform. Fourthly, because of higher capital inflows preceding CAC, the appreciating real

exchange rate would shift resources from tradable to non-tradable sectors (such as construction, housing, hotels and tourism, etc.) and this would happen in the backdrop of rising external liabilities. Finally, a convertible capital account could generate financial bubbles, especially through irrational investment in real estate and equity market financed by unrestrained foreign borrowing.

PRE-CONDITIONS

Generally, there are a number of prerequisites that need to be fulfilled prior to moving to CAC. One, a prudent fiscal policy is an important element in achieving and maintaining capital convertibility. Large fiscal deficits that require financing through money creation may destabilize the exchange rate and discourage both foreign and domestic investment. Reliance on foreign loans with high interest rates creates debt-management problems, reduces creditworthiness, and weakens an economy's ability to manage external shocks.

Secondly, a sound monetary policy that complements and is facilitated by fiscal discipline is another critical element, because excess liquidity expansion will spill over into the external sector. Moreover, a market-clearing exchange rate is essential to ensure external balance. Furthermore, to avoid wide exchange rate fluctuations, prudent macroeconomic policies need to be coupled with adequate international reserves.

An efficient and sound financial sector is an essential ingredient of capital account convertibility, enabling banks to invest capital inflows prudently and weather shocks. Efficiency requires market-based monetary instruments and a liberal regulatory framework. The sector's soundness depends on, among other things, effective banking supervision and observance of prudential ratios.

Finally, a well-functioning price mechanism is essential to avoid distortions that reduce the efficiency of resource allocation, affect capital flows adversely and hinder growth. Thus, subsidies, tax concessions and price controls need to be phased out.

LESSONS FROM COUNTRY EXPERIENCES

As adumbrated earlier, the early 1990s witnessed a boom in capital flows internationally followed by the reversal of such flows especially in the second half of the 1990s. The first reversal occurred in the aftermath of Mexico's currency crisis in December 1994. It was, however, restricted to some Latin American economies and capital flows resumed soon after. The second reversal, which was more severe, came in 1997 and led to the East Asian crisis. This was followed by the Russian default in August 1998, the Brazilian crisis in 1998-99 and by the collapse of the Argentine currency in 2001.

A number of lessons can be drawn from the experiences of various currency crises in the past sixteen years. In the first place, liberalisation of the capital account was gradual in most of the economies in the run up to full convertibility, combined with strengthened financial systems and prudential regulations. Even after "completely" liberalising the capital account these countries continue to impose certain capital controls.

Secondly, the gradual process of capital account liberalization does not eliminate the risks of crisis or pressures in the foreign exchange market. These risks, however, get minimized when an integrated approach to reform is pursued involving macroeconomic stabilization and institutional strengthening.

Along with other reform measures, another important lesson is that exchange rate flexibility is important while undertaking capital account liberalization. Under a flexible exchange rate scenario, monetary policy flexibility can be an instrumental mechanism to help maintain macro-economic stability.

Thirdly, limiting fiscal imbalances and preventing excessive build-up of domestic debt is essential to avoid chances of backtracking subsequent to capital account liberalization. Though fiscal consolidation may not by itself be a sufficient condition to prevent crises, it has been a necessary component of liberalization and its absence can create instability.

The fourth lesson from country experiences is that avoiding real exchange rate misalignment could minimize the impact of the crisis. This also calls for pursuing autonomous monetary policy. It would force market participants to hedge their positions that would be beneficial for forex market development.

Moreover, given the growing risks that are prevalent in a deregulated environment, it is important to focus on effective risk management strategies, improve prudential supervision and develop proper reporting standards to meet the emerging challenges.

At the same time, rapid easing of capital controls and subsequent backtracking seen in the case of many Asian and Latin American countries, clearly indicate the need for a more cautious and calibrated approach, and ensuring enough regulatory and prudential safeguards before moving towards capital account liberalization.

Again, there is evidence to suggest that countries have adopted capital account reforms after taking cues from the policy actions of countries within their spheres of influence. In particular, developing countries seem to have been influenced by countries in their same regional and income peer networks. This implies social emulation that could be a type of rational learning. The idea is that even when confronted by economic crises, countries, still uncertain about the costs and benefits of adopting capital account liberalization policy, will look to the experiences of similarly-situated countries to better assess the costs of that policy choice.³

STEPS TOWARDS CAC IN INDIA

India started liberalizing its capital account as part of comprehensive economic reforms initiated in the early 1990s that reversed its 40-year experiment with centrally planned development. The hallmark of the reform process has been a gradual, cautious approach that has been carefully phased and sequenced across the economy. As a result, India has come a long way from its pre-1991 highly restrictive exchange control regime. With gradual liberalization of both Foreign Direct Investment (FDI) and portfolio investment, the rupee has been made convertible for foreign investors. However, some controls remain in place to varying degrees for both foreign and domestic corporates and individuals, with resident corporates facing a more liberal regime than resident individuals.

In India, the current account convertibility was achieved in August 1994 by accepting Article VIII of the Articles of the International Monetary Fund (IMF). It was the Tarapore Committee on "Capital Account Convertibility" that defined the framework for forex liberalization in May 1997. This Committee had chalked out three stages, to be completed by 1999-2000. It had indicated certain signposts to be achieved for the introduction of CAC. The three most important of them were: fiscal consolidation, a mandated inflation target and strengthening of the financial system. However, the timetable was abandoned in the wake of the 1997-98 Asian financial crisis.

In April, 2006 a committee was formed again under the chairmanship of former Deputy Governor of the Reserve Bank of India (RBI) Mr. S. S. Tarapore to revisit the issue of CAC and suggest a road map for it. The committee proposed that India shift to Fuller Capital Account Convertibility (FCAC) in five years beginning 2006/07. In its report submitted to the RBI on July 31, 2006, the committee suggested that the proposed regime be embraced in three phases—2006-07 (phase I), 2007-08 and 2008-09 (phase II) and 2009-10 and 2010-11 (phase III).

The committee has pointed out that the concomitants for a move to fuller CAC would be fiscal consolidation, setting of medium-term monetary policy objectives, strengthening of the banking system, maintaining an appropriate level of current account deficit as well as reserve adequacy.

Some of the recommendations of the committee included the following:

- The centre and states should graduate from the present system of computing fiscal deficit to a new measure of Public Sector Borrowing Requirement (PSBR).
- Substantial part of the revenue surplus of the centre should be earmarked for meeting the repayment liability under the centre's market borrowing programme, thereby reducing the gross borrowing requirement.
- Revenue deficits of the states should be eliminated by 2008-09 and fiscal deficits of the states should be reduced to 3 percent of GDP.
- To strengthen the banking system, the minimum share of the government/RBI in the capital of Public Sector Banks (PSBs) should be reduced from 51 percent (55 percent for State Bank of India) to 33 percent.
- All commercial banks should be subject to a single legislation and all banks, including state-owned banks, be incorporated under the Companies Act.
- The RBI should evolve policies to allow, on merit, industrial houses to have stakes in Indian banks or promote new banks.
- The limits for banks' overseas borrowing should be linked to their paid-up capital and free reserves, and not to unimpaired tier I capital at present, and raised to 50 percent in phase I, 75 percent in phase II and 100 percent in phase III.
- To make Indian corporates compete in the global arena on an equal footing, the limits for corporate investments abroad should be raised in phases from 200 per cent of net worth to 400 per cent.
- Other than Non-Resident Indians (NRIs) who are allowed to invest in companies on Indian bourses, all individual non-residents should be allowed to invest in the Indian markets through Sebi-registered entities.
- Non-resident corporates should be allowed to invest in the Indian stock markets through Sebi-registered entities, including mutual funds and portfolio management schemes.
- Apart from multilateral institutions being allowed to raise rupee bonds in India, other institutions/corporates should also be permitted to raise such bonds (with an option to convert into foreign exchange), subject to an overall ceiling, which should be slowly raised.
- The annual limit of remittance by individuals to open foreign currency accounts overseas be raised to US\$ 50,000 in phase one from the current level of \$25,000 and further raised to US\$ 100,000 in phase two and US\$ 200,000 in phase three.
- The limit for mutual funds to invest overseas should be increased from the present level of US\$ 2 billion to US\$ 3 billion in phase one, to US\$ 4 billion in phase two and to US\$ 5 billion in phase three and these facilities should be available to SEBI registered portfolio management schemes apart from mutual funds.

Some useful lessons can be drawn from India's approach to capital account liberalization. One, capital account liberalization is regarded as a process and not an event. Two, it is recognized that there may be links between the current and capital accounts and, hence, procedures should be intact to avoid capital flows in the guise of current account transactions.

Thirdly, capital account liberalization is maintained in line with other reforms. The degree and timing of capital account liberalization need to be sequenced with other reforms, such as strengthening of banking systems, fiscal consolidation, market development and integration, trade liberalization, and the changing domestic and external economic environments.

Fourth, a hierarchy has been made with regard to the sources and types of capital flows. The focus in India has been to liberalize inflows relative to outflows, but all outflows related to inflows have been completely freed. Among the kinds of inflows, FDI is preferred for stability, while excessive short-term external debt needs to be avoided. A separation is made between corporates, individuals, and banks. For outflows, the hierarchy for liberalization has been corporates first, followed by financial intermediaries, and finally individuals. For individuals, residents are treated separate from nonresidents, and nonresident Indians have a clear intermediate status between residents and nonresidents.

Fifth, the speed and sequencing of liberalization is responsive to domestic developments, particularly in the monetary and financial sectors, and to the developing international financial architecture. As liberalization proceeds, administrative measures need to be lowered and price-based measures should be increased, but the freedom to change the mix and reimpose controls should be available.

The political economy also is crucial for the success of reforms.⁴ Although there have been coalition cabinets and periodic elections both at the center and in several states, the overriding feature of India's political system, overall, is system stability. Despite diversity in political ideologies and frequent elections, the progress of well-calibrated economic reforms seems to be striking.

To conclude this section, at the India-Europe Investment Forum in London in June 27, 2007, Finance Minister of India Mr. P. Chidambaram indicated that India would continue with its gradualist approach towards achieving full capital account convertibility. He said, "Large inflows of capital can create pressures that lead to inflation, and/or appreciation of the exchange rate... We have responded with an appropriate mix of policies in a calibrated fashion without imposing any unduly restrictive capital controls."⁵

NEPAL'S EXPERIENCES

Nepal has experienced nearly five decades of planned economy since 1956. It had followed an import substitution policy until the inception of Fourth Five-Year Plan (1969-74) after which export promotion strategies were designed.

Drastic reforms have been implemented in economic policies since 1991/92. Consequently, taxation, industrial, trade, financial, foreign investment and exchange rate policies have been substantially liberalized. The interest rate was deregulated and is now determined broadly by the market forces. Nepalese rupee was made fully convertible for the current account transactions in February 12, 1993. Along with the sharp cut in tariff rates to make rates compatible with the global tariff rates, foreign investors were granted facilities similar to local investors.

In a way, the process of gradual liberalization of capital account has, to some extent, already begun. The Foreign Investment and Technology Transfer Act, 1992 amended in 1996 guarantees full repatriation of the amount received from the sale of equity, profits or dividend and interest on foreign loan. Foreign exchange earners are permitted to retain cent percent of their foreign exchange earnings and are free to maintain foreign currency deposits with the local banks. Exporters are permitted to borrow in foreign currency from local banks. Moreover, the existing limit of exchange facility has been raised upward from US\$ 1,500 to US\$ 2,500 to individuals and institutions by commercial banks for settling petty international transactions for various purposes.

In Nepal, most of the economic fundamentals are currently neither strong nor sufficient to move instantly towards CAC. One, the fiscal position of the country is not very satisfactory and could adversely affect macroeconomic stability. Two, inflation is on the rise as the average annual rate of inflation was 6.4 percent in 2006/07. Three, the fragile base of exports, high transit costs for both exports and imports and weak market linkages pose additional challenges to the Nepalese economy. Again, the situation in the banking sector is not satisfactory either with problems persisting especially in the public sector banks. The NPA of the banking system as a whole was about 12 percent in mid-April 2007.

CHALLENGES

Since the economic fundamentals of the economy are not robust enough, the move towards CAC should take a gradual pace and should be undertaken when the macroeconomic, financial and exchange rate policies are in order. Liberalization of outflows and inflows need to be conducted in a balanced manner so that the pressure on exchange rate and money supply could be minimized.

Efforts must be made to bring exchange rate of Nepalese rupee *vis-à-vis* Indian rupee to a realistic level to make CAC sustainable. However, an *ad hoc* shift from a fixed regime maintained for a long period of time to market determined regime could create disturbances in the foreign exchange market.

Similar to macroeconomic stability, prudential regulation and supervision is a *sine qua non* for successful financial opening. Strong regulatory and supervisory policies are crucial for minimizing moral hazard (including corruption, fraud and excessive risk taking) in the banking system, ensuring the viability and health of the banking industry and making interest rate liberalization more effective.

In the ultimate analysis, as the *Report of the Committee on Fuller Capital Account Convertibility* was released on September 1, 2006, suggesting that the CAC scheme should be implemented in a five-year period in three phases, steps toward CAC in Nepal need to be initiated, to some degree, along the lines of the Indian roadmap.

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ENDNOTE:

¹ This definition is taken from RBI (2006), p. 6.

² This issue has been extensively dwelt in Nair (2006).

³ Brune and Guisinger (2003).

⁴ Since 1990, there have been six elections for the national parliament in India and seven prime ministers, while a number of national and regional political parties have been part of coalition governments. India has also faced border conflicts and sanctions.

⁵ For details, see *The Financial Express*, June 28, 2007.