



Causes and consequences of capital account convertibility in India: A theoretical study

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Abstract

The present study focused on exploring the causes and consequences of capital account convertibility in context of India. Capital account convertibility signifies that conversion of domestic currency into foreign currency and vice versa is free of any restriction so that residents could freely purchase investment assets abroad and similarly non-residents could acquire domestic investment assets easily. It will be a significant contribution to the overall macroeconomic policy of a nation and its stability. Till now, Indian economy has performed at the global front following the capital controls with regards to capital account convertibility. However, it is high time to make the capital account fully convertible since India is growing with the passage of the time and integrating with the world markets. Although the issue of capital account convertibility has remained controversial and is still under debate, its advocacy is still qualified and it will have to be accepted by all the nations including India.

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Introduction

In the aftermath of the second world war era, promotion of global trade has remained a central idea of the economic policies. However, simultaneously the issue of free trade could not attain the consensus among the economists as far as its numerous aspects are concerned. As per the article VIII (2) of the articles of agreement given by International Monetary Fund (IMF), none of the member nations can impose embargo in relation to settlement of current account based international financial transactions. Also, World Trade Organisation (WTO) consistently emphasises trade openness. India being a member of WTO has accepted article VIII of the IMF articles in 1994. As a consequence, free trade issue with regard to current account convertibility stood settled.

Government of India (GOI) introduced Liberalised exchange rate management system (LERMS) also called as dual exchange rate system in 1991-92. This dual exchange rate system permitted the exporters of India to convert 60% of their export earnings into local currency that is, rupee at prevailing market rates. The remaining 40% of the export earnings could only be converted into local currency through Reserve Bank of India (RBI) at the official exchange rate. Notably, here market rate tends to be higher in comparison to the official exchange rate. This led to resentment among Indian exporters and non-resident Indians (NRIs) working overseas.

Eventually, government of India declared full convertibility of the rupee firstly only on trade of visible items and then on the current account transactions in 1994. Also, government came up with Tarapore committee establishment first in 1997 and then in 2006 to evaluate the capital account convertibility (Report of Tarapore committee, 1997 & 2006). Rupee is still partially convertible on capital account transactions.

Capital account as a component of balance of payments (BOP), consists of international transactions concerning

investment assets, namely, equity, debt and even immovable property. Capital account convertibility signifies that conversion of domestic currency (INR) into foreign currency (USD) and vice versa is free of any restriction so that residents could freely purchase investment assets abroad and similarly non-residents could acquire domestic investment assets easily. Since capital account transactions consist both of long-term commitment and short-term like merely to book profits, here the implications in the form of challenge towards domestic economic stability are quite different from those of current account transactions. If capital account is made fully convertible, it will be applicable to both long-term as well as short-term assets without any distinction. But short-term capital account transactions could cause economic turmoil through buy and sell orders of foreign investors.

Considering this, capital account convertibility is actually the remaining portion of the impossible trinity according to Mundell and Fleming (1960)^[3].

Review of literature

Several studies are available analysing the impact of capital account convertibility on the macroeconomic stability. A handful studies are being described here in chronological order:

Khan (2004)^[2] performed empirical analysis which highlighted that the bank lending as well as capital inflows can be one of the reasons of vulnerability of 1997 Asian crisis among the other macroeconomic factors. The study considered variables such as real exchange rate, government budget as a proportion of GDP, M2 indicator of money supply as proportion to foreign exchange reserves, lending boom, investment inflows and current account balance as a ratio of GDP. It is concluded that the countries, which depend upon Japanese banks as their principal lender along with Thailand, were the first to bear the heat of Asian

financial crisis which ended up with exchange rate crisis. The study further supports the evidence that short term investment inflows like FIIs' investment also contributed to Asian financial crisis.

Sethi (2006) ^[6] verified the existence of long-run equilibrium association between few pairs of selected variables such as exchange rate and private capital inflows as well as between exchange rate and economic growth. The study revealed that economic growth and industrial production have not been significantly aided by foreign capital inflows.

Izhar and Masood (2008) ^[11] examined that how foreign capital inflows impacted few macroeconomic indicators in India based on quarterly data spanning 1994Q1 to 2007Q2. The variables taken into account are total capital inflows, current account balance, money supply, foreign exchange reserves and real as well as nominal exchange rate. The findings observed a bidirectional causal linkage between real exchange rate and the total capital inflows and also between forex and total capital inflows. However, a unidirectional causality has been observed from total capital inflows towards real exchange rate.

Pradhan (2011) ^[4] analysed a range of macroeconomic indicators including reserve money, gross domestic capital formation, capital flows, excess capital flow over current account balance, wholesale price index and index of real effective exchange rate using cointegration and Engel Granger tests for causality. The findings of the analysis do not indicate any type of causality between capital inflows and economic growth.

Likewise, Ramakrishna and Memdani (2012) ^[5] made an effort to explore the influence of foreign capital inflows on considered macroeconomic indicators of Indian economy including imports, exports, index for industrial production (IIP) and Inflows of Foreign Capital including foreign direct investment and foreign portfolio investment spanning 1990-91 Q1 to 2010-11 Q4. The findings of cointegration and error correction mechanism revealed that all the macroeconomic variables have shown positive growth over the period of capital account convertibility. The degree of variability has increased in tandem with this growth.

An outlook on impact of capital account convertibility with reference to india

The classical theory of impossible trinity states that economy could not attain all the three objectives, namely, fixed exchange rate, independent monetary policy and open capital flows simultaneously. Thus, this impossible trinity concept well explains the complexity of capital account convertibility. If a country follows open capital inflows and independent monetary policy, it will have no option but to fix the exchange rate. However, if a country does not want to keep the exchange rate fixed and wants that its exchange rate should be freely determined by market forces then it will have to restrict the capital inflows, otherwise, monetary autonomy will suffer. Likewise, if a country keeps its exchange rate fix and independent monetary policy then it will have to restrict the capital flows. It has been witnessed that since 1990, global capital flows have tremendously increased and the reason behind this is the capital account convertibility which is being consistently advocated by advanced countries and economies around the globe. Capital account convertibility comes with following advantages:

- All the advanced countries are having their capital account convertible and developing countries will have to make the capital account convertible and it will certainly happen in the future and it cannot be prevented permanently.
- Free flow of capital will bring in more opportunities in the form of pooling of global savings and thereby improving the domestic productivity which will eventually bring down the marginal cost of capital and contribute to the economic growth of the country.
- Further the capital account liberalisation provides more opportunities to the investors in the form of their portfolio diversification geographically.
- Capital account convertibility will be a significant contribution to the overall macroeconomic policy of a nation and its stability. Since an economy if has fully convertible capital account, it will have to duly consider the sound macroeconomic management policies.

Similarly, capital account convertibility also suffers from the following disadvantages particularly for the country like India:

- The first and the foremost danger of the capital account convertibility emanates from the nature of capital inflows in India. India recently received huge amount in the form of foreign portfolio investment inflows which is volatile kind of foreign investment and is of short-term nature and is highly sensitive for the domestic economy of India due to their inherent nature of frequent capital flights.
- These frequent capital reversals by foreign investors cause turmoil in the capital market of India as the foreign capital inflows in the form of foreign capital investments are basically comprised of debt and equity instruments, these are easily exposed to market instabilities due to the momentum strategies and herd behaviour of foreign investors.
- The impossible trinity concept implies that an open capital account and complete floating exchange rate system can cause a deep financial and economic turmoil like situation for the domestic economy since exchange rate may indicate huge deviations from the equilibrium value and severe volatility.
- Although the issue of capital account convertibility has remained controversial and is still under debate, its advocacy is still qualified and it will have to be accepted by all the nations.
- Tarapore committee has advised to make a cost benefit analysis for the implementation of the capital account convertibility. However, a nation like India if tries to move for the full capital account convertibility have to be cautious regarding the economic management as a consequence of the economic implications of capital account convertibility.

But there are still questions emanating from the various analysis made by the committee and earlier observations which are described as below,

- Is India unduly procrastinating the implementation of capital account convertibility?
- Is India acting prudently and following the precautionary principle regarding implementation of capital account convertibility?

In the context of these questions, capital account taxonomy for India is being discussed as below:

- Barring few sectors such as those involving strategic interest like defence, real estate which is exposed to become victim of bubble in pricing and sectors of social concern, India is open for foreign direct investments (FDI).
- However, there exists some operational constraints on FDI for the selection of investment instruments. Mostly, equity instruments are available for making the FDI investments since it is necessary that FDI should not accumulate debt. As far as FDI is concerned, besides capital account liberalisation other things that should be given due consideration are tax structure for the FDI investors, host country's investment environment, infrastructure of the host country, ease of doing business in the host country etc.
- Since 1993, foreign portfolio investment has shown tremendous growth in India and it is being hot money by nature involves severe shocks for capital market of India as well as macroeconomic management. As a consequence of frequent withdrawal by foreign institutional investors' (FIIs) investment, host country's economy becomes highly volatile due to the momentum strategies and herd behaviour followed by FIIs.
- Also, India has got assistance by means of external commercial borrowing for its various projects. By means of liberalising FDI, India will get several advantages in the form of improved access to technology and better know-how. The 'Make in India' programme of India is based on the logic that India will liberalise and attract more and more FDI for attaining the improved technology and eventually the quality of the products and services being produced in India.
- Till now, Indian economy has performed at the global front following the capital controls with regards to capital account convertibility. However, it is high time to make the capital account fully convertible since India is growing with the passage of the time and integrating with the world markets.
- Thus, considering the current integration level of the Indian market with the world markets and needs of India, it is vital to make the capital account convertible so that its benefits can be reaped.

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