

**Chapter 3. Monetary Developments**

Reserve bank of India calculates the 4 concepts of Money supply in India. They are called **Money Stock Measures**.

They are as follows:

- **M<sub>0</sub>**: This is the Currency notes and coins in circulation, plus banks' deposits with the RBI
- **M<sub>1</sub>**: This is Currency with the public as mentioned above + **Demand Deposits** of the public. It is called **Narrow Money**.
- **M<sub>2</sub>**: This is Narrow Money i.e. M<sub>1</sub> + Post office Savings Deposits.
- **M<sub>3</sub>**: M<sub>3</sub> is Narrow Money i.e. M<sub>1</sub> + Aggregate Deposits of the Public which is made up of Demand Deposits and Time Deposits.
- **M<sub>4</sub>**: M<sub>4</sub> refers to M<sub>3</sub> and Post Office Deposits

Out of them, the **Narrow Money (M<sub>1</sub>) and Broad Money (M<sub>3</sub>) are relevant**. The M<sub>2</sub> and M<sub>4</sub> are irrelevant *because of almost no changes in the Post Office deposits*. The RBI in all its policy documents, monthly Bulletins and other documents shows these aggregates. The following image shows the trend in M<sub>1</sub> and M<sub>3</sub> in 2011-12.

**Table 4.5 : Movement of Select Monetary Parameters**

Parameters	(per cent)					
	Yearly variation		Growth rates as on 2 December 2011			
	2009-10	2010-11	Financial-year basis		Year-on-year basis	
		2010-11	2011-12	2010-11	2011-12	
M <sub>0</sub>	17.0	19.1	6.4	0.7	22.3	→ 12.8
M <sub>1</sub>	18.2	9.8	4.0	-0.5	17.0	→ 5.0
M <sub>3</sub>	16.8	16.0	8.5	8.8	15.7	→ 16.3

What we see in the above table is that the growth rates of reserve money (M<sub>0</sub>) and narrow money (M<sub>1</sub>) have been lower than in the preceding year while broad money (M<sub>3</sub>) growth has been higher. **The moderation in growth of M<sub>1</sub> as against M<sub>3</sub> is on account of decline in the growth of demand deposits and currency, while time deposits have accelerated in response to hike in the deposit rates of banks.**

Please note that RBI initiated publication of a new set of monetary and liquidity aggregates as per the recommendations of the Working Group on Money Supply: Analytics and Methodology of Compilation. Following the submission of its report in June 1998, while no changes were made in the definitions of M<sub>0</sub> and M<sub>1</sub>, new monetary aggregates NM<sub>2</sub> and NM<sub>3</sub> as well as liquidity aggregates L<sub>1</sub>, L<sub>2</sub>, and L<sub>3</sub> were introduced, the components of which are elaborated as follows.

- NM<sub>1</sub> = Currency with the Public + Demand Deposits with the Banking System + 'Other' Deposits with the RBI.
- NM<sub>2</sub> = NM<sub>1</sub> + Short Term Time Deposits of Residents (including and up to the contractual maturity of one year).
- NM<sub>3</sub> = NM<sub>2</sub> + Long-term Time Deposits of Residents + Call/Term Funding from Financial Institutions.
- L<sub>1</sub> = NM<sub>3</sub> + All Deposits with the Post Office Savings Banks (excluding National Savings Certificates)
- L<sub>2</sub> = L<sub>1</sub> + Term deposits with Term Lending Institutions and Refinancing Institutions (FIs) + Term Borrowing by FIs + Certificates of Deposit issued by FIs
- L<sub>3</sub> = L<sub>2</sub> + Public Deposits of Non-banking Financial Companies.

Data on M0 are published by the RBI on weekly basis, while those for M1 and M3 are available on fortnightly basis. Among liquidity aggregates, data on L1 and L2 are published monthly, while those for L3 are disseminated once in a quarter.

The focus of the monetary policy during 2011-12 has been on controlling inflation and containing inflationary expectations. One indication of this stance is that the Reserve Bank of India (RBI) has raised policy rates 13 times since March 2010. The measures have helped contain inflation and anchor inflationary expectations, although both remain at elevated levels. The task was rendered difficult due to supply-side factors contributing to food inflation, low interest rates and repeated liquidity injections by industrial nations battling recessionary tendencies, and rise in international commodity prices. High inflation and some of the measures to control liquidity have also had detrimental effect on growth in the short run. The priority, however, has been to contain price rise so that long-term growth prospects are not affected.

Liquidity conditions for a large part of 2011-12 remained broadly around the comfortable level of liquidity deficit (1 per cent of NDTL (Net Demand & Time Liabilities) of the banking system), with occasional stress on account of quarterly tax flows or divergence between deposit and credit mobilization. There has, however, been rapid tightening of liquidity since November 2011.

This was on account of pressure created by foreign exchange outflows and quarterly advance tax collections in December. The RBI responded with a number of measures aimed at addressing the tightness in the foreign exchange market, including the conduct of open market operations (OMOs) to address rupee liquidity concerns.

#### Chapter 4: Money Markets

The money market in India encompasses a wide range of instruments with maturities ranging from one day to a year, issued by the government and by banks and corporate of varying credit rating, and traded in markets of varying liquidity. The money market is also intimately linked with the foreign exchange market *through the process of covered interest arbitrage* in which the forward premium acts as a bridge between domestic and foreign interest rates. Thus an analysis of money market interest rates covers four elements-

1. The term structure of interest rates (the segment of the yield curve up to a maturity of one year).
2. The credit spread between instruments of similar maturity but differing credit risk.
3. The covered interest differential between international interest rates adjusted for the forward premium and domestic interest rates of comparable maturity and default risk.
4. Market structure differences between continuously clearing auction markets and sticky price customer markets.

#### Features of Indian Money Market

Historically, the control of the RBI over the Indian money market has been limited. This is because of an indigenous banking system and unorganized money market. In recent years, a lot of NBFC have spread their roots in the system and still the market lacks complete integration. The money market at one time was divided into several segments which were loosely connected with each other, and partly independent of each another. However, now the RBI is fully effective in the organized sector and Indian Money Market is getting closely integrated. In Indian Money market there are too many interest rates existed since long. One reason attributed to this is immobility of funds from one segment to another. In Indian Money market, the rates are seasonal and during the busy season i.e. November to May-June, funds are required to move the crops and this busy season causes lack of liquidity and hike in the interest rates. In the slack season, there are surplus funds. For this RBI has been pumping in money in the busy season and pumping out in the slack seasons.

The short term bill market is not much popular in India. This market needs to be developed. One reasons attributed to this was that industry preferred to borrow rather than depending upon the short term bills. The RBI's New Bill Market Scheme of the early 1970s got failed. In call / notice money market in India has been highly volatile and the difference between highest and lowest quotations is very high. For example in 1990, the highest rate was 70% per annum and lowest rate was 4% per annum. Similarly, in 2008-09, the highest quotation was 23 percent per annum and lowest was 1% per annum. One reasons attributed to this is also the **short term money required by the Banks to maintain the RBI requirements of CRR / SLR.**

### Structure of Money Market

#### Call Money / Notice Money Market:

All banks in India participate in the Call Money / Notice Money market. This is a very short term market where the maturity is NOT more than 14 days (excluding holidays).

- If borrowing is more than 1 day, it is Notice Money otherwise Call Money Market.

This is **very liquid money market** and is the main indicator of the day to day interest rates. If the call money rates fall, this means there is a rise in the liquidity and vice versa.

*The call money market is an important segment of the money market where **uncollateralized** borrowing and lending of funds take place on overnight basis. Participants in the call money market in India currently include scheduled commercial banks (SCBs) (excluding regional rural banks), cooperative banks (other than land development banks), and primary dealers, both as borrowers and lenders (RBI's Master Circular dated 1 July 2011). **Prudential limits** in respect of both outstanding borrowing and lending transactions **in the call money market for each of these entities** are **specified by the RBI.***

#### Open Market Operations

OMOs are conducted by the RBI via the sale/purchase of government securities to/from the market with the primary aim of modulating rupee liquidity conditions in the market. OMOs are an **effective quantitative policy** tool in the armoury of the RBI, **but are constrained by the stock of government securities** available with it at a point in time.

#### The Liquidity Adjustment Facility

The LAF is the key element in the monetary policy operating framework of the RBI. On daily basis, the RBI stands ready to lend to or borrow money from the banking system, as per the latter's requirement, at fixed interest rates. The primary aim of such an operation is to assist banks to adjust to their day-to-day mismatches in liquidity, via repo and reverse repo operations. Under the repo or repurchase option, banks borrow money from the RBI via the sale of securities with an agreement to purchase the securities back at a fixed rate at a future date. The rate charged by the RBI to aid this process of liquidity injection is termed as the repo rate. Under the reverse repo operation, the RBI borrows money from the banks, draining liquidity out from the system. The rate at which the RBI borrows money is the reverse repo rate. The interest rate on the LAF is fixed by the RBI from time to time (with crucial changes introduced recently in the operating procedure of Monetary Policy detailed in the next paragraph). LAF operations help the RBI effectively transmit interest rate signals to the market.

#### Changes in the Operating Procedure of Monetary Policy

Effective 3 May 2011, based on the recommendations of the Working Group on Operating Procedure of Monetary Policy, the operating framework of monetary policy has been refined. The repo rate has been made the only independently varying policy rate. A new marginal standing facility (MSF) has been instituted, under which SCBs have been allowed to borrow overnight at their discretion, up to 1 per cent of their respective NDTL, at 100 bps above the repo rate. The revised MSF reverse repo corridor has been defined with a fixed width of 200 bps with the repo rate placed in the middle of the corridor. The reverse repo rate has been placed 100 bps below and the MSF rate 100 bps above the repo rate. It is expected that the fixed interest rate corridor, set by the MSF rate and reverse repo rate, by reducing uncertainty and avoiding difficulties in communication associated with a variable corridor, will help in keeping the overnight average call money rate close to the repo rate.

**Inter Corporate Deposits (ICD)**

ICD market is used for short term cash management of the large corporates.

- As per the RBI Guidelines, the Minimum period of ICDs is 7 days which can be extended to One year.
- The ICDs are of two types:
- Fixed Rate ICD : Interest rate is fixed and remains the same.
- Floating Rate ICD: They are benchmarked to NSE's MIBOR.

**Commercial Papers: (CP)**

The Commercial papers are “Unsecured” Promissory Notes. Since these papers are Unsecured and don't have any collateral security, **only highest credit rated firms are able to sell their CPs at reasonable price** and “Trust” over the company matters a lot in CP Business. The maturity of the CP is from 7 days to 1 year. Usually the CP is sold at a discount value and redeemed at face value. For example, if Suresh buys a CP with face value at ₹ 100 at the discount value of ₹ 98, when he redeems the CP on its maturity which may be anything between 7 days to 1 year , ₹ 2 would be his earning.

**Certificate of Deposit: (CD)**

There is no difference between a CP and CD except the **CD is issued by the Commercial banks and Finance Institutions**. Using the CDs banks are able to mobilize the bulk financial resources. CDS are again issued at a discount and the maturity is maximum 1 year. Most common CDs are in the form of 90 days CDs in the market.

**T-Bills:**

T-Bills mean Treasury Bills or the bills issued by the Government. The T-Bill is issued by the Government to fulfill its short term money needs. The T-bills are again issued at discount and the face value is higher than the discount value.

- **In India, the active T-Bills at present are 91-days T-Bills and 364-days T-Bills.**
- Please note that T-bills have an advantage over the other bills such as
- Zero Risk weightage associated with them. They are issued by the government and sovereign papers have zero risk assigned to them
- High liquidity because 91 days and 364 days are **short term maturity**.
- Transparency
- The secondary market is very active so they have a **higher degree of tradability**.

**Fixed Income Markets**

The maturity of the Fixed income markets is longer than 1 year. There are two kinds of instruments in the Fixed Income Markets viz. Bonds and Debentures.

**Bonds:**

Bond is an interest asset which can be issued by the Government, Companies, Banks, Public Bodies and any other large entities. The Bonds can be **discount bonds**, in which a fixed amount is paid back on maturity, or **Coupon Bonds**, in which the interest is paid at intervals.

- In our country, the **only the Government bonds are famous** and make the bulk markets.

**Debentures:**

A debenture is a Bond which is issued by a **corporate**. Its basically a debt instrument used by the large companies to borrow medium and long term loans. The debenture holders can freely trade them and **have NO voting rights** in the company. The Interest paid against the debentures is charged from the profit of the company.

**Government Bonds:**

The bond is a loan received by the issuer from the bondholders who are lenders. At the time of the Budget, the governments normally decide an amount that they plan to borrow for the financial year. This amount is determined usually on the basis of the deficit projected for that particular year, like the above news article says that government has the target of **Fiscal deficit** of 5.5%. This is called **Planned Borrowing**. **Planned Borrowing** is **managed** by the Reserve bank of India. However, there may be an unplanned increase in the Government expenditures due to

recession, war, natural calamities or an unforeseen decline in revenues of the Government. Then also Government can borrow. This borrowing is called "**Unplanned Borrowing**".

- Government Bonds are called **G-secs**.
- G-secs have a **minimum maturity of 2 years** and **maximum maturity of 30 years**, though the bulk of the trading is in between 5-15 years.
- The market of the Government securities / bonds is called **Guilt Edge Market**.
- This investment is **Risk Free** and there is **NO default risk**.

### Types of Government Bonds

The Government Securities are of the following types.

- ◆ Dated Securities
- ◆ Zero Coupon Bonds
- ◆ Floating rate Bonds
- ◆ Call / Put Option Bonds

### Dated Securities:

Dated Securities have fixed maturity and are identified with the date of maturity. They have either fixed rate of interest or coupon rates which are semiannually payable.

**For example:** 6.85% GOI 2021 means

- It will mature in 2021
- The coupon or interest rate is 6.85% paid annually (at 6 months intervals usually)

### Zero Coupon Bonds:

Zero Coupon Bonds are the securities which are **issued at Face Value and redeemed at Par Value**.

- They are not issued now. Zero coupon bonds were issued in 1990s only.

### Floating Rate Bonds:

These refer to the changing interest rate bonds. The interest rate or coupon rate is higher than a Benchmark rate and usually linked to that benchmark rate. When the benchmark rate increases, the coupon rate also increases.

### Bonds with Call / Put Option:

The Call/ Put Option bonds were issued in 2002 for the first time. The **call and put option** means that the bond holder **can sell it back to the government** and **Government could buy it from the bond holder**, after a prefixed period.

### Coupon Amount and Coupon Yield on Bonds

Please note that **Coupon amount** is the sum of money the bond holder **receives as an interest payment** at fixed intervals. **Coupon Yield** is the return that investor receives on his investment.

**Coupon Amount = Face Value X Coupon rate**

For example, in a 2021 GOI 6.50% security which has a face value of ₹ 1000, the investor will get the following:

- $1000 \times 6.5\% = ₹ 65$  annually in the form of ₹ 32.5 every six months.
- ₹ 1000 back in 2021.

The Yield of the Bond is denoted as percentage of the Bond's price at any point of time. It is denoted as following:

Coupon Yield % =  $(\text{Coupon Amount} / \text{Price}) \times 100$ .

In the above example, the face value is equal to the bond value i.e. ₹ 1000, so the Yield of Coupon will also be same i.e. 6.5%. But **if the face value of the Coupon goes down, the coupon yield goes up**. For example if we consider that the same bond has a value of ₹ 800, the yield of Bond will be as follows:

$$(65/800) \times 100 = 8.125\%$$

Similarly, if the value of the bond goes up, say ₹ 1200, then the Yield of the Bond will be as follows:

$$(65/1200) \times 100 = 5.416\%$$

- For a given coupon amount, the Yield of the Bond is inversely proportional to its price.

### Interest Rate Derivatives

Derivative is a product whose value is derived from the value of one or more basic variables. The basic variables are underlying assets, index or may be a reference rate and are known as **Bases**. **The asset can be an equity, a currency, a commodity etc.**

The classification of the derivatives is done on the basis of the underlying asset such as

1. Equity Derivatives
2. Forex Derivatives
3. Commodity Derivatives
4. Interest Rate Derivatives.

The Derivatives includes the following:

- ☞ A security that is derived from a debt instrument , share, loan whether secured or unsecured
- ☞ A contract that derives its value from the prices.

The derivatives can be OTC Derivatives or Over The Counter Derivatives or Exchange Traded Market derivatives. They are discussed as follows:

### OTC Derivatives:

In simple words OTC or Over the Counter derivatives are private , bilateral contracts in which the two parties agree on how the trade has to be settled in Future. It is done over the Telephone and is of two kinds viz. **Forward** and **Swaps**

### Forwards:

This is the simplest derivative instrument. In this a private agreement is held between the two parties and one party (buyer) agrees to buy from other party (seller) an asset at a future date. Here there are two prices play role

- Spot Price: Price when the contract is made.
  - Forward Price: Price when the contract matures.
- This future date is fixed at the start of the contract. When the date arrives there are two options to settle this contract:
- The forward contract is settled by the **physical delivery** of the underlying asset by the seller to the buyer.
  - Both parties may go for a cash settlement. In the cash settlement if the difference between the spot and forward is paid to the party which is eligible for it.

### Interest Rate Swap:

Interest Rate Swap is an over-the-counter (OTC) derivative instrument available in the currency market where counter parties can exchange a **floating payment for a fixed payment and vice-versa** related to an interest rate. Most common parties that go for Interest Rate Swaps are the financial institutions going for foreign borrowings with an objective to hedge their interest rate exposure due to fluctuating interest rates

### Interest Rate Swaps

- ☞ Interest Rate Swap is basically a contractual arrangement between two parties which are called "Counterparties". Commonly the counterparties are a Financial Institution and an issuer.

These counterparties agree to exchange the payments which are actually based upon a Principal amount.

- ☞ This Principal amount is NOT exchanged between the counterparties but the payments are based upon this principal are exchanged. .

- ☞ Interest Rate Swaps don't generate the new sources of funding themselves. Rather, they convert one Interest Rate Basis to another Interest Rate Basis. For example Floating to fixed interest rate or Fixed Interest rate to Floating.

- ☞ The Floating Interest Rate is benchmarked to some interest rates such as MIBOR in India.

- ☞ SWAP is not a lending facility. It's an interest rate management tool which can be used in conjunction with any viable rate lending facility.

Interest Rates Swaps were originally created to allow the multinational companies to evade the exchange controls. However, now, they are used to hedge against / speculate in the changes in the interest rates.

In an interest rate swap, each counter party agrees to pay either a fixed or floating rate denominated in a particular currency to the other counter party. The fixed or floating rate is multiplied by a notional principal amount (say Rupees 2 Crore).

In SWAP the parties agree to pay the “the difference between a fixed interest Rate and a series of variable interest rates over an agreed period of time”.

- Fixed rate is a fixed rate such as 5%, 6% as the case may be
- Variable rate is a rate that is linked to a variable rate such as MIBOR or LIBOR (London Interbank Offer Rate )

The agreement can be as follows:

- Fixed for Floating Swap Transaction
- Floating for Fixed Swap Transaction

We assume that a Party A is a borrower with a 3 year ₹ 2 crore Variable Rate MIBOR based facility, which rolls over on a quarterly basis at the prevailing 3 month MIBOR Rate. This party, in the current economic environment feels that the Interest rates may rise in near future and feels that the interest rate may go up than the current 5% rates. The party would seek an opportunity to lock in the borrowing cost at 5% rate. But since the party has a Variable Rate based facility , he/ she cannot change it and is exposed to the **assumed** interest rate hikes in the future.

Here, party A has an option. He/ she enters into an agreement with Party B for a period of 3 years for ₹ 2 Crore and pay the interest rate of 5% on quarterly settlement dates.

Now, we assume that the MIBOR linked interest rate hikes as party A assumed and it **becomes 6%**. But since party A has a contract with party B that it will pay only 5% interest rate as per the swap agreement. So, now the party B will have to compensate party A by 1% of ₹ 2 crore. This amount will be used by party A to offset the interest rates hiked by 1%. So party A is saved from this hike in interest rate.

Now if the MIBOR linked interest rate decreases and becomes 4%. Party A will pay 4% for his ₹ 2 Crore loan which is a Variable Rate MIBOR based facility. Here it saves 1% , but since with party B it has an agreement to pay 5%, party A will compensate the party B for this balance.

The interest rate swap is a hedging in which **if there is NO variation in the interest rates**, it is a **zero sum game** but if the rates vary, **one wins at the cost of another**.

## Exchange Traded Derivatives

Unlike the OTC instruments, these are traded over an exchange. So in these contracts Exchange play an intermediately to all transactions.

- ☑ There is a third party in ETD and that is Exchange.

The exchange provides a platform, where the buyers and sellers can come together and the orders are matched. Once this orders are matched, the exchange becomes seller to the buyer and buyer to the seller.

- Exchange saves one party from the counterparty risk and default of another party.

To do that the exchange charges a margin money, from both sides as collateral. The margin money varies depending upon the day to day price movements.

- ETDs can be used for both speculation and hedging.

The Exchange Traded Derivatives are of two types viz. Futures and Options.

- ❖ **Futures:** Futures is a contract between two parties, in which one party **agrees** to buy an underlying asset from the seller at a future date at a price which is agreed upon today.
  - The terms of the agreement are decided by the exchange and not the parties.
  - The prices are NOT decided by the exchange.
  - Both buyers and sellers are protected by a margin money which is equal to the loss of one party in the futures.
  - In India the **clearing corporations** such as **NSSCL** (National Securities Clearing Corporation Limited) protects the parties against the counterparty risk.
- ❖ **Options:** Option is a contract between two parties, in which one party has **an option** to buy an underlying asset from the seller at a future date at a price which is agreed upon today. One party gives another party the Option or right but **NOT the obligation**.
- ☞ In India, the **trading in options** in interest rate derivatives is **NOT allowed** as of now.

## Trends in Money Markets during 2011-12

The Latest Economic Survey notes that the money market generally remained orderly during 2011-12. The call rate declined at the commencement of the financial year with improvement in liquidity conditions. It, however, increased subsequently with tightening of liquidity and hikes in policy rates and generally hovered around the repo rate during the first half of 2011-12.

### Chapter 5: Balance of Payments



The Balance of International payments or Balance of Payments refers to the systematic and summary record of a country's economic and financial transactions with the rest of the world, over a period of time. As per IMF, the Balance of payments is a statistical statement for a given period showing:

- Transactions in goods and services and income between an economy and the rest of the world;
- Changes of ownership and other changes in that country's monetary gold, Special Drawing Rights (SDRs) and claims on and liabilities to the rest of the world; and
- Unrequited transfers and counterpart entries that are needed to balance, in the accounting sense, any entries for the foregoing transactions and changes which are not mutually offsetting.

Please note that Balance of Trade and Balance of Payments are different concepts. The balance of trade refers to the difference between the monetary value of exports and imports of output in an economy over a certain period. A positive balance is known as a trade surplus if it consists of exporting more than is imported; a negative balance is referred to as a trade deficit. Trade gap refers to trade deficit.

But the BoP is a wider term and Balance of Trade is one of its components. The Balance of Trade gives only partial picture, while the BoP gives a complete enumeration of the international transactions, by adding the net trade balance and all other payments and receipts.

The Balance of Payments account has various debit and credit entries, which are generally grouped under the following heads:

1. Current Account
2. Capital Account
3. Unilateral Payments Account
4. Official Reserves Assets Account

#### Current Account

Current account includes all those transactions which give rise to or use up national income. Thus, the Current Account consists of two major items

- Merchandise exports and imports
- Invisible exports and imports.

Please note that the Merchandise exports, which refer to sale of goods abroad, are credit entries because all transactions giving rise to monetary claims on foreigners represent credits. Merchandise imports, i.e., purchase of goods from abroad, are debit entries because all transactions giving rise to foreign money claims on the home country represent debits. Merchandise imports and exports form the most import international transactions of most of the countries. The Merchandise imports and exports are the most import international transactions of most of the countries. Invisible Exports refer to the sale of services. The export of services is credit entries and invisible imports, i.e., purchase of services, are debit entries.

Please note the following:

- The Expenditure of Foreign Tourists in India is a Credit entry because it is an invisible export.



- Income such as interests or dividends, received from the loans and investments made abroad is are invisible exports, so they are counted as credit entries.
- Purchase of foreign services like transport and insurance, tourist expenditure abroad and income paid on loans and investments (by foreigners) in the home country form the important invisible entries on the debit side. This is a debit entry and deemed to be invisible imports.
- In India, the Software exports have emerged as a very important invisible item of India's current account.

### Capital Account

The capital account consists is made up of both the short-term and long-term capital transactions. The Capital Transaction may be Capital outflow or capital inflow.

- Capital outflow represents debit and capital inflow represents credit.

#### *We take an example here:*

We assume that an American company is investing \$ 100 million in India. This investment will be represented as a debit entry in the BoP of America and credit entry in the BoP of India.

### Unilateral Transfers Account

- Unilateral transfers refers to the transactions such as gifts, private remittances, government grants, reparations and disaster relief.
- Unilateral payments received from abroad are credit entries and those made abroad are debit entries.

### Official Reserves Account

- Official reserves refer to the holdings by the government of official agencies of the means of payment that are generally accepted for the settlement of international claims.

### What is BoP Disequilibrium?

We all know that Foreign Currency is the backbone of a country's economic relations with other countries. The balance of payments of a country is said to be in equilibrium when the demand for foreign exchange is exactly equivalent to the supply of it. The balance of payments is regarded as being in disequilibrium when it shows **either a surplus or a deficit**.

There will be a deficit in the balance of payments when the demand for foreign exchange exceeds its supply, and there will be a surplus when the supply of foreign exchange exceeds the demand. A number of factors may cause disequilibrium in the balance of payments. Here is a brief information about some of them, so that you have a clear idea:

#### **Large Development Expenditures:**

The direct impact of the large scale development expenditures is seen in increase the purchasing power, aggregate demand and prices. This results in substantially large imports. This phenomenon is common in the developing countries, because the above factors and the large scale import of capital goods needed for carrying out the various development programmes give rise to a deficit in their balance of payments.

#### **Cyclical Fluctuations:**

Cyclical fluctuations in the business activity bring depression, stagnant and boom stage in world trade. Whenever a country is in boom, it will ordinarily experience a more rapid growth in its imports than in its exports, while the opposite will be true in case of recession. This means that the exports (comparing to imports) growth is more in case of recession.

**Sustained Disequilibrium**

The sustained or secular disequilibrium refers to a situation when, the BoP disequilibrium persists for long periods due to certain secular trends in the economy. It is seen in the **developed countries** where, the disposable income is generally very high and so the aggregate demand is also very high. But due to the higher aggregate demands, the **production costs are also very high**. This would result in **higher prices**, which may **result in the imports being much higher than the exports**.

**Structural Disequilibrium:**

Structural Disequilibrium occurs due to changes in the structure of the trade. This may include the development of alternative source of supply, development of better substitutes, exhaustion of productive resources or change in transport routes and costs.

**Political Factors**

A country with **political instability** may experience **large capital outflow** and inadequacy of domestic investment and production.

**How BoP is adjusted?**

There is not much bothering if there is a surplus in the balance of payments, however, every country strives to remove or at least reduce a balance of payments deficit. There are a number of adjustments, which are done to correct the balance of payments disequilibrium. Two of them are important, and they are automatic measures and deliberate measures.

**Automatic Measures:**

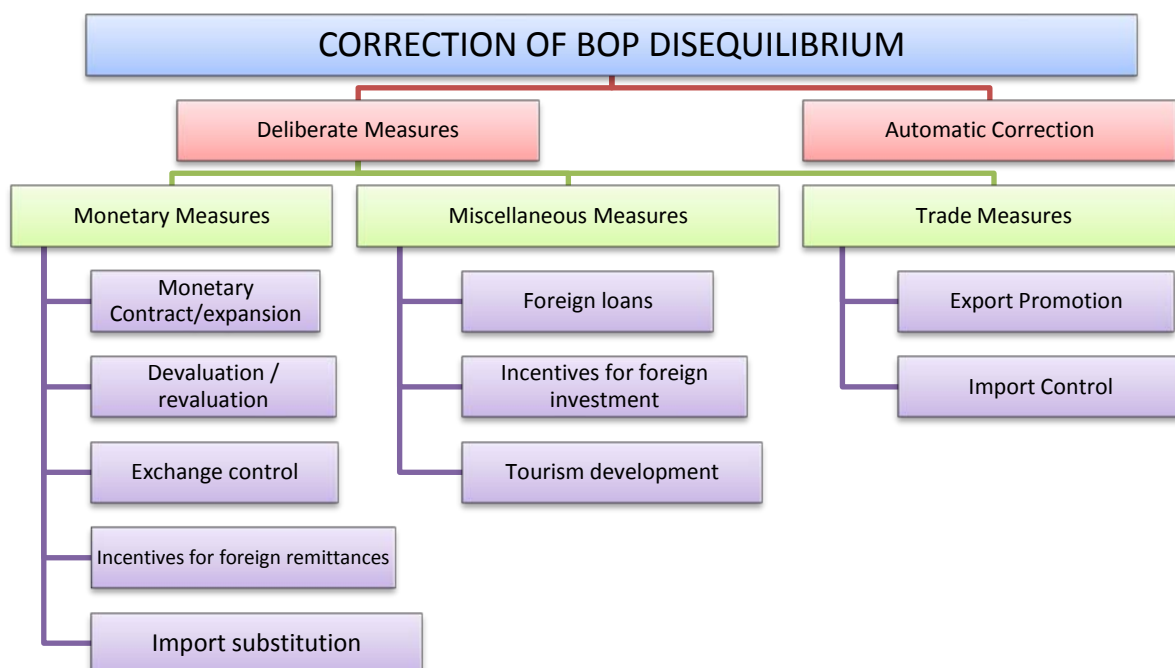
- The Automatic measures were useful and relevant when there was Gold Standard. Since, now the Gold Standard is not there, the whole mechanism is irrelevant, yet it works in Paper currency environment on the basis of the fact that if the **market forces of demand and supply are allowed to have free play**, in course of time, **equilibrium will be automatically restored**.
- This can be understood by a simple example that whenever there is a deficit, demand for foreign exchange exceeds its supply and this result in an increase in the exchange rate and a fall in the external value of the domestic currency.
- This would result in the exports of the country go cheaper and imports dearer than before. Consequently, the increase in exports and fall in imports restore the balance of payments equilibrium.

**Deliberate measures**

Deliberate Measures refer to the correction of disequilibrium by means of measures taken deliberately with this end in view. There are various deliberate measures such as

- Monetary measures such as Monetary Contraction, Devaluation, Exchange Control
- Trade measures : Export Promotion, Import Control
- Miscellaneous measures

These various measures have been shown in the following graphics:



**Monetary Contraction:**

The contraction or expansion of money supply affect the level of aggregate domestic demand, domestic price level and the demand for imports and exports, and this intervention can be used to correct the disequilibrium of the BoP.

*We take an example:*

- ↪ We assume there is a situation of **balance of payments deficit**. The BoP deficit means that there is an increased level of aggregate demand that have led to the increased imports.
- ↪ When the money supply is contracted, it would leave less money in the system and finally would reduce the purchasing power.
- ↪ The reduced purchasing power would reduce the aggregate demand.
- ↪ The reduced aggregate demand also reduced the domestic prices.
- ↪ The reduced domestic prices also reduced the demand for the imports. The fall in the domestic prices' would encourage more exports, to earn better money.
- ↪ Thus, the **overall result in case of monetary contraction is that Imports decrease and Exports Increase**. This results in the correction of a BoP deficit situation.

**Devaluation**

Devaluation is defined as a reduction of the official rate at which the currency is exchanged for another currency. The idea behind devalue the currency is to stimulate its exports and discourage imports to correct the disequilibrium. The direct impact of devaluation is that it makes the export goods cheaper and imports dearer. How? lets understand:

**We assume that Current Rate of Dollar is Rs. 45.**

- ↪ In this situation, an exporter in India would realize Rs. 4500 for an export worth 100 Dollars.
- ↪ We assume that the Rupee is devalued and now a Dollar becomes of Rs. 55
- ↪ In this situation, the same exporter would realize Rs. 5500. The result is that Export earnings would increase **and export of good would become cheaper**.
- ↪ We again assume that there is an importer who needs to make a payment of \$ 100 to a party sitting abroad.
- ↪ At Rs. 45, this importer would need Rs. 4500 to make payment.
- ↪ At Rs. 55, this importer would need Rs. 5500 to make payment. The result is the import becomes dearer. So, most commonly, the Currency devaluation takes place to correct the BoP deficit.

**Exchange Control**

This is yet another popular measure of correcting the BoP deficit. Under the exchange control, the government via the central bank assumes complete control over the foreign exchange reserves and earnings of the country. The recipients of foreign exchange, like exporters, are required to surrender foreign exchange to the government/central bank in exchange for domestic currency. By virtue of its control over the use of foreign exchange, the government can control imports and also increase its foreign currency reserves.

**Export Promotion:**

This may include the reduction and abolition of the export duties, providing export subsidy, encouraging export production and export marketing by giving monetary, fiscal, physical and institutional incentives and facilities.

**Import Control:**

"This may be done by improving or enhancing import duties, restricting imports through import quotas, licensing and even prohibiting altogether the import of certain inessential items.

**Miscellaneous Measures:**

Some example are obtaining foreign tourists and providing incentives to enhance inward remittances.

**India's BOP**

As we studied above, the BoP in India has been classified into

1. BoP at current account
2. BoP at Capital Account

**India's BoP at Current Account**

This is calculated as follows:

Exports – Imports = **Trade Balance (1)**

**What does Trade Balance show?**

Balance of trade is also known as Net Exports. It represents the difference between the monetary value of exports and imports of output in an economy over a certain period. As mentioned previously, a positive balance is known as a trade surplus if it consists of exporting more than is imported; a negative balance is referred to as a **trade deficit** or, informally, a trade gap.

Invisible Payments - Invisible Receipt = **Net Invisibles (2)**

**What do the net invisibles show?**

The invisibles account of the BoP reflects the combined effect of transactions relating to international trade in services, income associated with non-resident assets and liabilities, labour and property, and cross-border transfers, mainly workers' remittances. Here we have to remind ourselves that from 1951 till 1990-91, the **Net Invisibles of the country was always positive**. It was for the first time in 1990-91, that the Net invisibles of the country went to a negative zone with a deficit of Rs. 433 Crore. **The net invisibles work a cushion to neutralize the Trade deficit of the country.**

**(1) + (2) = BoP on Current Account.**

This can be understood by the following table taken from Economic Survey of India 2011-12.

India's Balance of Payments (Current Account)							(US\$ million)	
Sl. No.	Item	2006-07	2007-08	2008-09	2009-10	2010-11 <sup>PR</sup>	2010-11 H1 (April-Sept. 2010) <sup>PR</sup>	2011-12 H1 (April-Sept. 2011) <sup>P</sup>
1	2	3	4	5	6	7	8	9
<b>I</b>	<b>Current Account</b>							
1	Exports	128888	166162	189001	182442	250468	107331	150909
2	Imports	190670	257629	308520	300644	381061	176213	236674
3	Trade balance	-61782	-91467	-119519	-118203	-130593	-68883	-85765
4	Invisibles (net)	52217	75731	91604	80022	84647	39283	52923
	a Non-factor services	29469	38853	53916	36016	48816	21517	31060
	b Income	-7331	-5068	-7110	-8038	-17309	-8238	-9025
	c Transfers	30079	41945	44798	52045	53140	26004	30887
5	Goods & services balance	-32313	-52614	-65603	-82187	-81777	-47366	-54705
6	Current account balance	-9565	-15737	-27914	-38181	-45945	-29599	-32842

Here are some important survey notes on Current Account:

1. During 2010-11, exports **crossed the US\$ 200 billion mark for the first time**, increasing by 37.3 per cent from US\$ 182.4 billion in 2009-10 to US\$ 250.5 billion. This increase was largely **driven by engineering goods, petroleum products, gems and jewellery, and chemicals** and related products.
2. The improvement in exports was accompanied by a **structural shift in the composition of the export basket from labour-intensive manufacture to higher value-added engineering and petroleum products**. There was also a **diversification of export destinations** with developing countries becoming our largest export market in recent years.
3. Like exports, imports also recorded a 26.8 per cent increase to US\$ 381.1 billion in 2010-11 from US\$ 300.6 billion in 2009-10. **Oil imports showed an increase of 19.3 per cent in 2010-11 (as against a decline of 7.0 per cent a year ago)** and accounted for

28.1 per cent of total imports (30.2 per cent in 2009-10). Growth in imports has primarily been led by **petroleum** and related products and **pearls and semi-precious stones**.

4. The **trade deficit** increased by 10.5 per cent to US\$ **130.6 billion** as compared to US\$ 118.2 billion in 2009-10. This was primarily on account of higher increase in imports relative to exports on the back of a robust domestic economic performance in 2010-11.
5. The widening of India's CAD during H1 of 2011-12 reflects the impact of growth asymmetry between India and the rest of the world. India's export and import growth momentum, gained in 2010-11, continued during H1 of 2011-12.
6. In 2010-11, there was a sharp increase in both exports and imports of services.
7. **Goods and services deficit** (i.e. trade balance plus services) **decreased marginally** to **US\$ 81.8 billion** (4.9 per cent of GDP) during 2010-11 as compared to US\$ 82.2 billion (6.0 per cent of GDP) in 2009-10.

**India's BoP at Capital Account**

Capital inflows can be classified by instrument (debt or equity) and maturity (short-term or long-term). The main components of capital account include **foreign investment, loans, and banking capital**. Foreign investment comprising **FDI and portfolio investment** represents **non-debt liabilities**, while loans (**external assistance, ECBs, and trade credit**) and **banking capital including NRI deposits** are **debt liabilities**. In India, **FDI is preferred over portfolio flows** as the **FDI flows tend to be more stable than portfolio and other forms of capital flows**. **Rupee-denominated debt is preferred over foreign currency debt** and **medium- and long-term debt is preferred over short-term**. (You may expect a good question from this definition)

India's Balance of Payments (Capital Account)							(US\$ million)	
Sl. No.	Item	2006-07	2007-08	2008-09	2009-10	2010-11 <sup>PR</sup>	2010-11 H1 (April-Sept. 2010) <sup>PR</sup>	2011-12 H1 (April-Sept. 2011) <sup>P</sup>
1	2	3	4	5	6	7	8	9
<b>II Capital Account</b>								
1	Capital account balance	45203	106585	7395	51634	61989	38950	41061
	i External assistance (net)	1775	2114	2439	2890	4941	3036	705
	ii External commercial borrowings (net)	16103	22609	7861	2000	12506	5674	10592
	iii Short-term debt	6612	15930	-1985	7558	10990	6937	5940
	iv Banking capital (net)	1913	11759	-3245	2083	4962	839	19344
	of which							
	Non-resident deposits (net)	4321	179	4290	2922	3238	2163	3937
	v Foreign investment (net)	14753	43326	8342	50362	39652	30836	13657
	of which							
	a FDI (net)	7693	15893	22372	17966	9360	7040	12311
	b Portfolio (net)	7060	27433	-14030	32396	30293	23796	1346
	vi Rupee debt service	-162	-122	-100	-97	-68	-16	-32
	vii Other flows (net)	4209	10969	-5916	-13162	-10994	-8356	-9145
<b>III Errors and omissions</b>		968	1316	440	-12	-2993	-2320	-2500
<b>IV Overall balance</b>		36606	92164	-20080	13441	13050	7030	5719
<b>V Reserves</b>								
[increase (-) / decrease (+)]		(-) 36606	(-) 92164	20080	(-) 13441	(-) 13050	(-) 7030	(-) 5719

Source : RBI. Notes : PR: Partially Revised. P: Preliminary.

Here are some survey notes on Capital Account:

- In 2010-11, both gross inflows of US\$ 499.4 billion and outflows of US\$ 437.4 billion under the capital account were higher than gross inflows of US\$ 345.8 billion and outflows of US\$ 294.1 billion in the preceding year. **In net terms, capital inflows increased by 20.2 per cent to US\$ 62.0 billion** (3.7 per cent of GDP) in 2010-11 vis-a-vis US\$ 51.6 billion (3.8 per cent of GDP) in 2009-10 **mainly on account of trade credit and loans** (ECBs and banking capital).

- The **Non-debt flows** or foreign investment comprising FDI and portfolio investment (ADRs/GDRs and FIIs) on net basis **decreased** by 21.4 per cent from US\$ 50.4 billion in 2009-10 to US\$ 39.7 billion in 2010-11. Decline in foreign investment was offset by the **debt flows component of loans and banking capital** which **increased** by **130.3** per cent from US\$ 14.5 billion in 2009-10 to US\$ 33.4 billion in 2010-11.
- **Inward FDI showed a declining trend** while **outward FDI showed an increasing trend** in 2010-11 vis-a-vis 2009-10.
- Other categories of capital flows, namely debt flows of ECBs, banking capital, and short-term credit recorded a significant increase in 2010-11.

### BoP Crises in India- Short Introduction

#### Crisis of 1956-57:

- From 1947 till 1956-57, the India had a current account surplus. By the end of the first plan, the Trade deficit was Rs. 542 Crore and Net Invisibles was Rs. 500 Crore, thus giving a BoP deficit in Current Account worth Rs. 42 Crore.
- From this time onwards, the trade deficit increased from 3.8% of the GDP at market prices to 4.5% of GDP (at Market Prices). The result was an imposition of the exchange controls. This was the first BoP crisis, ever India faced, after independence.

#### Crisis of 1966

- In 1965, when India was at War with Pakistan, the US responded by suspension of aid and refusal to renew its PL-480 agreement on a long term basis.
- The idea of US as well as World Bank was to induce India to adopt a new agricultural policy and devalue the rupee. Thus, the Rupee was devalued by 36.5% in June 1966.
- This was followed by a substantial rationalization of the tariffs and export subsidies in an expectation of inflow of the foreign aid. The BoP improved, but not because of inflow of foreign aid but **because of the decline in imports**.
- After the 1966-67, the BoP of India remained comfortable till 1970s. The first oil shock of 1973-74 was absorbed by the Indian Economy due to buoyant exports. After that there was an expansion of the international trade.

#### Crisis of 1990-91:

- BoP crisis had its **origin from the fiscal year 1979-80 onwards**. By the end of the 6th plan, India's BoP deficit (Current account) rose to Rs. 11384 crore. It was the mid of 1980s when the BoP issue occupied the centre position in India's macroeconomic management policy. The **second Oil shock of 1979 was more severe and the value of the imports of India became almost double** between 1978-78 and 1981-82. From 1980 to 1983, there was global recession and India's exports suffered during this time.

The trade deficit was not been offset by the flow of the funds under net invisibles. Apart from the external assistance, India had to meet its colossal deficit in the current account **through the withdrawal of SDR and borrowing from IMF under the extended facility arrangement**. A large part of the accumulated foreign exchange fund was used to offset the BoP.

- During the 7th plan, between 1985-86 and 1989-90, India's trade deficit amounted to Rs. 54, 204 Crore. The net invisible was Rs. 13157 Crore and India's BoP was Rs. 41047 Crore. India was under a sever BoP crisis. In 1991, India found itself in her worst payment crisis since 1947. The things became worse by the 1990-91 Gulf war, which was accompanied by double digit inflation.

- India's credit rating got downgraded. The country was on the verge of defaulting on its international commitments and was denied access to the external commercial credit markets. In October 1990, a Net Outflow of NRI deposits started and continued till 1991.

The only option left to fulfill its international commitments was to borrow against the security of India's Gold Reserves.

The prime Minister of the country was Chandra Shekhar and Finance Minister was Yashwant Sinha. The immediate response of this Caretaker government was to secure an emergency loan of \$2.2 billion from the International Monetary Fund by pledging 67 tons of India's gold reserves as collateral. This triggered the wave of the national sentiments against the rulers of the country. India was called a "Caged Tiger".

On 21 May 1991, Rajiv Gandhi was assassinated in an election rally and this triggered a nationwide sympathy wave securing victory of the Congress.

The new Prime Minister was P V Narsimha Rao. P V Narsimha Rao was Minister of Planning in the Rajiv Gandhi Government and had been Deputy Chairman of the Planning Commission. He along with Finance Minister Manmohan Singh started several reforms which are collectively called "Liberalization". This process brought the country back on the track and after that India's Foreign Currency reserves have never touched such a "brutal" low.

In 1991, the following measures were taken:

- In 1991, Rupee was once again devaluated.
- Due to the currency devaluation the Indian Rupee fell from 17.50 per dollar in 1991 to 45 per dollar in 1992.
- The Value of Rupee was devaluated 23%.
- Industries were delicensed.
- Import tariffs were lowered and import restrictions were dismantled.
- Indian Economy was opened for foreign investments.
- Market Determined exchange rate system was introduced.

### LERMS System

In the Union Budget 1992-93, a new system named LERMS was started. LERMS stands for "Liberalized Exchange Rate Management". The LERMS was introduced from March 1, 1992 and under this, a system of double exchange rates was adopted.

- Under LERMS, the exporters could sell 60% of their foreign exchange earning to the authorized Foreign Exchange dealers in the open market at the open market exchange rate while the remaining 40% was to be sold compulsorily to RBI at the exchange rates decided by RBI.
- Another important feature of LERMS was that the Government was providing the foreign exchange only for most essential imports. For less important imports, the importers had to arrange themselves from the open market. Thus, we see that LERMS was introduced with twin objectives of building up the Foreign Exchange Reserves and discourage imports. The Government was successful in this.

### Rangarajan Panel for Correcting BoP

The High Level Committee on Balance of Payments, 1993, chaired by Dr. C. Rangarajan, recommended that the RBI should target a level of reserves that took into account liabilities that may arise for debt servicing, in addition to imports of three months. The important recommendations of this panel were as follows:

- A realistic exchange rate and a gradual relaxation of the restrictions on the current account should go hand in hand.
- Current account deficit of 1.6% of GDP should be treated as a ceiling.

- Government should be cautious of extending concessions or facilities to the Foreign Investors. The concessions were more to the foreign investors than to the domestic players.
- All external debts should be prioritized on the basis of the Use on which the debt is to be put.
- No approval should be accorded for a commercial loan which has a maturity of less than 5 years.
- There should be efforts so that Debt flows can be replaced by the equity flows.

### Partial Convertibility of Rupee

The above mentioned **Liberalized Exchange Rate Management System (LERMS)** introduced a dual exchange rate system. This is also called as partial convertibility of the Rupee.

#### What is Convertibility?

The convertibility of a currency has different meanings in different times. In existing standards, it means that *the country's currency becomes convertible in foreign exchange and vice versa*. The Convertibility of Rupee gives the indication of the real value of rupee, hence called floating of Rupee. Full Convertibility of Rupee encourages the exports by increasing the profitability of the exports, as the free market rate is higher than the official rate.

Further, it is seen the convertibility of the Rupee and liberalization of Gold imports has made the illegal remittances and gold smuggling less attractive.

✎ *Partial Convertibility of Rupee was introduced in March 1992*

Under the partial convertibility of Rupee, dispensation of 40% of the Foreign exchange had to be surrendered to the Reserve Bank of India at the official rate and balance 60% of the foreign exchange had to dispose off by the exporters at the market rate.

✎ As expected, the **market rate was higher than the official rate**.

✎ The Partial convertibility of Rupee is known as **Dual exchange system**.

✎ At that time, India's current account was showing large deficit so it was risky to introduce the full convertibility of Rupee.

✎ The major objective of the partial convertibility of Rupee was to *"make the foreign exchange available at a low price for essential imports so that the prices of the essentials is not pushed up by the high market price of the foreign exchange"*.

### Full convertibility of Rupee

The Government when introduced the Partial convertibility of Rupee in 1992, had announced its intention to introduce the full convertibility on the current account in 3-5 years. The **full convertibility** means **unified market determined exchange rate regime**. Encouraged with the success of the LERMS, the government introduced the full convertibility of Rupee in Trade account from March 1993 onwards. With this the **dual exchange rate system was abolished** and LERMS was now based upon the open market exchange. The full convertibility of Rupee was followed by stability in the Rupee Rate in the next many months coming up.

✎ The above full convertibility was introduced on Trade account. The Government wanted to introduce the Full convertibility of Rupee on Current account (means invisible also included).

✎ In August 1994, the Government of India declared full convertibility of Rupee on Current account with announcing some relaxations as per requirements of the Article VIII of the IMF.

These were:

- Repatriation of the income earned by the NRIs and overseas corporate bodies of NRIs in a Phased manner in 3 years period.



- The ceiling for providing foreign exchange for foreign tours, education, medical treatment, gifts and services was made just an indicative. Above this ceiling, foreign exchange could be obtained for payments, while making a reference to RBI.
- While the Principal amount on the NRNR (Non Resident Non Repatriable) Accounts was non repatriable, the interest was made repatriable.

### Capital Account Convertibility

Please note that the concept of **Capital Account Convertibility was coined by RBI** and CAC is now almost synonymous with the **SS Tarapore Committee**.

We know that the capital account is made up of both the short-term and long-term capital transactions. The Capital Transaction may be Capital outflow or capital inflow.

Capital account convertibility (CAC) or a floating exchange rate means the **freedom to convert local financial assets into foreign financial assets and vice versa at market determined rates of exchange**. This means that capital account convertibility allows anyone to freely move from local currency into foreign currency and back.

Please note that convertibility on the capital account is usually introduced after a certain period of introducing the Current account convertibility. The **most important effect of introducing the capital account convertibility is that it encourages the inflow of the foreign capital**, because under certain conditions, the foreign investors are enabled to repatriate their investments, wherever they want.

But the **risk is that it may accelerate the flight of the capital from the country if things are unfavorable**. For example, **an Indian can sell property here and take the Capital outside**. This is why, it is generally introduced after experimenting with the convertibility on current account.

CAC refers to the removal of restraints on international flows on a country's capital account, enabling full currency convertibility and opening of the financial system.

### Capital Account Convertibility v/s Current Account Convertibility

Current account convertibility allows free inflows and outflows for all purposes other than for capital purposes such as investments and loans. So, it allows residents to make and receive trade-related payments -- receive dollars (or any other foreign currency) for export of goods and services and pay dollars for import of goods and services, make sundry remittances, access foreign currency for travel, studies abroad, medical treatment and gifts, etc.

Presently, India has current account convertibility. This means one can import and export goods or receive or make payments for services rendered. **However, investments and borrowings are restricted.**

#### Some Important reasons:

- ✓ CAC is considered to be one of the major **features of a developed economy**. CAC helps attract foreign investment and offers foreign investors a lot of **comfort as they can re-convert local currency into foreign currency** anytime they want to and **take their money away**.
- ✓ Capital account convertibility also makes it **easier for domestic companies to tap foreign markets**.

### Tarapore Committee on Capital Account Convertibility

Jumping into capital account convertibility game without considering the downside of the step can harm the economy.

The Committee on Capital Account Convertibility (CAC) or Tarapore Committee was constituted by the Reserve Bank of India for suggesting a roadmap on full convertibility of Rupee on Capital Account. The committee submitted its report in May 1997. The committee observed that there is no clear definition of CAC. The CAC as per the standards, refers to the freedom to convert the local financial assets into foreign financial assets or vice versa at the market determined rates of exchange.

The Tarapore committee observed that the Capital controls can be useful in insulating the economy of the country from the volatile capital flows during the transitional periods and also in providing time to the authorities, so that they can pursue discretionary domestic policies to strengthen the initial conditions.

The CAC Committee recommended the implementation of Capital Account Convertibility for a 3 year period viz. 1997-98, 1998-99 and 1999-2000. But this committee had laid down some pre conditions as follows:

- Gross fiscal deficit to GDP ratio has to come down from a budgeted 4.5 per cent in 1997-98 to 3.5% in 1999-2000.
- A consolidated sinking fund has to be set up to meet government's debt repayment needs; to be financed by increased in RBI's profit transfer to the govt. and disinvestment proceeds.
- Inflation rate should remain between an average 3-5 per cent for the 3-year period 1997-2000.
- Gross NPAs of the public sector banking system needs to be brought down from the present 13.7% to 5% by 2000. At the same time, average effective CRR needs to be brought down from the current 9.3% to 3%
- RBI should have a Monitoring Exchange Rate Band of plus minus 5% around a neutral Real Effective Exchange Rate RBI should be transparent about the changes in REER
- External sector policies should be designed to increase current receipts to GDP ratio and bring down the debt servicing ratio from 25% to 20%
- Four indicators should be used for evaluating adequacy of foreign exchange reserves to safeguard against any contingency. Plus, a minimum net foreign asset to currency ratio of 40 per cent should be prescribed by law in the RBI Act.

The above committee's report was not translated into any actions. India is still a country with partial convertibility.

However, some important measures in "that direction" were taken and they are summarized as below:

- The Indian Corporate were allowed full convertibility in an automatic route up to the \$ 500 million overseas ventures. This means that the limited companies were allowed to invest in foreign countries.
- Indian corporate were allowed to prepay their external commercial borrowings via automatic route if the loan is above \$ 500 million.
- Individuals were allowed to invest in foreign assets , shares up to \$ 2, 00, 000 per year.
- Unlimited amount of Gold was allowed to be imported.

*"The last measure, i.e. allowing unlimited amount of Gold is equal to allowing the full convertibility in capital account via current account route"*

### **The Second Tarapore Committee on Capital Account Convertibility**

Reserve Bank of India appointed the second Tarapore committee to set out the framework for fuller Capital Account Convertibility. The committee was established by RBI in consultation with the Government to revisit the subject of fuller capital account convertibility in the context of the progress in economic reforms, the stability of the external and financial sectors, accelerated growth and global integration.

The report of this committee was made public by RBI on 1st September 2006. In this report, the committee suggested 3 phases of adopting the full convertibility of rupee in capital account.

1. First Phase in 2006-7
2. Second phase in 2007-09
3. Third Phase by 2011.

Following were some important recommendations of this committee:

1. The ceiling for External Commercial Borrowings (ECB) should be raised for automatic approval.
  2. NRI should be allowed to invest in capital markets
  3. NRI deposits should be given tax benefits.
  4. Improvement of the Banking regulation.
  5. FII (Foreign Institutional Investors) should be prohibited from investing fresh money raised to participatory notes.
  6. Existing PN holders should be given an exit route to phase out completely the PN notes.
- ✓ **At present the rupee is fully convertible on the current account, but only partially convertible on the capital account.**