Full capital account convertibility will globalise Indian currency

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Green shoots have begun to appear and the weeds of the past blown away. The International Monetary Fund or IMF has assessed that the Indian economy is poised to grow around 7.9 per cent this financial year, after a 7.4 per cent growth in the last fiscal. They have also said that India will be fastest growing economy in the world, higher than even China whose growth rate is expected to taper off to 6.4 per cent.

Given the present economic scenario, the government is contemplating permitting capital account convertibility in the next few years. This means that an average citizen could walk up to a bank with Indian rupees and request them to convert to US dollars at the prevailing exchange rate (with no limit on the amount to be converted). This indeed is a most welcome step towards liberalising the use of foreign exchange. If and when it happens, we will join the big leagues comprising developed countries where currency conversion is a day-to-day occurrence.
However, the question to ponder is whether India is ready to take this big step and what the impact on the capital outflow and rupee exchange rate would be.

Also, will RBI take a 'laissez-faire' attitude and allow the rupee value to be completely market-determined?
Before any action is taken, we need to look at all the possibilities. First, currently our foreign exchange reserves stand at $343 billion. This is relatively a huge reserve and can easily support 8 to 10 months of imports even assuming zero exports. Also, if all goes well with economic growth, the foreign direct investment or FDI into India will keep coming in large amounts; more so given the free-market orientation of the Modi government.
This will send a positive signal to foreign investors that Indian trade activities are set to expand in a big way. Some of the reluctance to act in the past on capital account convertibility is understandable because of the sudden upsurge in the current account deficit, which exceeded 4 per cent of the GDP in the last year.
At that time, Brent crude was trading above $120 to a barrel. Today, we are looking at a price of around $60 per barrel. The price of crude is further likely to stabilise and result in a major savings in our import bill. Further, when our government's 'Make in India' policy gains momentum, it will bring the current account deficit down to no more than around 2 per cent of GDP. All these are positive signs for India's foreign exchange reserves to go up.
This said, the extreme volatility that appeared in the East Asia Currencies in the second half of 1997 (Asian currency crisis) is a point of consideration. At that time, the emerging market economies faced the reverse flow of funds back to the US because of the change in the US interest rate. The outcome was a massive depreciation of the local currencies along with very high levels of volatility. Hedge funds used non-deliverable forward contracts and decimated the values of currencies like the Thai Baht, Malaysian Ringgit and the Indonesian Rupiah. Could that happen to us, too? The answers is Yes and No. Yes, there is a remote possibility. But by exercising caution, putting an initial limit on the size of convertibility and later removing the barriers could be a solution. And no, our currency is not overvalued except perhaps marginally. The market price discovery pricing of the currency will automatically take care of this problem.

Besides, our overseas activity is approximately 15 per cent and so our exposure to the world economy is very limited as a proportion of the total economy. Also, our foreign trade is less than 2 per cent of the global trade. Compared to China's 15 per cent, it is relatively small. So any apprehension in this regard is seriously misplaced.

Currently, the FIIs are having a bonanza by investing in our market. We had set a limit of $30 billion for the FII investment in our bond market, yet it was oversubscribed multi-fold. Our stock market with the current price earnings ratio of 18 is extremely attractive given the 10-year US treasury is yielding a measly 1.5 per cent. Besides, the large part of the FII money is here to stay for many years to come.

In all likelihood, the Indian economy will continue to forge ahead with a growth percentage of above 8 per cent. In that growth environment, corporate profit growth can be expected to be about 15 per cent. For the FIIs, the math is simple - compared to the other emerging markets, (Russia, China and Brazil) India will be the best bet. It will, therefore, not be a big surprise if in the next few years our reserve reaches $400-450 billion.

Our government must have a clear understanding of the source and use of funds. They are in the process of passing the GST bill, which will enhance revenues to the government. The fiscal and the cash deficit will definitely move to lower levels as a proportion of GDP. Thus, many of the concerns related to current account convertibility will become irrelevant.

Given the right fiscal and monetary policies, we can expect our rupee to actually appreciate. Therefore, it is about time that the government looks into current account convertibility and takes a proactive stand. A precautionary approach to start with will be very helpful. First a set of limits may be set for convertibility like total amount and frequency. As our economic growth picks momentum, the need for foreign capital will increase significantly. Currency convertibility will infuse much confidence into both local and foreign investors, who may therefore choose to invest here for a longer period of time. Lastly, setting pre-requisites like low currency value volatility and preventing hedge fund intervention may not be realistic, given that all currencies face the same possibilities. Volatility is a part of the game and the Indian rupee is certainly not an exception. However, our currency may not be subject to large fluctuations since we are a fast-growing economy. Capital account conversion will certainly lead to the globalization of Indian currency. Indian companies, whose activities are limited due to limited gross capital formation and domestic savings rate, will now be in a position to borrow rupees (not the dollars) overseas. This will help them realistically compare their real cost of capital since no foreign exchange risk is involved.

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