

Convertibility: Has India got it right?

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Introduction

1. A crucial insight of the Impossible Trinity is that the choice of exchange rate regime cannot be considered separately from the convertibility (CAC) issue.
2. The Impossible Trinity and the Bipolar View: explanation and assessment.
3. India's external payments arrangements are a combination of an intermediate exchange rate regime and targeted capital controls. This regime has served India well in the 1990s as well as in the current decade. A burning question facing Indian policymakers is whether this regime should be continued or dismantled.

Exchange rate policy

4. Neither a permanently fixed nor a clean floating exchange rate would be suitable for India in the near-term future. The critical consideration is that it is vital to maintain export competitiveness and therefore to resist significant (real) exchange rate appreciation. Hence, a managed float or a "dirty crawl" continues to be the appropriate regime.
5. It follows that rapid capital account liberalisation, particularly of bank flows, should be avoided. Note that the policy of keeping the exchange rate mildly undervalued does not have to imply running current account surpluses.

Reserve Accumulation

6. Maintaining an intermediate exchange rate regime requires both a stock of foreign exchange reserves and some capital controls. It is important to realise that there is a tradeoff between the two.
7. Reserve accumulation provides insurance but it makes no sense to over-insure. So the insurance benefit of reserves has to be compared with the cost of reserve accumulation. If the

move to CAC causes a large inflow of unstable, short-term capital, the need for reserve accumulation would rise *pari passu*. If so, an argument in favour of retaining capital controls is that it lessens the need for costly reserve accumulation.

8. India's reserve position is comfortable by all standard criteria and macroeconomic policy should aim to absorb inflows at the margin, rather than to sterilise them. But this need not be achieved exclusively by real exchange rate appreciation.

Capital controls

9. Maintaining some capital controls is a corollary of retaining an independent monetary policy and an independent exchange rate policy at the same time.

10. Capital controls should not be pervasive. Empirical work shows that FDI is stable as well as growth-promoting. This is also true, albeit to a lesser extent, of portfolio equity investment. But short-term capital flows are strongly associated with crises.

11. There are various arguments in favour of full CAC. But in the Indian context the most important ones are that (a) it is a necessary complement of increased inward and outward FDI – though that is belied by Chinese experience; and (b) it is a necessary condition for greater efficiency in the financial sector. In my judgement, these arguments do not imply that CAC has to come in a big bang.

12. The central message of Tarapore 2 is that the approach to CAC should be firm but gradual. This message is, I think, essentially correct though the Report could have spelled out the underlying analytical framework more cogently.

13. Tarapore 2 is right in emphasising that it would be dangerous to move to CAC without further progress in fiscal consolidation. With CAC, the government would operate in an integrated world capital market, so its cost of borrowing could rise sharply, especially during a crisis episode. This would make the dynamics of government debt and deficits very tricky.

It would also not be sensible to have a big bang CAC before the banking system has become more robust.

14. Tarapore 2 was muddled in its recommendations on the exchange rate regime and on a few other issues but its essential thrust was correct.

Conclusion

15. In the long run, India should, as a future global economic power, move to a floating exchange rate, inflation-targeting and CAC. But the approach to this goal-post should be cautious. In the near-term, a rapid move to CAC could disrupt the country's large and unfinished reform agenda.

Table 1

India's balance of payments

	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06
Current Account (% GDP)	-0.8	0.2	0.8	1.4	-0.7	-1.3
Capital Account (% GDP)	1.9	2.2	2.3	3.6	4.4	3.0
Foreign Exchange Reserves (\$ billion)	42.3	54.	75.4	112.9	141.0	151.0
(months of imports)	(8.6)	(11.3)	(13.8)	(17.0)	(15.0)	(12.0)

Table 2**India: Reserve Adequacy Indicators (End March 2006)**

	\$ billion	Ratio (rounded)
Reserves	151	-
Merchandise imports	156	1.0 (12 months)
Gross foreign liabilities	229	0.7
External debt	125	1.2
Short-term ext. debt (by residual maturity)	14.9	10.1
Reserve money	129	1.2
GDP	792	0.2

Table 3**Sources of increase in reserves**

	(2000/1-2005/6)	
	<i>Share of total change (%)</i>	
<i>Current Account</i>	4.9	
Trade Balance	-129.4	
Invisibles	134.3	
Software exports	51.5	153.8
Remittances	103.3	
Other	-20.5	
<i>Capital Account</i>	95.1	
FDI	19.1	
Portfolio Investment	36.0	76.6
“Other Capital inflows”*	40.6	
Commercial loans (M<)	4.1	
Foreign Aid	-4.7	
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Increase in reserves	100	

*Note: “Other Capital inflows” = “Banking Capital” + “other capital” + “short-term capital” + “errors and omissions”

Table 4
India: Major Macroeconomic Indicators

(% increase p.a. unless otherwise specified)

	GDP (overall)	GDP (Industry)	Broad Money	Reserve Money	Wholesale Prices	Fiscal Balance (% GDP)	Govt Debt (% GDP)
1993/94 -1999/00	6.6	6.9	17.3	14.4	6.7	-9.4 (1990/1)	61.3 (1995/6)
2000/01	5.2	6.6	16.2	8.1	7.0	-9.5	70.8
2001/02	5.6	3.2	14.2	11.4	3.6	-9.9	76.4
2002/03	4.3	6.2	12.8	9.2	3.4	-9.6	81.0
2003/04	8.5	6.6	16.4	18.3	4.6	-8.5	81.6
2004/05	7.5	7.4	12.3	12.0	5.0	-8.4	82.5
2005/6	8.4	7.6	17.0	17.2	4.4		

Table 5
India: Nominal and Real Exchange Rate

(Base: 2004/5=100)

	Re/\$	NEER	REER
1993/94	31.4	144.4	98.6
1994/95	31.4	138.9	104.3
1995/96	33.5	127.7	99.8
1996/97	35.5	125.2	99.6
1997/98	37.2	126.8	102.9
1998/99	42.1	111.7	94.7
1999/00	43.3	111.2	96.2
2000/01	45.7	111.6	101.3
2001/02	45.7	109.6	101.2
2002/03	48.4	102.7	96.1
2003/04	46.0	100.7	97.5
2004/05	44.9	100.0	100.0
2005/06	44.3	103.1	105.2
2006/07 (Q1)	46.3	98.9	101.2

Re/\$: Bilateral exchange rate, Rupees per U.S. Dollar; **NEER:** Nominal effective exchange rate; **REER:** Real effective exchange rate.

Source: Reserve Bank of India (Sept 2006), Bulletin.

Table 6
India: Sources of Reserve Money Growth

Year	Δ RM	Δ NFA	Δ NDA
2000/01	227.0	313.0	-86.0
01/02	347.0	668.0	-321.0
02/03	309.0	942.0	-633.0
03/04	673.7	1261.7	-588.0
04/05	524.9	1283.8	-758.9
05/06	839.3	601.9	237.4

Notation: Δ = increase; RM = Reserve Money; NFA = Net foreign exchange assets of RBI; NDA = Net domestic assets of RBI.