

PART III

FINANCIAL INTEGRATION

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Domestic Financial Liberalization and International Financial Integration: An Indian Perspective

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India and China are both large, poor countries that have benefited from greater integration into the world economy; both are still at an early but crucial stage of their development path. In both countries, financial systems were relatively controlled for a long period: while they played an important role in resource mobilization, they were not accorded an important independent role in resource allocation. In both countries, the formal financial system remains dominated by publicly owned, deposit-money banks.

In both countries, increased international linkages of the wider economy have put a repressed financial system under strain. Domestic firms require financing at close to international terms in order to be competitive. Greater international trade and human links open up opportunities for de facto movement of capital, providing competition for domestic financial institutions. As planning gives way to the market, financial institutions have a potentially important role to play in investment project selection and monitoring. In brief, the whole machinery of rising productivity, which motivates market-led liberalization and of which glo-

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balization is now an essential part, requires liberalization of the domestic financial system.

Contemporary systems of global production are driven increasingly by investment rather than just trade. Such foreign investment creates its own pressures for the financial system. Foreign capital needs to be able to enter and leave under predictable rules; pressures soon develop for domestic firms to enjoy similar privileges. Freedom for capital flows, in turn, has implications for the monetary and exchange systems.

Yet wholesale liberalization of capital flows also carries its own risks, both apparent and real. These include the risk of appreciation of the real exchange rate, the risk of sudden reversals of flows, and the risks of inflation. These risks of liberalization were noted early on (Diaz-Alejandro, 1985) even with respect to domestic liberalization. In the 1990s, financial crises in many emerging markets created a similar caution regarding the speed of external financial liberalization, although it continues to be considered a desirable final goal.

This chapter attempts to describe the links between domestic liberalization and financial integration for India, a journey which is still incomplete. The goal is to make accessible and transparent, particularly for an interested Chinese audience, the issues of sequencing that have arisen along the way. It may be mentioned that the Reserve Bank of India (RBI) has also provided considerable documentation on these issues; for example, Chapter VI of the *Report on Currency and Finance 2004–05* (RBI, 2005b).

In India's case there are two additional, linked, considerations that have begun to influence the debate on external financial integration. The first is the aspiration to develop Mumbai as a regional financial center; the second is for India to participate in broader initiatives for financial integration in Asia. These twin initiatives would both stimulate, and benefit from, greater integration between India's financial market and that of the region and of the rest of the world.

India's ambitions for Mumbai are, in turn, derived from two perceptions of India's underlying comparative advantage. The first is that finance is a skill-intensive service industry where India may be able to provide quality offshore services at a competitive price in software development and information-technology-enabled services. The second is that there is considerable talent of Indian origin in financial institutions worldwide. As China has successfully tapped the Chinese diaspora across Asia to strengthen its capabilities in manufacturing, India could succeed in doing the same in financial services. Indeed, it is perhaps not too fanciful to expect that, as China's own need for sophisticated financial services increases, Mumbai

could offer an alternative to both Hong Kong SAR and Singapore for the provision of these services.

Domestic Financial Liberalization

The Origins of Financial Repression

Prior to its independence in 1947, India enjoyed a relatively liberal domestic financial system with capital account convertibility within the sterling area; indeed the Indian rupee was a medium of exchange throughout the Persian Gulf region. Exchange controls were introduced as a wartime measure (RBI, 2005b). The large sterling balances that India had accumulated during the war were blocked as Britain struggled to balance her external accounts with various creditors, notably the United States. Domestically, India's financial system was relatively sophisticated, with established stock and commodity exchanges, and domestic and foreign banks largely under private ownership.

A series of landmark events between the mid-1950s and the late-1960s transformed what had been a relatively liberal system into a highly repressed one. It may be mentioned that this evolution was in keeping with the larger world-wide intellectual trends of the time that were influenced by the work of John Maynard Keynes and the apparently successful modernization of the Soviet Union, which accorded the state an important role in manipulating the financial system to achieve the goals of planned development. This global consensus was reflected in the World Bank's active support of state-guaranteed development finance institutions (DFIs) in the 1950s and 1960s.

In 1955, the State Bank of India, India's largest bank, was nationalized; in 1956, independent India encountered its first foreign exchange crisis, leading to an intensification of both import and exchange controls. It was the beginning of a siege mentality with regard to foreign exchange availability that is only now slowly receding, 50 years later. The private banking system was criticized as the tool of the major industrial houses and for being insufficiently oriented to the needs of an agrarian country embarking on planned development. This perception led to the nationalization of 14 of the largest private domestic banks in 1969 as part of a populist move by then Prime Minister, Mrs. Indira Gandhi. (For a further account of the India's growth experience since independence, see Singh and Bery, 2005.) Foreign banks, though heavily controlled, were not nationalized. A further 6 smaller banks were nationalized in 1980.

Following nationalization, there was significant branch expansion. The number of bank branches rose from about 8,800 in 1969 to about 60,600 in 1991, and the share of rural branches increased from about 22 percent to 58 percent (Mohan and Prasad, 2005). This helped the government in mobilizing household savings. The ratio of broad money to GDP increased from 24 percent of GDP in 1970–71 to 46 percent in 1990–91, and 73 percent in 2004–05.

India became increasingly politically aligned with the Soviet bloc in the 1970s. This was largely in response to U.S. foreign policy in that era, both toward the subcontinent and in Southeast Asia. India's foreign policy stance manifested itself in domestic financial sector policies, which increasingly became populist, rigid, and directive. Although the implementation of such policies was facilitated by public ownership of the main banks, they were, in principle, applicable to all commercial banks. Interest rates ceased to have a significantly allocative role, and competition among banks was suppressed in favor of publicly managed consortia. Fiscal policy remained relatively prudent until the 1980s; nonetheless, public debt was administratively placed through compulsory portfolio requirements imposed on the banks and on other institutions such as insurance companies and provident funds. Capital markets remained privately owned and operated. Although the secondary market was relatively free, primary capital issues were subject to government control and scrutiny. Monetization of the fiscal deficit took place through the automatic acceptance by the RBI of what were known as ad hoc treasury bills; as these accumulated, they were packaged as dated securities. Finally, the exchange regime essentially remained the Bretton Woods system of adjustable pegs, with periodic, brusque adjustments usually associated with exchange crises (RBI, 2005b).

Before leaving this era of financial repression (whose heyday lasted from 1970 until the late 1980s, but whose influence can be felt even in 2006), a few observations are perhaps in order. First, throughout, important sectors of the financial markets (and institutions) remained in private hands. Thus the skill base was by and large retained, although the pressures for financial innovation were slight. Second, the Indian allergy to inflation ensured that the damage done by these policies was more at the microeconomic than the macroeconomic level. Third, as the Indian nonfinancial private sector continued to survive, if not thrive, the assets of the public sector banks remained free from dominance of public-sector corporations, in contrast to the experience of China and the COMECON countries.

Liberalization, 1985–91

Moves toward liberalization initially came out of concerns for monetary management, signaled by the so-called Chakravarty Committee report of 1985 (RBI, 1985). The committee recommended a gradual deregulation of banking system interest rates so that monetary policy could be conducted using more modern, market-oriented instruments rather than the blunt portfolio controls of that time. In addition, a working group was set up to analyze money market issues. Both committees continued to regard social goals and priority sectors as appropriate guiding principles for their recommendations, rather than issues of competition, innovation, stability, and soundness. They accordingly recommended a continuation of the overall administered rate structure with calibrated cross-subsidization.

Despite these new instruments, the repression of the financial system continued to be enforced through quantitative controls, specifically the cash reserve ratio (CRR) meant for containing liquidity growth and the statutory liquidity ratio (SLR) a tool of captive financing for the government.^{1,2} At the end of 1990–91, the CRR and SLR stood at 15.5 and 38.25 percent, respectively; the two requirements together preempted more than half of the net demand and time liabilities. The actual ratio exceeded 60 percent because public sector banks preferred to hold excess SLR in preference to commercial loans. Owing to the absence of transparent, international standards for income recognition, the true quality of bank assets was not known widely outside the RBI—then, as now, the sole banking regulator for the scheduled commercial banks (RBI, 2005b, Chapter V).³

¹Since 1962, the RBI has been empowered to vary the CRR between 3 and 15 percent of the total demand and time liabilities. CRR in excess of 3 percent is currently remunerated at 4 percent per annum (Reddy, 1999).

²Over and above the CRR, banks are required to maintain a minimum amount of liquid assets in cash, gold, and government securities, amounting to a specified share of their demand and time liabilities.

³The RBI is vested with regulatory and supervisory authority over commercial banks and urban cooperative banks (UCBs), DFIs, and nonbanking financial companies (NBFCs). On March 31, 2005, there were 289 commercial banks (89 Scheduled Commercial Banks), 196 Rural Regional Banks (RRBs), and 4 Local Area Banks, 1,872 UCBs, 8 DFIs, and 13,187 NBFCs. The Board for Financial Supervision has been constituted as a Committee of the Central Board of the RBI since November 1994 and is headed by the Governor with a Deputy Governor as Vice Chairperson and other Deputy Governors and four Directors of the Central Board as members. In respect of state and district central cooperative banks, while the RBI is the regulator, supervision is vested with the National Bank for Agriculture and Rural Development. The Insurance Regulatory and Development Authority regulates

Domestic Liberalization (1991–2005)

The process of reform

India's financial sector liberalization since 1991 has been a comprehensive program involving issues related to banking, capital markets, fiscal policy, and international financial integration. Issues of linkage and sequencing between these areas have been central. India makes heavy use of expert commissions to float and develop ideas and agendas. In apparent contrast to China, there is little formal use made of foreign advisors. The two key regulators, the RBI and the Securities and Exchange Board of India (SEBI) have increasingly taken to inviting comments and discussion on major regulatory and market development issues through the Internet, press debate, and conferences/meetings with stakeholders. The finance ministry initiates and drafts needed legislation for parliamentary review. An important stimulus for reform has been provided by a series of market frauds (or scams) that resulted in improvements in market institutions and infrastructure.

Responding to the balance of payments crisis in 1990, wide-ranging economic reforms were introduced in 1991. Two important committees were constituted in the financial sector: the Committee on Financial Systems (CFS), and the Committee on Banking Sector Reforms (CBSR)⁴. The CFS took note of excessive administrative and political interference in internal management and credit decision making in public sector banks and observed that the economic reforms in the real sectors of the economy could not realize their full potential without reform of the financial sector.

The CFS and CBSR (henceforth the first and the second Narasimham Committees) provided the blueprint for reforming the financial system. Based on the committees' recommendations, a series of measures were undertaken beginning in 1992. The suggested reforms included decontrol of interest rates, development of securities markets, building a credible risk-free yield curve, greater reliance on open market operations, auctions of government securities, phased decontrol of the capital account, and

the insurance sector while the Securities and Exchange Board of India (SEBI) regulates securities and mutual funds (RBI, 2005b).

⁴The report of the CFS was submitted in 1991. Mr. M. Narasimham, a former RBI governor was the chairman of the committee. Subsequent to this report, the government appointed another committee, the CBSR, again with Mr. Narasimham as committee chairman, to review the progress made in reforming the banking sector and to chart the actions needed to strengthen the foundation of the banking system. The CBSR report was submitted in April 1998. For a summary see RBI (1998).

establishing prudential norms and mechanisms for supervision of the banking sector in line with international standards and practices, specifically those proposed by the Basel Committee for banks with significant international operations (the so-called Basel I norms). Significantly, neither committee forcefully championed denationalization.

In its external payments regime, India made the transition to a managed float of the rupee in 1993 (RBI, 2005b). Concurrently, most restrictions on current transactions were removed, and India accepted the disciplines of Article VIII status (current account convertibility) at the IMF as of March 1993. The exchange rate regime is officially described as market-determined, with no target rate, but the RBI reserves (and exercises) the right to intervene in the market to resist speculative attacks and to guide the exchange rate in the directions of “appropriate” competitiveness. One measure of this intervention has been the accumulation of foreign exchange reserves, which reached US\$150 billion by March 2006. By way of comparison, the equivalent figure at the end of March 2001 was US\$54.1 billion. While part of this intervention has been designed to strengthen India’s defense against a speculative attack, part has been designed to insulate the nominal exchange rate from what are perceived as temporary capital inflows (Lal, Bery, and Pant 2003; Patnaik, 2004; Joshi and Sanyal, 2004).

Interest rate regime liberalization and the lowering of statutory requirements

The framework of administered interest rates has been almost dismantled since 1997. In the case of deposit rates, only the rate on savings bank deposits remains under RBI control. At present, this is prescribed at 3.5 percent. The effective yield on deposits is lower, however, because interest is payable only on the minimum balance between the tenth day and the last day of each month. As for lending rates, the RBI now directly controls only the interest rate charged on export credit, which accounts for about 10 percent of commercial advances and indirectly controls the interest rate on small loans of up to Rs. 200,000, which accounts for about 20 percent of total advances⁵. Commercial banks are not allowed to exceed their Prime Lending Rate (PLR) in the case of loans up to Rs. 200,000.⁶

⁵For export credit, the RBI provides refinancing at concessional rates that mitigate the burden of this particular control on the banking system.

⁶Each commercial bank is statutorily required to declare its PLR in advance.

The RBI specifies an interest rate ceiling for nonresident Indians' foreign currency deposits and nonresident Indians' rupee deposits. Since July 2003, these are linked to the London Interbank Offered Rate (LIBOR) for selected international currencies, less 25 basis points for nonresident Indians' foreign currency deposits and plus 250 basis points for nonresident Indians' rupee deposits.

With these reforms and given larger trends in financial markets, as influenced by the RBI's monetary policy actions, the nominal deposit rate for 1–3 year maturities has dropped from 12.0 percent in 1991–92 to 4–5.25 percent in 2004–05, and the nominal lending rate has over the same period dropped from 16.0 to 10.25 percent.

The minimum cash reserve ratio has been lowered to 4.75 percent from 15.5 percent (prior to the reforms), and banks are paid interest on deposits in excess of the 3 percent statutory minimum at the rate of 6 percent, which is equal to the RBI policy-determined Bank Rate. The statutory liquidity ratio was gradually brought down from an average effective rate of 37.5 percent in 1992 to the statutory minimum of 25 percent in 1997, and it continues to be at that level, although actual holdings still remain in excess of the minimum.

Increasing role of private sector domestic and foreign banks

Since the start of reforms in 1991, private sector banks, both domestic and foreign, have been allowed more liberal entry, albeit with different degrees of freedom. By end-March 2004, the domestic private sector banks held 18.6 percent of assets, 17 percent of deposits, and 19.8 percent of advances. The corresponding numbers for foreign banks were 6.9 percent, 5.1 percent, and 7.0 percent. While there is thus a substantial presence of private banking in India, the public sector banks (the State Bank of India group and the nationalized banks) continue even now to dominate the Indian banking sector. Indian banks, led by the public sector banks, have also continued to expand their presence overseas.

Expansion of foreign banks in India and their acquisition powers over domestic private banks have been the subject of considerable attention and debate, as well as being governed by India's commitments under the General Agreement on Trade in Services. As India's economy has improved, foreign banks have sought to expand their presence, both by branch expansion and by acquisition of private banks. (Unlike China, there has been no interest in providing a minority "strategic stake" in public sector banks even though this is not prohibited by law.)

Following an announcement in the 2002–03 budget, foreign banks in India have been given more flexibility in their Indian operations wherein

they are allowed to operate as branches of their overseas parent or as subsidiaries in India. Under a three-phase road map set out by the RBI on February 28, 2005, between March 2005 and March 2009 foreign banks satisfying the RBI's eligibility criteria will be permitted to establish a wholly owned banking subsidiary (WOS) or to convert their existing branches into a WOS. The WOS is required to have minimum capital of Rs. 3.0 billion with sound corporate governance. The WOS will be treated on par with the existing branches of foreign banks for branch expansion with flexibility to go beyond the existing World Trade Organization (WTO) commitments of 12 branches in a year and preference for branch expansion in under-banked areas. The RBI would also prescribe market access and national treatment consistent with WTO commitments and also other appropriate limitations consistent with international practices and the country's requirements. Permission for acquisition of shareholding in Indian private sector banks by eligible foreign banks will be limited to banks identified by the RBI for restructuring. Where such acquisition is by a foreign bank already present in India, a maximum period of six months will be given for conforming to the "one form of presence" concept. The second phase will commence in April 2009 after a review of the experience gained. Extension of national treatment to WOS, dilution of stake, and permitting mergers and acquisitions of any private sector banks in India by a foreign bank would be considered, subject to an overall investment limit of 74 percent (RBI, 2005a).

Strengthening prudential norms

In order to strengthen the banking system, the RBI has already introduced capital adequacy norms to ensure uniform measurement of regulatory capital consistent with the recommendations of the Basel Committee and income recognition (Basel I). The initial target was to obtain a capital-to-risk weighted assets ratio (CRAR) of 8 percent as required by Basel I. The government contributed about Rs. 40 billion (0.6 percent of the 1990–91 GDP) to the paid-up capital of public sector banks between 1985–86 and 1992–93 and again about Rs. 177 billion (about 1.9 percent of the 1995–96 GDP) between 1992–93 and 2001–02 (Mohan and Prasad, 2005). Constrained by competing fiscal demands, the government permitted banks to raise fresh equity to meet a shortfall in capital requirements. Public sector banks were also encouraged to raise Tier-II (i.e., debt) capital without a government guarantee, subject to certain limits linked to their capital. Several public sector banks also accessed capital in India and abroad through global depository receipts (GDR), while other banks raised subordinated debt through private placement

for inclusion under Tier-II capital. Unlike the big Chinese banks, however, there is no appetite in India for the sale of strategic stakes to foreign banks. Where the domestic private sector banks are concerned, foreign equity holdings are currently restricted to a total of 74 percent, with no individual shareholder able to exercise more than 10 percent of voting rights, other than with the RBI's approval with sublimits for the three categories of foreign direct investment (FDI), foreign institutional investors (FIIs), and nonresident Indians (NRIs) (RBI, 2005a).⁷ With these efforts, the Indian banking sector has achieved more than required capital adequacy in almost all the groups except two banks in the old private sector (Table 7.1).

After substantially complying with the Basel I requirements, Indian banks are now moving towards the New Capital Adequacy Framework on International Convergence of Capital Measurement and Capital Standards (Basel II) regime (November 2005), which entails three pillars for establishing minimum capital requirements (incorporating credit risk, operational risk, and market risk), supervisory review, and market discipline. The RBI has, in principle, accepted to adopt Basel II. Accordingly, all commercial banks in India except RRBs are required to adopt the Standardized Approach for credit risk and the Basic Indicator Approach for operational risk by March 31, 2007. Banks are encouraged to formalize their capital adequacy assessment process in alignment with their business plan and performance budgeting system.

In order to ensure a smooth transition to Basel II, the RBI has appointed a steering committee comprising senior officials from 14 banks. On the basis of the recommendations of the steering group, draft guidelines on implementation of the New Capital Adequacy Framework were formu-

⁷The guidelines require that: (1) important shareholders (i.e., with shareholding of 5 percent and above) are "fit and proper" as per the RBI's guidelines on acknowledgement for allotment and transfer of shares, (2) the directors and the Chief Executive Officer who manage the affairs of the bank are "fit and proper" and observe sound corporate governance principles, (3) banks have minimum capital/net worth for optimal operations and systematic stability, and (4) policies and processes are transparent and fair.

On the issue of aggregate foreign investment in private banks from all sources (FDI, FII, NRI), the guidelines stipulate that it cannot exceed 74 percent of the paid-up capital of a bank. If FDI (other than by foreign banks or foreign bank groups) in private banks exceeds 5 percent, the entity acquiring such stake would have to meet the "fit and proper" criteria indicated in the share transfer guidelines and get the RBI's acknowledgement for transfer of the shares. The aggregate limit for all FII investments is restricted to 24 percent, which can be raised to 49 percent with the approval of the board/shareholders. The current limit for all NRI investments is 24 percent, with the individual NRI limit being 5 percent, subject to the approval of the board/shareholders.

Table 7.1. Scheduled Commercial Banks: Frequency Distribution of CRAR (end-March 2005)

Bank Group	Negative	0–9 Percent	9–10 Percent	10–15 Percent	15 Percent and Above	Total
Public sector banks	0	0	2	22	4	28
SBI group	0	0	0	8	0	8
Nationalized banks	0	0	2	14	4	20
Private sector banks	0	2	4	16	7	29
Old private sector banks	0	2	2	11	5	20
New private sector banks	0	0	2	5	2	9
Foreign banks	0	0	1	10	19	30
All banks	0	2	7	48	30	87

Sources: RBI (2005a); off-site supervisory returns submitted by the banks.

Notes: Data for March 2005 are unaudited and provisional. SBI: State Bank of India. CRAR: capital-to-risk weighted assets ratio.

lated and issued to banks on February 15, 2005. An internal working group was also constituted for identifying eligible domestic credit rating agencies whose ratings may be used by the banks for computing capital for credit risk under Basel II (RBI, 2005a). It is the responsibility of bank management, however, to develop an internal capital adequacy assessment process and accounting standard.

In addition, the enactment of the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002 (with amendments in 2004), has offered great opportunities to step up loan recoveries and tighten credit administration procedures, which could further enhance the scope for greater profitability. The banks' readiness is reflected in significant improvements in CRAR and nonperforming assets (NPA) across the banking sector (Table 7.2) while maintaining reasonable profitability.

Strengthening regulatory and supervisory institutions

In order to strengthen the regulation and supervision of the banking system, a Board for Financial Supervision has been constituted as a Committee of the Central Board of the Reserve Bank since November 1994 and is headed by the Governor with a Deputy Governor as Vice Chairperson and other Deputy Governors and four Directors of the Central Board as members. The Board has focused on restructuring the inspection system, setting up off-site surveillance, enhancing the role of external auditors, and strengthening corporate governance, internal controls, and audit procedures, disclosures, and transparency.

Table 7.2. Select Financial Indicators

Item	Period	Scheduled Commercial				
		Banks	DFIs	PDs	NBFCs	SUCBs
CRAR	March 2004	12.9	22.0	42.7	26.8	11.0
	March 2005	12.8	22.8	54.3	22.9	12.7
Gross NPAs to gross advances	March 2004	7.4	16.4	n.a.	8.2	30.4
	March 2005	5.2	11.5	n.a.	8.1	24.9
Net NPAs to net advances	March 2004	2.9	10.5	n.a.	2.4	20.8
	March 2005	2.0	3.7	n.a.	3.4	8.9
Return on total assets	2003–04	1.1	-0.2	5.9	2.5	0.4
	2004–05	0.9	1.1	-1.8	n.a.	0.3
Return on equity	2003–04	19.3	-1.2	19.9	13.6	n.a.
	2004–05	14.0	4.8	-5.1	n.a.	n.a.
Cost/income ratio	2003–04	45.6	0.2	16.9	14.1	24.9
	2004–05	49.3	0.2	297.0	n.a.	25.5

Source: RBI (2005a)

Notes: n.a.: not available. Data for March 2005 are provisional. Data for nonbank financial companies (NBFCs) pertain to deposit-taking NBFCs having an asset size of Rs. 10 crore and above. Data for 2005 in respect of NBFCs pertain to the period ended September 2004. Data for scheduled commercial banks pertain to domestic operations only and may not tally with the balance sheet data. Data in respect of Development Financial Institution (DFIs) as on March 2005 do not include IDBI due to its conversion into a banking company. In regard to UCBs, data for CRAR relate to 52 scheduled Urban Cooperative Banks (UCBs) while other data relate to 53 scheduled UCBs (out of 55). Data for scheduled UCBs are based on offsite surveillance statements.

Since March 1998, mandatory disclosures have also included profitability indicators such as the ratio of interest and noninterest income to working funds and the financial position of subsidiaries. And, since March 2000, banks have to disclose the maturity profile of loans and advances, investments, movements in nonperforming assets, and lending to sensitive sectors.

Greater stress is also given to timely identification and monitoring of the behavior of troubled banks. The role of external auditors has been extended to verifying and certifying almost all aspects of balance sheets including financial ratios. Concurrent audits have also been introduced.

With the increasing use of credit cards and electronic banking, supervision has taken on another dimension: integrity of e-money. As of October 2004, different banks had already issued about 37.85 million plastic cards covering a range of credit cards, debit cards, and smart cards (RBI, 2004). The RBI has constituted several working groups on electronic money, and the recommendations are being implemented.

Capital market reforms

The Capital Issues (Continuance of Control) Act, 1947,⁸ was used to control the issue of capital in the Indian market up to 1992. Under this Act, any firm wishing to raise funds from the market had to obtain approval from the government, which also determined the amount, type, and price of the issue. In order to pave the way for market-determined allocation of resources, the 1947 Act was repealed in 1992 and the Securities and Exchange Board of India Act, 1992 was enacted with statutory power granted to SEBI to (a) protect the interest of investors in securities, (b) promote and develop the securities market, and (c) regulate the securities market. In addition to the SEBI Act, 1992, three other acts are applicable to the capital market. These are: the Securities Contract (Regulation) Act, 1956 (SC(R)A); the Companies Act, 1956; and the Depositories Act, 1996. The government has framed rules under all these three acts, and SEBI issues notifications and guidelines that must be complied with by market participants. The Department of Economic Affairs, Department of Company Affairs, the RBI, and the SEBI with clear areas of jurisdiction under different applicable Acts share the responsibility of regulating the securities market.

SC(R)A was amended in 1995 to lift a ban on the writing of options in securities, and was again amended in December 1999 to expand the definition of securities to include derivatives in order to bring these into the general frame of regulations applicable to any other security. In addition, a 30 year old ban on forward trading was withdrawn in order to make trading in derivatives a reality.

Historically, brokers owned, controlled, and managed stock exchanges in India, which often led to extreme volatility in the securities market. In March 2001, in order to corporatize the stock exchanges, the government proposed de-mutualization, whereby ownership, management, and trading membership would be segregated from one another. The government has offered tax incentives to facilitate this transformation.

⁸Control of Capital Issues was introduced through the Defense of India Rules in 1943 under the Defense of India Act, 1939, to channel resources to support the war effort. The control was retained after the war with some modifications as a means of controlling the raising of capital by companies and to ensure that national resources were channeled to serve the goals and priorities of the government, and to protect the interests of investors. The relevant provisions in the Defense of India Rules were replaced by the Capital Issues (Continuance of Control) Act in April 1947. (See <http://www.sebi.gov.in/chairmanspeech/histspeech.html> for more information.)

SEBI (Central Listing Authority) Regulations, 2003, were issued to provide for the constitution of a Central Listing Authority (CLA) by SEBI. In addition, the regulations provided for mandatory recommendation from CLA before listing in any stock exchange and appeal to SEBI and the Securities Appellate Tribunal in case of refusal of issuance of letter of recommendations from CLA. The CLA was constituted on April 9, 2003.

The National Stock Exchange of India Limited (NSE) was established during the early 1990s as a competing exchange under public ownership with state of the art technology to supplement the business at the Bombay Stock Exchange (BSE), both of which have traded in derivatives of securities since June 2000. The market presently offers index futures and index options on two indices and stock options and stock futures on 31 stocks. NSE quickly introduced a nationwide, on-line, and fully automated screen based trading system (SBTS). The SBTS electronically matches orders on a strict price/time priority, cutting costs and reducing risk of error.

Rolling settlement on a T+5 basis was introduced for all scripts in December 2001 to reduce the trading cycle (to as little as 1 day, in the case of specified scripts), which earlier used to take 14 days for specified scripts and 30 days in the case of other scripts. T+5 gave way to T+3 in December 2002, T+2 in April 2003, and now it is moving toward T+1. With a view to make the trading system more efficient and less time consuming, effective April 2004, Straight Through Processing became compulsory for all institutional trades.

The Companies (Second Amendment) Act, 2002, was enacted to provide for a new, modern, efficient, and time-bound Insolvency Law to provide for both rehabilitation and winding up of sick companies within a maximum time frame of two years. It envisaged the setting up of a National Company Law Tribunal with several Benches to be notified by the government all over the country.

Public debt

The RBI is the regulator of the market for government securities and it also services and manages the public debt for both the central and state governments. Following the scam of 1992, where lack of transparency in the pricing and settlement of government securities created a funding channel for stock market speculation, significant reforms have been made to markets for both bills and dated securities.

Until 1991, the government securities market consisted mainly of pre-determined, low-coupon, long-maturity loans. There was no benchmark rate for the market. In 1992, however, the government began borrowing at market interest rates through an auction system, and, by April 1997, it

abolished the system of automatic monetization via ad-hoc treasury bills. These actions paved the way for rapid reforms. New instruments such as zero coupon bonds, floating rate bonds, bonds with call-put options, and capital-indexed bonds were introduced across the maturity spectrum. A system of primary dealers (PDs) was introduced with liquidity support and incentives for underwriting. This, along with permission for FIIs to invest in dated securities and treasury bills in the primary and secondary market segments, added depth and liquidity to the market. The transparency was increased by announcements of an auction calendar for treasury bills, online dissemination of information, creation of the Negotiated Dealing System for delivery, and settlement through the Clearing Corporation of India Limited (CCIL). Market participants can now hedge their risks through interest rate swaps and forward rate agreements on the over-the-counter market and through rate futures on exchanges (RBI, 2005b, Chapter VII). While market infrastructure has clearly become much more robust, and has facilitated the move from direct to indirect instruments, provision of adequate liquidity remains a challenge, perhaps aggravated by the RBI's habitual ambivalence to the role of brokers in the public debt markets. Liquidity is an even larger issue in the fragmented market for corporate debt, even though other elements of market infrastructure, such as independent and well-staffed rating agencies, have existed for a number of years.

With the legislative framework in place and responsive to market changes, the securities market is also becoming increasingly integrated with the international markets. Indian companies have been permitted to raise resources from abroad through issues of American Depository Receipts, GDRs, Foreign Currency Convertible Bonds, and External Commercial Borrowings (ECBs) and are also allowed listing on foreign stock exchanges under certain conditions. The FIIs enjoy full capital account convertibility. They can invest in a company under portfolio investment up to 24 percent of the paid-up capital of the company, which can be increased up to the sectoral cap/statutory ceiling if it is approved by the Indian company's board of directors and also its general body.

Money market development and innovations

In order to bring financial stability and facilitate the movement of the short-term money market rate within a corridor, a full-fledged liquidity adjustment facility (LAF) was established on June 5, 2000, to be operated through repo and reverse repo instruments. The LAF is now fully supported by a real time gross settlement system and a computerized public debt office. Liquidity is injected by the RBI through the Collateralized

Lending Facility to banks, export credit refinance to banks, and liquidity support to PDs in government securities. The absorption of liquidity takes place through fixed-rate reverse repos (rates being announced daily) and open market operations in government-dated securities by the RBI. However, it is important to note that these operations occur within the given framework of the CRR (that directly affects liquidity) and the Bank Rate which signals the central bank's medium-term view on short-term rates. The CCIL now handles most overnight transactions in the repo/reverse repo market.

Introduction of the LAF has been one of the most important recent changes in the money market. It gives the RBI the flexibility to affect liquidity and signal interest rates in the short-term money market. In order to provide the RBI with additional tools to cope with the recent surge in capital flows, however, the Government of India signed a memorandum of understanding with the RBI on March 25, 2004, detailing the rationale and operational modalities of a Market Stabilization Scheme (MSS) to be effective from April 2004. Under the MSS, the government would issue treasury bills and/or dated securities in addition to its normal borrowing requirements, so as to facilitate the RBI's efforts in absorbing liquidity from the system. The treasury bills and dated securities issued for MSS purposes are matched by an equivalent cash balance, which is held by the government in the RBI. The interest payments on treasury bills and/or dated securities outstanding under the MSS will be the only impact on government revenue and fiscal balances.

Thus, effective April 2004, the MSS became an important instrument of liquidity absorption and sterilization. Initially, an annual provision was made of Rs. 600 billion, which was increased to Rs. 800 billion for 2005–06.

In his budget speech in February 2000, the Indian Finance Minister mooted the idea of amending the RBI Act to accord greater operational flexibility to the Reserve Bank in conducting monetary policy and regulation of the financial system. Accordingly, the Reserve Bank of India (Amendment) Bill, 2005, was introduced in India's lower house of Parliament (the Lok Sabha), which aims at bestowing enabling powers on the RBI to use a larger variety of financial instruments than hitherto, including derivatives, and more flexibility to set the cash reserve ratio. Apart from these legislative changes, there remains a rich agenda of additional reform to improve the liquidity and efficiency of the money market further, both to serve commercial needs and to improve its sensitivity and responsiveness to the RBI's monetary policy actions. A few examples follow.

The repo market is still at an early stage of development. Reforms on the rollover of repos and on documentation are expected to pave the way for a deeper and more liquid repo market. With appropriate regulatory safeguards, guaranteed settlement through notation in the CCIL, trading in dematerialized form, and uniform accounting, valuation, and disclosure norms, it is expected that the market will deepen further (see also, Mohan and Prasad, 2005).

It is also being proposed to remove the provision for payment of interest to banks on the excess CRR maintained by the commercial banks, as this reduces the effectiveness of the CRR as a monetary policy tool.

There is finally the issue of ownership. Several studies including those of the World Bank (2001) and Barth, Caprio, and Levine (2001) indicate that private banks are more efficient. Given the public banks' large current share in intermediation, it will take time for new entrants to displace growth, although the capital markets provide an increasingly viable alternative for large listed companies. There is currently no credible proposal, however, to dilute public ownership in these banks to passive, minority status.

Assessment

Somewhat unexpectedly, financial sector reform can now be counted as one of the relative successes of India's economic reform program since 1991. Significant liberalization and (as will be discussed further below) significant international financial integration have occurred without, so far, a major financial crash. Yet, as Kletzer (2004) points out, the lack of coordination between fiscal adjustment and financial reform has had significant implications through the loss of revenue associated with financial repression. He further argues that funding of the government's high debt stock will become harder as the capital account liberalizes.

Positive surprises over the 15-year span have been the growth in assurance and professionalism of both the RBI and SEBI, as well as the beneficial impact of increased competition from some of the newly established domestic private sector banks. By contrast, so far the collective impact of foreign banks has not been significant. Yet, while the stability of the system is no doubt greater now than at the beginning of the process (Table 7.3), the contradictions between a still largely nationalized banking system and the needs of an increasingly sophisticated and rapidly growing economy are growing more serious and glaring. Unfortunately, denationalization is even less discussed than before. The fact that India emerged unscathed from contagion in the Asian crisis of 1997–98, the fact that China has succeeded in growing rapidly despite a largely publicly owned

banking system, and the exigencies of domestic politics have all served to make bank privatization the “third rail” of Indian reform.

India has shown an impressive capacity to reform its financial system behind the protective barrier of a semi-closed (but gradually opening) capital account. The issue is whether this impetus is running out of steam. Reducing these protective barriers is one way to stimulate competition and domestic financial innovation, but to do so in the presence of widespread public ownership of banks and a large fiscal deficit raises additional challenges and risks. It is to an examination of these issues that the paper now turns.

International Financial Integration

Context

Global economic integration increased progressively during the 1980s and 1990s. World trade in goods and services increased from 37.9 percent of global GDP (at market prices and exchange rates) during 1981–85 to 48.0 percent during 2001–03 (Table 7.4). During the same period international flows of gross private capital (direct, portfolio, and other) increased from 7.4 percent to 22.9 percent and gross foreign direct investment increased from 2.3 percent to 11.1 percent of GDP. In low-income countries, trade increased from 23.6 percent to 43.7 percent, gross private capital flows from 2.4 percent to 4.4 percent, and gross foreign direct investment from 0.3 percent to 1.6 percent of GDP, respectively.

Global attitudes on the need for and priority of capital account convertibility (KAC) have evolved substantially since World War II. Certain countries (Canada, later Indonesia) were early adopters, largely because of the infeasibility of imposing capital controls given their proximity to major financial hubs. But, for most countries, the focus of domestic and international policy following the war was on liberalizing trade and ensuring a payments regime that was supportive of this more liberal trade. Free capital movements were considered potentially disruptive, and capital controls were not disallowed under the Articles of Agreement of the IMF. Capital mobility was, however, established as a goal for members of the Organization for Economic Cooperation and Development when it was founded in the early 1960s, although certain of the more recent members retain capital controls.

Many of the developed European countries only gradually dismantled their capital controls during the 1970s and 1980s. As private flows began

Table 7.3. Moody's Weighted Average Bank Financial Strength Index

	December 2002	December 2003	December 2004
China	10.0	10.0	10.0
Hong Kong SAR	62.3	62.3	62.3
India	27.5	27.5	24.2
Indonesia	3.0	3.0	7.3
Korea	16.7	18.3	18.3
Malaysia	31.7	33.3	35.2
Philippines	20.4	20.4	19.2
Singapore	74.7	74.7	74.7
Thailand	15.8	15.8	15.8
Argentina	0.0	0.0	0.0
Brazil	25.0	24.3	24.3
Chile	52.5	56.5	57.8
United Kingdom	83.8	83.3	83.3
Japan	12.9	12.0	20.6
United States	75.0	75.0	77.0

Source: World Bank, *Global Development Finance* (2005).

to dominate official flows in development finance, and as financial institutions in the developed countries regained interest in furnishing financial services to the individuals and companies of the developing world, KAC started to assume a larger place in international debate.

Financial Integration: Analytic Considerations

China and India are both being led toward greater KAC as an inevitable by-product of their desire for greater overall integration into the global economy, and as part of their effort to strengthen their domestic systems of financial intermediation and risk mitigation. Yet, unlike the case for trade liberalization, the academic community remains divided in its assessment of the benefits of accelerating KAC. Indeed, in contrast to trade in goods, there even remains confusion as to the definition of KAC. Arguments rage both on the importance (and priority) of KAC for long-term economic growth, as well as the balance between benefits and risks of approaching full KAC. The experience with financial crises in Asia in the late 1990s has clearly checked some of the earlier enthusiasm for a more rapid move toward KAC. In addition, issues of monetary management and autonomy in a world of capital movements have become more pressing. Below we review major arguments in the literature, for and against KAC, before assessing the current status of KAC in India and the relevance of these arguments for India at its present juncture.

Table 7.4. Selected Indicators of Global Integration and Domestic Financial Deepening

	World		High Income		Low Income		China		India	
	1981-85	2001-03	1981-85	2001-03	1981-85	2001-03	1981-85	2001-03	1981-85	2001-03
Trade in goods and services (percent of GDP)	37.9	48.0	38.8	45.7	36.6	43.7	18.4	56.5	14.2	29.6
Exports of goods and services (percent of GDP)	18.7	24.0	19.2	22.6	9.5	20.8	9.0	29.6	6.0	14.4
Gross FDI (percent of GDP)	1.3	5.5	1.4	5.9	0.3	1.6	0.5	4.7	0.0	0.9
Gross private capital flows (percent of GDP)	7.4	22.9	7.7	25.4	2.4	4.4	1.9	10.8	0.4	3.2
FDI, net inflows (percent of gross capital formation)	2.3	11.1	2.1	11.1	1.3	6.6	1.0	9.0	0.1	3.3
Share of FDI, net inflows (BoP, current US\$)	100	100	77.9	76.9	2.3	2.1	1.7	7.1	0.1	0.6
Market capitalization of listed companies (percent of GDP)	57.9	84.7	106.0	95.6	8.6	26.5	5.70 ¹	43.0	9.9	31.7
Money and quasi-money (M2) as percent of GDP	55.0	80.1	67.0	83.0	30.8	46.3	42.2	162.8	35.0	57.9
Share of services sector in GDP	57.4	67.9	60.6	71.3	40.6	47.8	23.3	33.6	38.3	50.4
Per capita GDP growth	0.9	0.8	2.0	1.0	1.3	3.3	9.3	7.6	3.1	4.3

Source: World Bank, *World Development Indicators*, 2005.¹Data pertain to 1991-95.

Notes: FDI: foreign direct investment; BoP: balance of payments.

Several theoretical studies have attempted a rigorous defense of the benefits of financial integration. In a continuous-time stochastic model, Obstfeld (1994) argues that growth depends on the availability of an ever-increasing array of specialized, and hence inherently risky, production inputs and that most countries could reap large steady-state welfare gains through the beneficial effects of consumption from enhanced financial integration and wider risk sharing.

As against this, other analyses, based on a neoclassical growth model with an exogenous capital account regime, find that the potential gains from mitigating inefficiency due to international credit rationing might be quite moderate as compared to the gains from upgrading domestic financial intermediation—for example, by relaxing domestic credit rationing (Gourinchas and Jeanne, 2006).

A key argument put forth by the advocates of international financial integration is that there are endogenous productivity gains from capital mobility. It is also argued that the superior efficiency of foreign banks in allocating domestic saving, or the competition they introduce in the domestic financial system, accelerates domestic financial development resulting in efficiency gains in the whole economy (Levine and Zervos, 1998). Prasad and others (2005) argues that financial globalization with good governance and good macroeconomic policies appears to be conducive for growth. In a more revealing empirical analysis of the relationship between financial openness and industrial growth, Vanassche (2004) finds evidence that financial openness has a positive effect on the growth of industrial sectors, regardless of their characteristics. Moreover, industries that rely relatively more on external finance grow disproportionately faster in countries with more integrated financial systems. The process is enhanced further by improving the functioning of the domestic financial system.

In contrast to this benign view of KAC, Rodrik (1998), Panagariya (1998), and Bhagwati (1998) vehemently oppose full capital account convertibility. They argue that financial and goods markets are fundamentally different; also that the irreversibility of KAC enjoins prudence and caution. Panagariya cites research that demonstrates that once a country lives with an open capital account it is impossible to return to effective capital controls because residents and banks are quickly able to devise channels that circumvent the control. Bhagwati (1998) further argues that substantial gains from “full” KAC have been asserted not demonstrated, and that the decision, once taken, is irreversible.

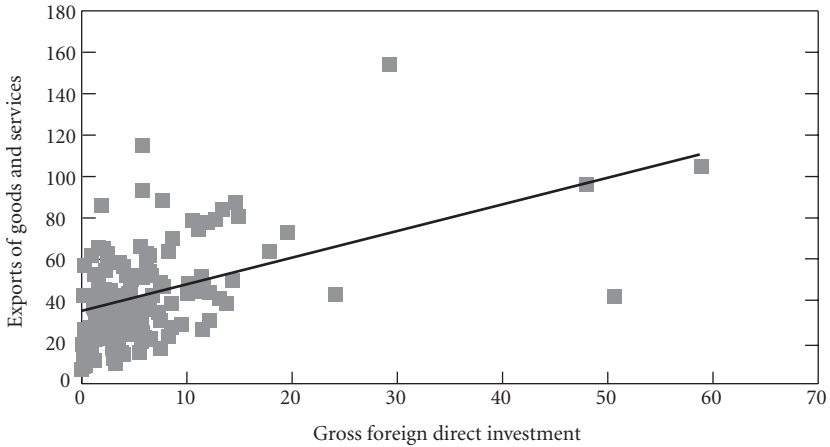
It may be remarked that these arguments are very much in the spirit of the founders of the IMF, notably Keynes, who felt that free capital move-

ments were at best irrelevant and at worst harmful for liberal trade. It might also be noted that many developing countries (particularly India) were initially hostile to all forms of international engagement and that attitudes first to liberal trade and then to liberal direct investment have changed only slowly. The underlying mechanism by which liberalization of trade and foreign direct investments affects productivity is through increased competitive pressure. The issue is whether these gains are further enhanced by increasing the competitive pressure on the financial system, and, if so, at what cost and risk.

It is now abundantly clear that there are tight links between the growth of trade and exposure to foreign direct investment (FDI). Countries attracting a larger share of FDI are also likely to have a higher export percentage of GDP (Figure 7.1). Although the direction of causality is not clear, higher exports are typically associated with faster growth of productivity. As the Chinese experience itself suggests, though, it is possible, at least for a while, to attract substantial volumes of FDI without full financial liberalization, although few would hold up China as a model of efficient capital allocation.

At present, just about 3.3 percent India's capital formation is contributed by FDI; in the case of China, the FDI share capital formation is over 9 percent despite much higher investment rates. While China has made formidable inroads in the manufacturing sector, the Indian economy is driven by the services sector (see Table 4). In a recent speech, Prime Minister Manmohan Singh pointed out the need to strengthen India's comparative advantage in the services sector, arguing that in this area, unlike manufacturing, there may be tighter links between direct investment and financial integration in order to modernize technology and enhance productivity, while actively managing the risks involved (Singh, 2006).

These long term arguments for increased financial integration aside, fear of currency crisis is perhaps the single most important reason for resisting international financial integration. The so-called first-generation models of currency crises were developed to explain crises arising from current account and balance of payments deficits, and the depletion of foreign exchange reserves (Krugman, 1979). The so-called second-generation models (so-called capital account crises) are particularly useful in explaining self-fulfilling contagious currency crises (Obstfeld, 1986). This theoretical work suggests four factors that can influence the onset and magnitude of a currency crisis: domestic public debt, domestic private debt, expectations, and the state of financial markets. A common ingredient has typically also been the need to defend a currency peg.

Figure 7.1. Scatter Plot Between Gross FDI and Exports (2001–03)*(In percent of GDP)*

With regard to the first-generation models, it has been argued that open (or repressed) inflation is incompatible with convertibility and a stable exchange rate. Therefore, “easy money policies, budgetary deficits, [and] lax credit policies are all incompatible with convertibility and stability of the currency” (Haberler, 1954, p. 22). With the experience of so-called capital account crises in the 1990s, several other preconditions have been added, mostly in the nature of strengthening prudential and risk management practices in the domestic financial system.

The importance of fiscal discipline as a precondition for KAC can be traced to the Latin American debt crises of 1982, which unleashed an entire literature on over-borrowing in developing countries, placing the blame squarely on expansionary fiscal policies (and, in some countries, on inappropriate sequencing of liberalization). This literature is also known as the “Neo-Alejandro” paradigm based on Diaz-Alejandro (1985), which relies on three problems associated with governments (Pesenti, 2001). The first one is the over-borrowing/over-lending/over-investment syndrome, wherein domestic and foreign creditors keep lending against future bail-out revenue, unprofitable projects, excessively risky investments, and cash shortfalls being refinanced and rolled over. In the case of foreign borrowing, this translates into an unsustainable path of current account deficits. The second problem is public guarantees (explicit, implicit, or simply presumed) and expected bailouts. Whether or not depositors are explicitly insured, “the public expects governments to intervene to save most depositors from losses when financial intermediaries run into trouble.

Warnings that intervention will not be forthcoming appear to be simply not believable” (Diaz-Alejandro, 1985, p. 13). And, thirdly, even if public deficits may not be high before a crisis, when the government steps in and guarantees the stock of private liabilities, it must undertake complementary fiscal reforms. If these involve recourse to seigniorage revenue and money creation, expectations of inflationary financing may lead to speculation in the currency market. If the central bank intervenes to stabilize the domestic currency, it loses reserves that could otherwise be used to bail out insolvent private institutions, and vice versa. Thus, the parallel phenomenon of currency and banking crises appears. In many cases, currencies are pegged, which again amounts to a kind of guarantee, and the consequences are similar.

Such crises did not go away when governments became better behaved on the monetary and fiscal front. For example, the European Exchange Rate Mechanism (ERM) crisis in 1992 could not be blamed on lax monetary and fiscal policies in Europe, and therefore led to a new set of models with multiple equilibria (Rodrik, 1998).

International and Indian Practice

The IMF’s *Annual Report on Exchange Arrangements and Exchange Restrictions* is the standard official source documenting controls on capital transactions imposed by its member countries. Controls and other provisions are broadly classified into 13 groups (Table 7.5), which are further classified as controls/provisions on inflows and outflows (see Appendix II). India is among the few countries that have controls and restrictions of one form or the other in all 13 groups.

IMF (1999) provides a comprehensive overview of the pervasiveness of exchange and capital controls during 1996. According to the indices reported there, even the East Asian countries involved in the 1997 crisis were not excessively open by international standards. Extensive exposure to intra-regional trade and currency trading were perhaps more important mechanisms for contagion.

India’s balance of payments recovered surprisingly swiftly after the 1991 crisis, and as previously mentioned, current account convertibility was declared in 1993. Given the international intellectual support for capital account convertibility in emerging markets at that time, and despite the Mexican crisis of late 1994, a committee was constituted in 1996 by the RBI to review international experience and prepare a road map for liberalization of India’s capital account. The committee was chaired by a former Deputy Governor of the RBI, Mr. S.S. Tarapore. Its report “Report of the Committee

Table 7.5. Features of Exchange Controls in Selected Countries

Capital Transactions	**	India	United States	Brazil	China
December 2001 Position					
Control on					
Capital market instruments	69	1	1	1	1
Money market instruments	60	1	1	1	1
Collective investment securities	55	1	1	1	1
Derivatives and other instruments	45	1		1	1
Commercial credits	59	1		1	1
Financial credits	61	1		1	1
Guarantees, sureties, and financial backup facilities	52	1		1	1
Direct investment	78	1	1	1	1
Liquidation of direct investment	31	1		1	1
Real estate transactions	74	1			1
Personal capital movements	50	1		1	1
Provisions specific to					
Commercial banks and other credit institutions	84	1		1	1
Institutional investors	45	1		1	
Proportion of controls		100	31	92	92
December 2004 Position					
Control on					
Capital market instruments	68	1	1	1	1
Money market instruments	55	1	1		1
Collective investment securities	52	1	1		1
Derivatives and other instruments	45	1		1	1
Commercial credits	53	1			1
Financial credits	59	1			1
Guarantees, sureties, and financial backup facilities	47	1		1	1
Direct investment	77	1	1	1	1
Liquidation of direct investment	29	1			1
Real estate transactions	73	1			1
Personal capital movements	52	1		1	1
Provisions specific to					
Commercial banks and other credit institutions	84	1			1
Institutional investors	49	1		1	
Proportion of controls		100	31	46	92

Source: IMF, *Annual Report on Exchange Arrangements and Exchange Controls* (2001, 2005).

Notes: **: proportion of member countries having a particular feature. A "1" means that the item is a feature of capital control in that country.

on Capital Account Convertibility" (henceforth, Tarapore Committee or TC) was finalized in 1997, on the eve of the Asian financial crisis.

As the committee had been asked to examine the positive case for KAC, it is not surprising that it accepted that there were several ben-

efits that could be expected to flow from a more open capital account. These included mobilization of external capital for domestic investment, convergence between domestic and international interest rates, portfolio diversification by residents, and enhanced innovation in the domestic financial sector. The TC emphasized that capital controls progressively become ineffective, costly, and even distortionary. One could add that, like all other discretionary controls, restrictions on access to cheaper sources of overseas capital are also a potential source of both corruption and discrimination.

The TC further noted that domestic financial liberalization had already served to expose weaknesses in the domestic economy. The introduction of KAC could be even more damaging, so that “proactive policy action” would be needed to prepare the economy for KAC. But, on the whole, the committee believed that KAC would impose a strong (presumably positive) discipline on the financial system and would “expedite the early rectification of infirmities in the system and lead to widening/deepening of markets to enable the spreading distribution of risks” (RBI, 1997, para. 1.27). Thus the TC was commendably clear on the two-way links between domestic liberalization and KAC: the financial system had to be prepared for KAC, but, in turn, KAC would stimulate further development of the financial system for the greater benefit of both the government and the private sector.

At this point it is worth distinguishing between official capital account convertibility and *de facto* convertibility. With expanding trade, foreign investment, and travel, and given India’s large overseas migrant population, it is increasingly difficult to make capital controls even partially effective. Opening trade without opening capital flows creates opportunities for under- or over-invoicing as export and import activity is used as a cover for capital exports and risks constraining the growth of trade as cumbersome controls are needed to enforce capital account restrictions (Krueger, 2004). In addition to such manipulated invoicing, there are legion other mechanisms of unauthorized capital flight. Evidence from China as well suggests that capital movements have been much more volatile than anything that could be suggested from having effective capital controls (Anderson, 2005).

In India, the distinction between remittance flows and capital movements is particularly blurred. India has historically been the hub of the so-called “hawala” market for informal financial flows between the sub-continent and the Persian Gulf. This market has been associated with smuggling, tax evasion, and illegal gold transactions (even allegedly the financing of terrorism, making this market a major focus for control of

money laundering). But this market also serves legitimate cross-border payments needs of individuals efficiently, cheaply, and swiftly. India's ambivalence on the need for effective capital controls is exemplified by the numerous exemptions made for NRIs, a very broadly defined category of foreigners of Indian ethnic origin who are granted privileged access to Indian financial and physical assets as compared to other overseas natural persons.

KAC is not an unambiguous concept in the literature, and the concepts of capital account convertibility and currency convertibility are sometime intertwined and conflated. Bhalla (1999) follows the definition of the TC report, which defines KAC as "the freedom to convert local financial assets into foreign assets and vice-versa at market determined rate of exchange" (Reserve Bank of India, 1997, p. 339). India too has relaxed inflows of FDI and portfolio flows by foreign institutional investors but outflows by residents have been more strictly controlled. In fact, some feel that liberalization of inflows is almost complete (Bhalla, 1999). However, there remains a marked difference in treatment by type of entity. Differential restrictions are applied to residents vs. nonresidents and to individuals vs. corporates and financial institutions (Reddy, 2002). Nonresident corporates now have almost complete FDI access other than limits on FDI related to the financial and infrastructure sectors, and to retail trade.

Nonresident corporates and individuals are required to channel their portfolio investments through registered FIIs. FIIs are allowed to invest in Indian stocks and Indian corporates and are allowed to raise funds abroad through depositary receipts. They are also allowed to list in selected overseas stock exchanges. Domestic corporates require approval for ECB, equity issues, and overseas acquisitions, but these regulatory approvals are generally liberally provided. The regime for nonresident individuals discriminates between NRIs and other nonresidents. While NRIs are allowed direct access to onshore bank accounts, shares, and real estate, other nonresidents face restrictions in undertaking such investments. Following the budget announcements of 2002–03, NRI accounts have been made fully convertible. Transactions involving NRIs and Indian joint ventures abroad have been made more liberal for investment in fully convertible countries subject to specific limits.

While inflows have thus been liberalized for domestic and foreign corporates and for nonresident individuals of Indian origin on the outflow side, India continues to maintain a restrictive regime for capital outflows on individual accounts for domestic residents; such relaxations as have occurred are discretionary and easily reversed. With the recent marked improvement in external sector conditions, particularly the surge in foreign exchange

reserves, cautious moves have been made in small steps to permit overseas bank accounts and portfolio investments by individuals. Most recently, some provisions have also been made to allow controlled outflows by Indian corporates. Companies can now offer all forms of guarantees subject to an overseas investment cap of 200 percent of their net worth, corporates can disinvest their stakes in wholly owned subsidiaries and joint ventures without RBI approval, and proprietary concerns can set up joint ventures and subsidiaries abroad without prior RBI approval.

The consolidated fiscal deficit position of the central and state governments has improved relatively little. Combined total net domestic public debt is around 76 percent of GDP. It is often noted that India's fiscal and debt indicators now are worse than many other emerging markets that have suffered crisis, and comparable to levels at the time of India's 1991 crisis (Ahluwalia, 2001a). Kletzer argues that the maintenance of capital controls has been critical to preventing the fiscal position from leading to crisis: "Capital controls are instrumental to financial repression in India in that they separate domestic financial intermediation from international financial markets and capture domestic savings for the financing of the public sector budget deficit" (Kletzer, 2004, p. 256).

Greater integration would increase pressure for fiscal reform, which would be growth enhancing in the long run. Empirical studies have shown that, if capital account liberalization were to be exogenously imposed, *ceteris paribus*, the government's budget deficit would be reduced by 2.275 percent of GDP (Kim, 2001). The disciplinary effect was also found to be stronger in the 1990s. With the Fiscal Responsibility and Budget Management (FRBM) Act, 2002 (in effect as of July 2005), the central government is bound to bring in fiscal discipline. Capital account liberalization will only add to the urgency with which such measures are implemented.

India has been faced with huge capital inflows since 2000. Like other Asian economies, India has chosen to accumulate foreign exchange reserves, rather than allow its nominal exchange rate to appreciate. In addition, India has chosen to sterilize the domestic counterpart of this intervention. On the whole, India's management of its exchange rate and its domestic monetary affairs has been well regarded, although the wedge between domestic and international monetary conditions has only been possible because of capital controls. One of India's successes has been to lengthen the maturity of its (relatively low) external debt. This may be difficult to maintain with convertibility. India's trade liberalization still has some way to go. Greater volatility in nominal and real exchange rates would make this harder to sell politically. The increased competitiveness of the corporate sector, however, and a large and diversified economy, are

positives. Given its competitive private sector, India stands to reap substantial benefits from the more efficient resource allocation that would likely flow under a liberalized capital account.

Conclusion

International financial integration offers significant economic gains for countries, but it also carries the possibility of crises. The history of international financial market growth and economic development suggests that financial crises cannot be avoided, just as India's domestic financial liberalization has been punctuated by politically painful but economically salutary scams. Many officials and some researchers fear that premature liberalization of the capital account could be so damaging as to jeopardize the whole reform effort. In our view, this is too risk-averse a position to take. The banking system has demonstrated stability and strength over recent years. Similarly, an open capital account would supplement the transparency provided by the FRBM Act to get on with promised fiscal adjustment. The strength of the international and domestic economies and India's strong reserves position are other propitious factors. Monetary and financial integration sooner or later must accompany the real integration that is under way (and desired) in South Asia and East Asia and would facilitate India's desire to develop as a regional financial center. Many less sophisticated economies have had open capital accounts for a long time; others, in Southern Europe, for example, moved to integration with Europe even before the euro. It is interesting that Mr. Tarapore has been called upon once again, in 2006, to examine the case for full convertibility. Given the progress that India's financial system has made, and the natural caution of our bureaucracy, it is unlikely that India will do anything reckless.

Appendix I

The Tarapore Committee (TC) recommended that India achieve the following benchmarks as preconditions for capital account convertibility.

1. Consolidate public finances to achieve a sustainable position (defined as a deficit of the central government of 3.5 percent of GDP or less, accompanied by a reduction in the deficit of the states and the quasi-fiscal deficit). The fiscal deficit in 2005–06 is 4.1 percent of GDP.

2. Reduce inflation, to 3–5 percent annually. Average inflation for last three years (2003–04 is 5.5 percent; 2004–05 is 6.5 percent; 2005–06 is 4.4 percent).
3. Strengthen the financial system, including by:
 - a. taking steps to reduce the net nonperforming asset ratio to 5 percent in 1999–2000; achieved 5.2 percent in 2004–05.
 - b. reducing the cash reserve requirement to 3 percent over the same period.
 - c. leveling the playing field between banks and nonbanks.
 - d. harmonizing the cash reserve requirement on domestic liabilities with those on overseas and nonresident liabilities (with a possibly higher cash reserve requirement on nonresident liabilities including overseas borrowing by banks).
 - e. improving risk management by financial institutions (marking to market, monitoring currency and maturity mismatches, internal control systems, accounting and disclosure, capital adequacy to cover market risk, and training in best practices techniques with the adoption of corresponding technology).
 - f. improving prudential supervision (effective off-site surveillance, more stringent capital adequacy norms than the Basel minimums, tighter income recognition, and asset clarification norms).
 - g. increasing the autonomy of public sector banks and financial institutions to deal with increased competition from foreign banks and the growing private sector.
 - h. strengthening legal framework for loan recovery and execution of collateral to deter default.
4. Establish a monitoring band for real exchange rate developments (+/–5 percent around an estimate of a neutral real exchange rate).
5. Adopt macroeconomic policies consistent with a current account deficit that can be sustainability covered by normal capital inflows and, consistent with this, trade and external financing policies that would allow the debt service ratio to decline. The current account surplus (+)/deficit (–) positions for the last three years are as follows (percentage of GDP):

2003–04	2.3 percent (surplus)
2004–05	0.8 percent (deficit)
2005–06 (April–December)	1.7 percent (deficit)
6. Maintain adequate foreign exchange reserves (at least six months of imports) and legally required reserves to currency ratio of at least 40 percent.

Appendix II

Types of Capital Transactions Possibly Subject to Control

	Restrictions on Inflow	Restrictions on Outflow
Controls on capital market instruments	Purchase locally by nonresidents Sale or issue abroad by residents Purchase locally by nonresidents Sale or issue abroad by residents	Sale or issue locally by nonresidents Purchase abroad by residents Sale or issue locally by nonresidents Purchase abroad by residents
Controls on money market instruments	Purchase locally by nonresidents Sale or issue abroad by residents	Sale or issue locally by nonresidents Purchase abroad by residents
Controls on collective investment securities	Purchase locally by nonresidents Sale or issue abroad by residents	Sale or issue locally by nonresidents Purchase abroad by residents
Controls on derivatives and other instruments	Purchase locally by nonresidents Sale or issue abroad by residents	Sale or issue locally by nonresidents Purchase abroad by residents
Controls on credit operations	To residents from nonresidents To residents from nonresidents To residents from nonresidents	By residents to nonresidents By residents to nonresidents By residents to nonresidents
Controls on direct investment	Inward direct investment	Outward direct investment Controls on liquidation of direct investment
Controls on real estate transactions	Purchase locally by nonresidents	Purchase abroad by residents Sale locally by nonresidents

Appendix II (concluded)

	Restrictions on Inflow	Restrictions on Outflow
Controls on personal capital movements	Loans Gifts, endowments, inheritances and legacies Settlements of debts abroad by immigrants; transfer of assets	By residents to nonresidents By residents to nonresidents Transfer abroad by emigrants
Provisions specific to banks and other credit institutions	Borrowing abroad	Maintenance of accounts abroad Lending to nonresidents
Provisions specific to institutional investors	None	Limits (maximum) on securities issued by nonresidents and on portfolio invested abroad Limits (maximum) on portfolio invested locally

Source: IMF (1999, Table 5).

Appendix III

Indices of Exchange Controls, 1996

	Exchange and Capital Controls (ECI)	Current Payment and Transfers (CCI)	Capital Controls (KCI)
Netherlands	0.03	0.05	0.01
Norway	0.03	0.01	0.05
United Kingdom	0.05	0.03	0.07
Denmark	0.05	0.02	0.07
Germany	0.05	0.04	0.07
New Zealand	0.05	0.02	0.01
Greece	0.06	0.06	0.06
Canada	0.07	0.09	0.06
Italy	0.08	0.10	0.06
Spain	0.08	0.04	0.11
United States	0.09	0.05	0.13
France	0.10	0.04	0.16
Latvia	0.10	0.10	0.10
Kenya	0.11	0.05	0.17
Uruguay	0.11	0.09	0.13
Argentina	0.11	0.03	0.19
Australia	0.12	0.04	0.20
Saudi Arabia	0.12	0.03	0.21
Japan	0.12	0.09	0.16
Czech Republic	0.19	0.04	0.33
Mexico	0.21	0.05	0.36
Egypt	0.21	0.12	0.30
Turkey	0.26	0.16	0.36
Philippines	0.32	0.16	0.47
Hungary	0.33	0.10	0.57
Indonesia	0.34	0.18	0.50
Israel	0.35	0.16	0.54
Thailand	0.40	0.17	0.63
Poland	0.40	0.12	0.69
Korea	0.40	0.10	0.70
South Africa	0.43	0.29	0.56
Brazil	0.46	0.31	0.60
Pakistan	0.48	0.31	0.66
Morocco	0.49	0.27	0.72
Tunisia	0.51	0.21	0.81
China	0.53	0.33	0.73
India	0.55	0.22	0.87
Chile	0.56	0.22	0.89
Côte d'Ivoire	0.58	0.34	0.82
Russia	0.59	0.27	0.91
Kazakhstan	0.62	0.30	0.95
<i>Summary statistics</i>			
Mean	0.39	0.26	0.13
Standard Deviation	0.30	0.20	0.10
Minimum	0.01	0.03	0.01
Maximum	0.62	0.34	0.95

Source: IMF (1999).

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