CAPITAL ACCOUNT CONVERTIBILITY

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Understanding Capital Account Convertibility

– By Prof. *Simply* Simple ™

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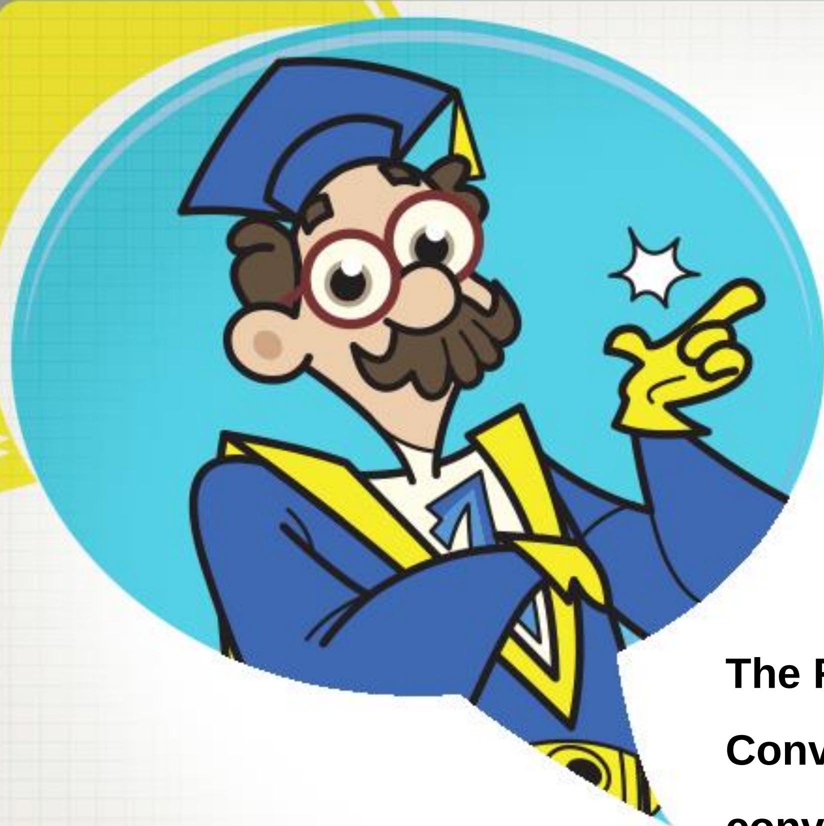

The RBI has defined Capital Account Convertibility (CAC) as the freedom to convert local financial assets into foreign financial assets and vice versa at market determined rates of exchange without any sort of intermediation and regulation.

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So what is its use?

- It is intended for local merchants to easily conduct trans-national business freely without any regulation or control.
- In case a currency is fully capital account convertible, then anybody from anywhere in the world can invest in any asset in that currency.
- Thus, a US citizen could buy a flat in India, allow it to appreciate and sell the same and take his contribution as well as the profits out of India to the US freely.
- Since this is not allowed in India and the government has its own rules and policies to regulate foreign investments, we say that India does not have full CAC.

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However, a word of warning…

- **CAC also allows the people and companies not only to convert one currency to another, but also free cross-border movement of those currencies, without the interventions of the law of the country concerned.**
- **Thus, Indians could convert their rupees into dollars and park it in the US if there was capital account convertibility here.**
- **Imagine if a large number of Indians were to do this out of an irrational fear that India might go to war with Pakistan!**

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What would happen then?

- **This would lead to an irrational demand for dollar and would cause a free fall in the value of the Indian Rupee, thereby detrimentally affecting the economy.**
- **Something like this happened in the Asian crisis in Thailand where the citizens lost confidence in the Thai Baht leading to a mass sale of the currency and subsequent collapse of the same.**
- **This happened because their currency was fully capital account convertible.**

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So when can India expect to have full Capital Account Convertibility?

- **For full CAC, the economy should be extremely stable so that its citizens are never made to feel insecure about their economy and drive them into irrationally converting their currencies and investing them abroad.**

- **Under the Tarapore Committee recommendations, this was possible only when the following conditions were satisfied:**
  - **The average rate of inflation should vary between 3% to 5% during the debt-servicing time.**
  - **Decreasing the gross fiscal deficit to the GDP ratio by 3.5% in 1999-2000.**

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Convertible Account Convertibility

in India is regulated as follows…

All types of liquid capital assets must be able to be feely exchanged, between any two nations, with standardized exchange rates.

- **The amounts must be a significant amount (in excess of $500,000).**
- **Capital inflows should be invested in semi-liquid assets, to prevent churning and excessive outflow.**
- **Institutional investors should not use CAC to manipulate fiscal policy or exchange rates.**
- **Excessive inflows and outflows should be buffered by national banks to provide collateral.**

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In India…

According to the RBI, as the Indian rupee is not fully convertible, it is not possible to go in for dual listing of shares which allows people to buy shares in the stock exchanges of one country and sell in the bourses of another country.

- **Why? Because under dual listing, an African citizen could buy the stock in Africa and sell it in India, collect the rupees, convert it into ‘Rand’ and take them into the African economy – all this without any controls, permissions and regulations.**
- **This unhindered capital flow is not currently favored by the Indian Govt.**

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To Sum Up

- **What: Capital Account Convertibility is concerned about the ownership changes in domestic or foreign financial assets and liabilities.**

- **Why: This is so that local merchants can easily conduct trans-national business without falling short of foreign currency exchanges to handle small transactions.**

- **How: It allows people and companies not only to convert one currency to the other, but also free cross-border movement of those currencies, without the interventions of the law of the country concerned.**

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Hope you have now understood the concept of Capital Account Convertibility

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