

## EXTERNAL SECTOR VULNERABILITIES AND CAPITAL ACCOUNT CONVERTIBILITY ISSUES IN INDIA – A RE-APPRAISAL

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### ABSTRACT

The Paper re-appraises the level of integration of the Indian economy to the Global economy / markets to find the status after more than a decade of reform measures. The talk of de-coupling effect in Indian economy and the issues of vulnerability to external sector shocks are examined empirically. An assessment of the tools of Capital account management viz., FDI, FPI, ECBs, FCCBs and how has it behaved over the years and the various timelines of policy measures adopted in managing the capital account have been minutely tracked and plotted. A re-appraisal of where does India stand with regard to Capital Account Convertibility (CAC) is dealt in deep which might enlighten the audience.

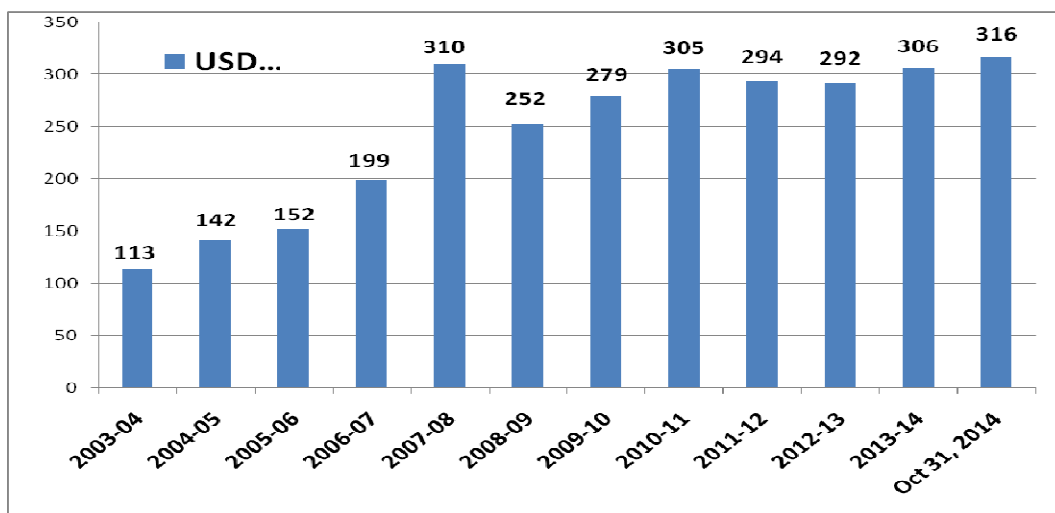
**KEYWORDS:** Reserves Adequacy, Capital Account Convertibility, CAC, India's Sectoral FDI Inflows, FPI, ECBs, FCCBs, De-Coupling Effect, External Sector Vulnerability

### 1.0 INTRODUCTION

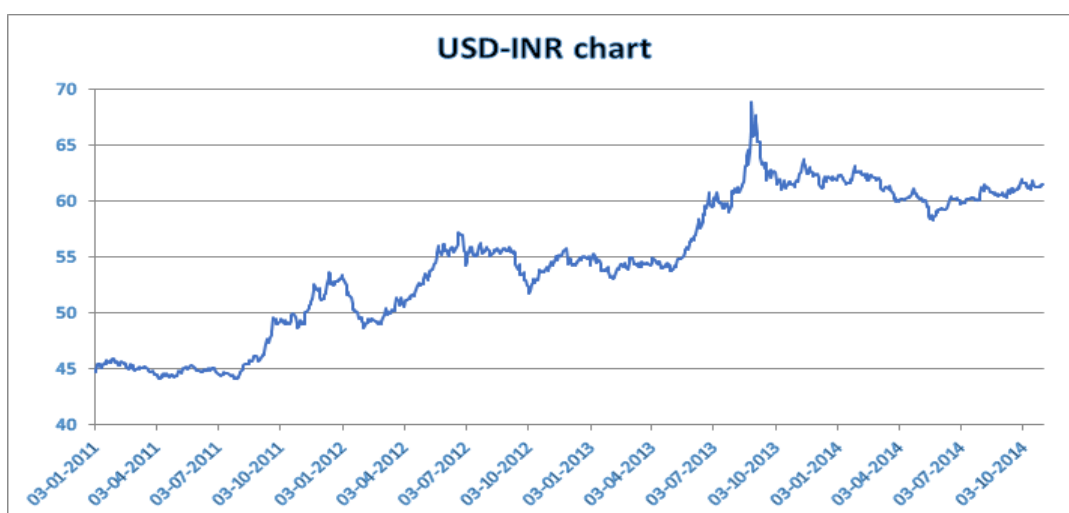
Post economic reforms of 1991, How far has Indian economy integrated with the World economy?; Is the decoupling effect of the Indian economy which many experts talked about in the global market meltdown post sub-prime 'Real' ?; What does the measure of quantitative easing adopted by the US signify for the Indian economy; Where do we stand in terms of 'Capital Account Convertibility' now, which we have been hearing for more than a decade ?; With the heightened decibels for FDI and the various sectoral issues that cropped up, how are we managing the Capital flows through different instruments / components of 'Capital Account Management'?. This paper tries to dwell deep into it empirically to re-appraise the Indian effort and understand it better.

### 2.0 RESERVES ADEQUACY

Reserves Accumulation is an objective of the Central Bank to stabilize the exchange rate. Large reserves that many emerging economies have built up is often viewed as a bulwark to guard against contagion effects of global crisis and risk aversion. In the face of sharp appreciation of the domestic currency, the intervention is directed at mopping up excess supply of foreign currency in order to preserve export competitiveness, While, in case of sharp depreciation, there is a loss of reserves, particularly in a country like India where the external liabilities far exceed the official reserves. Figure 2.1 & Figure 2.2 below depicts, India's Forex Reserves Position and the USD- INR Exchange rate over the years and research on these shows that India has acquitted well so far in managing these two.



**Figure 2.1: India's Forex Reserves Position in the Last 10 Years (in USD Billion)**



**Figure 2.2: USD- INR Rate from Jan 2011 (Nearly 4 Years)**

Compared to the days of Post 1991, where in India liberalised its economy and unleashed its globalization policy, it is now a lot more integrated economy with the world economy and also the global financial markets. The earlier belief of decoupling has proven to be a myth with the Global financial crisis of 2007 and the Euro zone crisis. Emerging market economies including India faced enhanced uncertainty, especially in the external sector on the back of both local and global developments. In addition to the various domestic factors, these have also impacted our economy. The worsening of India's external environment was reflected in the deterioration in various external sector vulnerability indicators between end-March 2011 and end-March 2013.

### 3.0 EXTERNAL SECTOR VULNERABILITIES IN INDIA

India faced the following vulnerabilities in the external sector which can be gauged from the following indicators:

- The external debt to GDP ratio increased from 18.2 per cent to 22.0 per cent.
- Import cover of reserves, which stood at 9.5 months at end-March 2011 declined sharply to about 7.0 months at end-March 2013

- The Current Account Deficit ie. CAD-GDP ratio deteriorated from 2.8 per cent to 4.7 per cent during the period.
- CAD has since fallen sharply on the back of measures taken to curtail gold imports and moderation in crude prices. CAD is forecast at 2.0 per cent for 2013-14 and is expected to remain around this level.
- Sharp deceleration in GDP growth rate (4.5 per cent in 2012-13 and 4.4 per cent in Q1 of 2013-14)
- High level of inflation
- Average CPI and average WPI inflation of 10.2 per cent and 7.4 per cent respectively in 2012-13 and large fiscal deficit (4.8 per cent of GDP in 2012-13)
- Growth constraints.
- Inflation shows signs of moderation though concerns remain

### 3.1 Measures to Stabilise Rupee

On the back of the afore-said vulnerabilities, whole lot of measures was seen taken by the Central Bank and policy makers which can be summarised as follows:

- Forex market intervention
- Reduction in banks' access to overnight LAF
- Increase in MSF and CRR
- Import compression of non-essential items , including in gold
- Increase in overseas borrowing limit of banks
- Bringing outbound FDI beyond 100% of NW under approval route.
- Special dollar swap window for the PSU oil companies
- Special concessional window for attracting FCNR (B) deposits,
- Reduction in Liberalised Remittance Scheme entitlement
- FIIs, hedging the currency risk of its sub-account holders required to obtain a mandate from the sub-account holder.
- Banks prohibited from taking any proprietary trading position on Currency Futures.
- Positions in the CF segment can not be set off in the OTC market
- SEBI imposed restrictions in the exchange traded currency derivatives segment

### 3.2 Capital Account Convertibility Conundrum

Amidst these backdrop, what happened to the issue of an Open Capital account or what is commonly referred to as 'Capital Account Convertibility (CAC)'. When we check the interventions / roadmap on this front of Capital Account Liberalisation and the timeline so far, we can note that three committee reports provided the analytical foundation for capital account management framework in India

- Reports of the High level Committee on Balance of Payments- - 1992
- Tarapore Committee Report on Capital Account Convertibility(CAC) - (1997)
- Tarapore Committee Report on Fuller Capital Account Convertibility – II (2006)

The broad objective seem to be to treat CAC as a process and not as an event and also to ensure macro economic and financial stability. To be precise, the focus was on sequencing the process.

### 3.2.1 Pre-Condition and Open Capital Account- Benefits / Risks

While a stable inflation, flexible interest rate structure, appropriate exchange rate policy and a sustainable fiscal deficit aided by strong prudential supervision are a pre-condition for CAC, it can bring home the following benefits for the economy:

- Greater financial efficiency, specialisation and innovation by exposing the financial sector to global competition
- An open capital account attracts larger foreign capital.
- An open capital account permits both savers and investors to protect the real value of their assets through risk reduction.
- Residents get the opportunity to base their investment and consumption decisions on world interest rates and world prices for tradeables, which could enhance their welfare
- Can lead to export of domestic savings and thus affect domestic investment
- May expose the economy to greater macroeconomic instability arising from the volatility of short term flows
- If the speed and sequencing are not appropriate, it may witness surge in short term flows that destabilizes the economy
- Speculative short term movement in interest rates may make monetary policy operation difficult.

### 3.3 Capital Account Management- Instruments

When we check the various instruments employed for Capital Account Management and what has been India's approach to Instruments like FDI, FPI, FII, ECB, FCCBs etc., we could notice that an hierarchy has emerged over the years of liberalization and we seem to be learning from all quarters of the world.

#### Hierarchy of Capital Flows- Indian Approach

- Encourage non-debt creating flows and long term flows
- Preference hierarchy
  - Nature of flows
    - Equity over Debt
    - FDI over Portfolio
    - Debt for capital formation

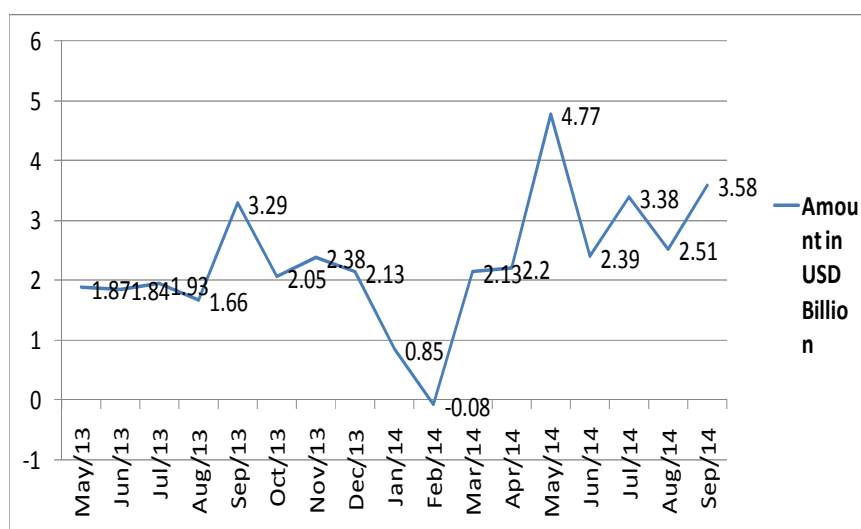
- Long term over short term
- Short term debt only for trade transactions
- Sectors/ Agents
  - Real sector including infrastructure
  - Individuals
  - Financial Sector

### 3.3.1 Foreign Direct Investment (FDI)

The Indian experience on FDI is characterized by:

- Lasting interest and some degree of management control by the investor,
- Is positioned high in the hierarchy of capital inflows not only for resource augmenting but usually it also brings in better technology and more efficient management and business practices
  - The only restriction on FDI pertains to sectoral investment limits – the degree of control that can be ceded to a non-resident-motivated by strategic or socio-economic considerations.
  - Sectoral caps determined by the government (except Banks and NBFCs)
  - FDI limits allowed/increased in certain sectors like Multi brand & single brand retail
  - Simplification of FDI regime
  - Composite cap

Figure 3.3a and 3.3b depicts FDI inflows in the recent years and the sectors attracting highest FDI Equity inflows



Source: [www.rbi.org.in](http://www.rbi.org.in)

Figure 3.3a: Foreign Direct Investment

**SECTORS ATTRACTING HIGHEST FDI EQUITY INFLOWS:**

Ranks	Sector	Amount in Rs. crores (US\$ in million)				% age to total Inflows (In terms of US\$)
		2011-12 (April - March)	2012-13 (April - March)	2013-14 (April, 13- January, 2014)	Cumulative Inflows (April '00- January'14)	
1.	<b>SERVICES SECTOR **</b>	24,656 (5,216)	26,306 (4,833)	10,680 (1,804)	182,955 (39,039)	18 %
2.	<b>CONSTRUCTION DEVELOPMENT: TOWNSHIPS, HOUSING, BUILT-UP INFRASTRUCTURE</b>	15,236 (3,141)	7,248 (1,332)	5,914 (966)	106,963 (23,047)	11 %
3.	<b>TELECOMMUNICATIONS</b> (radio paging, cellular mobile, basic telephone services)	9,012 (1,997)	1,654 (304)	1,063 (172)	59,796 (13,028)	6 %
4.	<b>COMPUTER SOFTWARE &amp; HARDWARE</b>	3,804 (796)	2,656 (486)	6,230 (1,020)	59,796 (13,028)	6 %
5.	<b>DRUGS &amp; PHARMACEUTICALS</b>	14,605 (3,232)	6,011 (1,123)	7,128 (1,269)	56,008 (12,711)	5 %
6.	<b>CHEMICALS (OTHER THAN FERTILIZERS)</b>	18,422 (4,041)	1,596 (292)	2,950 (496)	43,446 (9,376)	4 %
7.	<b>AUTOMOBILE INDUSTRY</b>	4,347 (923)	8,384 (1,537)	6,144 (1,050)	45,314 (9,344)	4 %
8.	<b>POWER</b>	7,678 (1,652)	2,923 (536)	4,281 (704)	40,418 (8,538)	4 %
9.	<b>METALLURGICAL INDUSTRIES</b>	8,348 (1,786)	7,878 (1,466)	2,599 (432)	37,413 (7,939)	4 %
10.	<b>HOTEL &amp; TOURISM</b>	4,754 (993)	17,777 (3,259)	2,306 (382)	35,566 (7,013)	3 %

Note: (i)\*\* Services sector includes Financial, Banking, Insurance, Non-Financial / Business, Outsourcing, R&D, Courier, Tech. Testing and Analysis

(ii) Cumulative Sector- wise FDI equity inflows (from April, 2000 to January, 2014) are at - Annex-B'.

(iii) FDI Sectoral data has been revalidated / reconciled in line with the RBI, which reflects minor changes in the FDI figures (increase/decrease) as compared to the earlier published sectoral data.

Source: Constructed from RBI data

**Figure 3.3b: Sectors Attracting Highest FDI Equity Inflows Table 1**

Further changes were initiated in the FDI specific to infrastructure in the following ways:

- 100 % FDI allowed under automatic route in power sector.
- 100% FDI permitted under automatic route in petroleum products, natural gas pipelines and petroleum refining by private sector.
- 49% FDI allowed under Government route in any petroleum refining in Public Sector Undertaking (PSU). However, dilution or divestment of domestic equity is now allowed in existing PSUs.
- 100 % FDI permitted under automatic route in setting up new and established industrial park.
- In order to attract private and foreign investment, some more sectors like telecommunication, oil, gas storage and irrigation have been allowed for viability gap funding under the scheme called 'Support to PPP in Infrastructure'.

### 3.4 Foreign Portfolio Investment (FPI)

Same way when we analyse the FPI, we could note that the policy objective was two-fold :

- Containing the interest rate and exchange rate volatility and
- Developing the debt market by attracting long-term stable investment flows through endowment funds, pension funds, sovereign wealth funds,

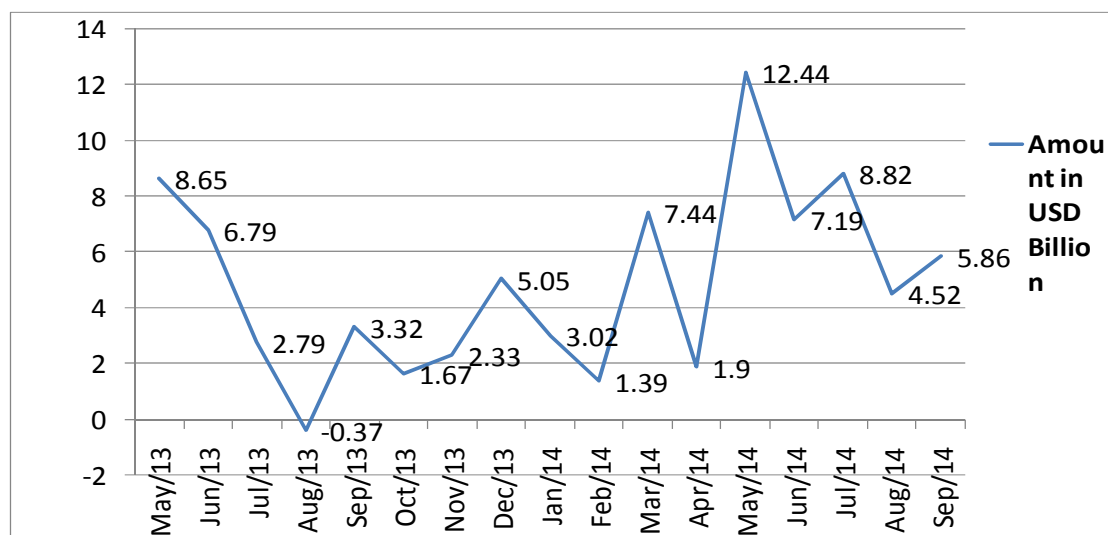
The following measures on the FPI front was observed :

- Inflows on account of foreign portfolio investments is calibrated, as it has the potential to cause sudden stoppages or reversals.
- FPI limits are either through the automatic route or approval route of the Government
- The recent simplifications and liberalizations brought about in the scheme in sync with regulations notified by the Securities and Exchange Board of India (SEBI) wherein the FIIs and QFIs have been merged into a single class of investors known as Foreign Portfolio Investors (FPI) and simplified the KYC verification norms for opening of bank accounts for the portfolio investors. Allowed to participate in the Exchange Traded Currency derivatives from June, 2014

As regards, FPI Investment in Bonds the following measures were seen :

- FPI investment in G-sec and Corporate bonds streamlined
- All separate limits merged- No separate limits for FII or QFI or long term investors
- All maturity restrictions removed
- Allocation and utilization simplified- G-sec up to USD 30 billion and corporate debt up to USD 51 billion
- No investment in T-bills and CPs

Figure 3.4 depicts the FII Inflows from May 2013 onwards where in most of the amends have come in .



Source: [www.rbi.org.in](http://www.rbi.org.in)

Figure 3.4: Foreign Institutional Inflows

### 3.5 External Commercial Borrowings (ECB)

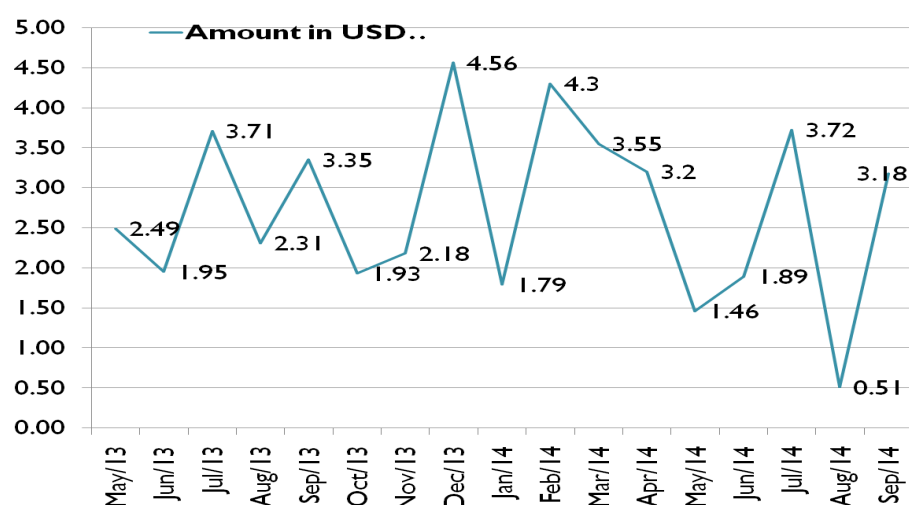
The next instrument which was heavily used by RBI for Capital Account Management is the route of 'External Commercial Borrowings'. ECB can be raised either under automatic route or under approval route to address the adverse selection problem. In recent years, keeping in view the investment needs, particularly for those in the infrastructure sector and those having forex earning capabilities to service ECBs, the regulatory framework for ECB has been relaxed in several respects. These are codified as follows:

- ECB to repay rupee loan(s) availed from the domestic banks (June 2012)
- Refinancing of existing ECBs permitted (April 2012)
- ECBs allowed for working capital for airlines (April 2012)
- Import of services, technical know-how and license fee -a permissible end use (June 2013)
- ECB allowed in the sphere of low cost affordable housing.
- NBFCs, categorized as Asset Finance Companies (AFCs) can avail of ECB (July 2013)
- All recognized ECB lenders (non-resident) have been permitted to extend Rupee denominated ECB to eligible resident entities subject to conditions. Earlier this facility was available only from the foreign equity holder.

There has been amends in Financing ECB through Infrastructure which are summarized :

- **Special Purpose Vehicles (SPVs) in Infrastructure:** Holding Companies are permitted to raise ECB for project use in SPVs
- **Import of services, technical know-how and payment of license fees**
- **Interest during Construction (IDC):** To refinance IDC subject to IDC being capitalized and forming part of the project cost

The incremental performance in ECBs is captured in Figure 3.5



Source: www.rbi.org.in

Figure 3.5: External Commercial Borrowings

### 3.6 Foreign Currency Convertible Bonds (FCCBs)

There has been amends in the Instrument of Foreign Currency Convertible Bonds (FCCBs) from its original scheme of 1993. FCCBs was brought under the ECB guidelines in August 2005. Now, FCCBs are to have Maturity of not less than 5 years. Financial intermediaries are not allowed to access to FCCBs (other than those who were part of textile / steel restructuring). FCCBs can be repaid with raising fresh FCCBs/ ECBs. Even buy back of FCCBs at discount prior to maturity is allowed.



## 4.0 CONCLUSIONS

From the above re-appraisal undertaken on India's status with regard to External Sector Vulnerabilities and how we are placed in the issue of Capital Account Convertibility, it could be noticed that measures like liberalization in exchange controls, simplification of operating procedures, introduction of several new instruments etc., have provided greater flexibility to the market participants in undertaking foreign exchange operations and managing their currency risks. It has made the market broader, deeper and a bit more vibrant. The Indian foreign exchange market has come a long way in terms of variety of instruments, participants and the overall market turnover. The modulation and calibration in Capital account un-winding, seemed to have helped to wither many a storm in the global markets, atleast till now. Undoubtedly, the economy has demonstrated that it is linked to the global economy and markets and is not de-coupled as was believed earlier. With inflation, debt market and infrastructure creation still a big concern, how will it pan out in the days to come will be watched more closely.

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