DEGREES OF INCONVERTIBILITY

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Ashok V Desai[1]

The liberalization of foreign trade is well advanced. In the 1992 budget, the finance minister brought down the maximum tariff to 150 per cent. In the trade policy announced a month later, the minister of commerce abolished import licensing of industrial inputs and capital equipment. In the subsequent years, the maximum tariff was brought down progressively to 20 per cent, rapidly at first and more gradually later. Import licensing was largely abolished in 2002. Today, consumer goods and agricultural goods are subject to heavy import duties; and imports of narcotic drugs, military goods and duty-free inputs for exports continue to be licensed. But except for these restrictions, trade has been largely freed.

In contrast, the liberalization of external payments has been less advanced. Although payments restrictions have been considerably liberalized in the past 15 years, the structure of exchange control is more or less what it has been for almost seven decades – from the outbreak of World War II onwards. This relative stasis has not been a deliberate policy, for the central government has declared its intention to liberalize the capital account a number of times.

This relative lack of progress can be traced to the fact that the central government has given control over the balance of payments to the Reserve Bank of India (RBI), which has moved with caution. This paper seeks to explore the reasons for that caution, and the policy options that are available in light of it.

The paper begins with by describing the origin and structure of exchange control, and then goes on to an examination of three official documents that have addressed the issue: the reports of the first and second Tarapore committees (RBI 1997, RBI 2006) and the report of the Percy Mistry Committee (MoF 2007). In the third section, it deals with the difference in the approach of the Tarapore Committees and of the Percy Mistry Committee. It then goes on establish a connection between various degrees of liberalization and the domestic policy reforms they require. In conclusion, it proposes a course of policy action that might break the present deadlock.

I Origin of exchange control

There were no restrictions on the acquisition and use of foreign exchange until the outbreak of World War II in 1939. Then, exchange control was introduced in India as part of an exchange allocation mechanism encompassing the entire British Empire. Once the war began, Britain's import requirements ballooned, while the war on the sea restricted the scope, increased the risks and limited the shipping available for foreign trade. The only major source for supplies that remained outside the war was the United States. Hence US dollars had to be rationed out for war requirements. After 1941, when it entered the War, the US government instituted a programme called Lend Lease. In theory, the US lent money to the British government for buying war supplies from itself; the volume of the loans was so huge, however, that it could not be expected that Britain

[1] Consultant Editor, *Business World,* Express Building, 2nd floor, Bahadurshah Zafar Marg, New Delhi 110 002. E-mail: ashok.desai@gmail.com.

would be able to repay them after the war. So it was aid in effect. When it instituted Lend Lease, the US insisted that Britain set up a mechanism to ensure that the US dollars it lent were used only for essential wartime supplies. So exchange control was initially set up as a mechanism for rationing US dollars. The US dollars were pooled for the entire British Empire and allocated centrally for the conduct of the war.

Just as Britain ran a balance of payments deficit with the US during the war, it ran one with India as well which it did not settle with immediate payments. The debt it accumulated was termed sterling balances. These too were so large that when India became independent in 1947, Britain refused to allow them to be spent freely. It entered into an agreement with India on periodic releases from the sterling balances, which had to be allocated between uses. Hence after independence, India extended exchange control to ration sterling as well as US dollar – in effect, all foreign receipts and payments (Desai 1970).

II Principles of exchange control

Exchange control was based on the principle that the state had a monopoly of possession and ownership of foreign exchange. It decreed that no one – neither individuals nor institutions – could keep foreign exchange in excess a certain limit; for individuals, the limit in the 1990s was $2000. If they received any foreign exchange, they had to sell it to a money-changer or an authorized dealer (AD) licensed by Reserve Bank, within three months. A money-changer could not stock foreign exchange; he had to sell whatever foreign exchange he received to an AD.

ADs, which consisted of banks, could hold inventories of foreign exchange and open accounts for or with foreign dealers. The stocks they were allowed to hold were related to the volume of their foreign exchange business; the excess had to be sold. It could be sold to another AD, or to Reserve Bank. Reserve Bank bought only US dollars, and only in tranches of US$500,000 or its multiples. Because of the limits on the inventories they could hold, any surplus foreign exchange accumulating amongst ADs had to be passed on to Reserve Bank. Thus Reserve Bank pegged the Rupee to the US dollar and let other exchange rates be determined in transactions between authorized dealers and through them, by foreign exchange markets. A resident who had to make a transaction in foreign exchange could be certain about its rupee value only if it was in US dollars. This gave residents a powerful incentive to transact in US dollars.

If a resident wanted to make a payment in foreign exchange, he had to ask an AD to make on his account. He could not get possession of foreign exchange except in limited circumstances that will be shortly described; the payment was made for him by the AD. For common transactions, such as imports, Reserve Bank laid down a drill to be followed by ADs to ensure that the foreign exchange was spent for an authorized purpose. The authorization came from the central government in one form or another. For instance, for imports, the commerce ministry issued licences. Foreign investment was approved by the central government as part of its industrial licensing mechanism; it implied approval to remit dividends and interest. Anyone who wanted foreign exchange for these purposes had to submit the relevant central government approval to Reserve Bank. For transactions that did not fall in one of the categories of government-approved transactions, the AD took an application from the resident and sent it to Reserve Bank for approval.

Thus every payment in foreign exchange either fell in one of the categories allowed or was expressly sanctioned by Reserve Bank. The exceptions under which a resident could hold possession of foreign exchange were three. First, he could get some for travel; how much, depended on the category of traveler – whether businessman, student or other – he fell into and the ration laid down per day or per year by Reserve Bank. Second, reputed exporters were allowed to have foreign exchange accounts to be used only to receive export proceeds and pay for imports. Third, if a business firm was given permission to set up a branch or subsidiary abroad, it was allowed ipso facto to open accounts abroad.

Foreign exchange transactions exposed residents to risk. They were not allowed to hedge these risks, but ADs were allowed to offer residents forward cover, options and swaps on foreign exchange, commodities and gold. These derivatives could only back transactions of residents entered into for other purposes, such as trade and investment; residents could not take "speculative" positions not backed by underlying transactions. ADs, on the other hand, were not allowed to sell the derivatives on their own, and no markets in the derivatives were allowed to operate or develop within India. ADs were required to back up the derivatives by parallel transactions on foreign markets or with foreign banks. In other words, they acted as commission agents to put through futures transactions on foreign markets on behalf of their customers. They could also hedge their own exposure on foreign markets, but again, they could not take speculative positions.

III Central government's reforms

Originally, when all expenditure of foreign exchange needed the central government's approval, exchange control was just an instrument of compliance: it ensured that payments accorded with what had been approved by the centre. For instance, Reserve Bank required a copy of an import licence before it allowed imports to be paid for; before it allowed dividends to be remitted to foreign investors, it required a copy of the centre's approval for the foreign investment.

In the liberalization from 1991 onwards, the central government abolished the need to take its permission for an increasing number of categories of foreign exchange expenditure. The principal steps in liberalization were the following:

1. In the Foreign Exchange Regulation Act, 1973, the government had allowed foreign direct investment up to 40 per cent in Indian companies without its prior approval. This relaxation was meaningless since any project that involved such investment would have to get an industrial licence, which also acted as a licence for the foreign investment. In 1991, however, the government abolished industrial licensing except in a few industries; and it began to increase the 40 per cent exemption limit selectively in various industries. Hence many firms could now take in foreign direct investment without seeking government permission.
2. In its 1992 import policy, the ministry of commerce abolished import licensing of raw materials and capital goods; in 2002, this exemption was extended to all goods except some whose imports were restricted on the grounds of health or defence.
3. On 14 September 1992, the government allowed what it called foreign portfolio investment in Indian companies through the stock markets. Portfolio investment was defined as holding of less than 5 per cent of a company's equity capital;

portfolio investors did not have voting rights. Individuals were not allowed to invest; only foreign investment institutions (FIIs) registered with a regulator abroad. They had to get themselves registered with SEBI. They could invest on behalf of their clients; they had to have at least 50 clients, and none must hold more than 5 per cent of the investment. Initially, total portfolio investment of 20 per cent was allowed. This proportion was raised to 24 per cent in 2001, and the boards of individual companies could raise their own limits to 30 per cent. This discretionary limit was raised later to 49 per cent, and to the maximum allowed for foreign direct investment for the industry in which the company operated. As a result, there are companies today with over 70 per cent of their equity in the hands of so-called portfolio investors who have no voting rights. Foreign portfolio investment regulations have led to the eclipse of outside shareholders and the dominance of promoter in a large number of companies; the only reason for their controllers to provide good management is the need to keep portfolio investors happy.

4. In 1995, the government relinquished control on the setting up of subsidiaries and joint ventures abroad by Indian companies.

Although these activities involving expenditure of foreign exchange were freed of central government's control, they could not be freed of exchange control, for exchange control cannot be partial. If some transactions are freed of exchange control and others kept subject to it, there will be an incentive for a resident to divert foreign exchange illegally from an uncontrolled to a controlled use. So whenever the central government abolished a certain control, it simultaneously issued a general instruction that anyone who was thereby exempted had to approach Reserve Bank for permission; in effect, it transferred the controls from itself to Reserve Bank.

This progressive transfer of power had considerable potential for misuse; it could give rise to corruption, speed payments and informal deals between the controller and the controlled – all phenomena that were in evidence in the operation of central controls. To prevent such malpractices, Reserve Bank tried in every case to lay down clear, transparent criteria under which every expenditure would be approved, promised a decision within a certain period – usually 21 days – and refused to have any direct dealings with an applicant; it required applicants to approach it only through an AD or by letter. These practices were by and large effective; there were no complaints of corruption or misgovernment. But no controls that involved foreign exchange were abolished.

The central government has been aware of this; central ministers have often wished to extend the liberalization to Reserve Bank as well. In his budget speech in 1997, P Chidambaram said that capital account convertibility was a 'cherished goal'. Soon after he returned to the finance ministry in 2004, he appointed a committee to work on making Bombay an international finance centre – no doubt in the realization that it could not become such without full capital account convertibility. In March 2006, the Prime Minister gave a speech in Reserve Bank in which he called for progress towards capital account convertibility.

IV The first Tarapore Committee

In response to P Chidambaram's 1997 budget speech, Reserve Bank appointed a committee under the chairmanship of S Tarapore, one of its retired officials, on capital account convertibility (RBI 1997). This committee will be referred to as the first Tarapore committee, or FTC.

The FTC began with a map of the existing exchange controls. It distinguished between residents and nonresidents. Within these broad categories It distinguished between corporates, banks, nonbank financial corporations (NBFCs) and individuals, and separately considered restrictions on financial products and markets. Further subcategories were distinguished within some of the categories; for instance, there were special provisions for project exporters and other exporters within corporates. For each category of subjects, exchange control distinguished between the purposes for which they may want foreign exchange. Release of foreign exchange for certain purposes was banned. But for most purposes, financial limits and conditions for release were set. The large number of combinations of categories, purposes, limits and conditions accounted for the extreme complexity of exchange control regulations. The FTC did not propose any radical relaxation or simplification. It primarily advocated greater freedom for businesses in retaining their exchange earnings and in investing abroad; and for Indian banks in their operations abroad. It suggested that regulation of foreign investment in Indian equities should be left to SEBI. It wanted Reserve Bank to develop markets for government securities and for interest and currency futures. The important relaxations suggested by the FTC were as follows:

Corporates: Equity issues to resident investors denominated in foreign currencies (though it is difficult to see why there would any demand for such issues), issue of gross depository receipts or American depository receipts (both are nonvoting shares) to nonresidents, and opening of offices abroad should not require prior permission. Annual expenses on such offices should be free of control up to an upper limit. Direct equity investment in companies abroad should be allowed automatically up to $50 million and by special permission beyond. Borrowings from abroad should be allowed as long as they did not exceed US$ 250,000 and interest on them did not exceed LIBOR. Foreign currency bond issues should be rationed within an annual ceiling. Exporters should be allowed to keep their entire earnings in foreign exchange accounts in India and use them for permitted current and capital expenditures.

Foreign investment inflows: Sale and purchase of equity by foreign investors – both portfolio investment, and direct investment within the maximum equity shares defined by the central government – should not require permission.

Banks: Indian banks operating outside India should be allowed to provide banking services to Indian subsidiaries and joint ventures abroad, finance foreign importers of Indian goods, take deposits from foreigners that could only be repaid in Rupees, and invest in foreign money markets, security markets and mutual funds subject to limits based on their capital and as long as they did not take speculative positions. Foreign banks should be allowed to keep deposits in and take overdrafts from Indian banks within limits.

Indian mutual funds: They should be allowed to invest abroad within a limit of US$500 million to be rationed out between them.

Foreign portfolio investors: As long as they were registered with Securities and Exchange Board of India (SEBI,the capital market regulator), they should not require permission to buy and sell equity, or to buy equity in new issues up to 15 per cent of the issue. They should be allowed to invest in debt instruments within an overall limit. Regulation of investment by foreign individuals in Indian securities should be left to SEBI.

Resident individuals: They should be allowed to open accounts with banks in India which are denominated in foreign currencies but can be operated only in Rupees. They should be allowed to pay interest as long as it was less than LIBOR on loans from relatives abroad. They should be allowed to open accounts abroad and invest abroad up to US$25,000 a year.

Markets: Interest and currency futures markets should be developed. All those entitled to make spot foreign exchange transactions should be allowed to hedge them in futures markets. All banks and financial institutions should be allowed to deal in the money market subject to uniform reserve requirements and prudential norms. Reserve Bank should create a market for treasury bills by giving two-way quotes, and development a market for government bonds by licensing more primary dealers, give them access to credit, and licensing mutual funds that would sell the bonds to individuals.

V Action on the first Tarapore Committee

While The FTC was deliberating, the finance ministry began to work on the repeal of the Foreign Exchange Regulation Act (FERA), 1973. However, the FTC's report made it clear that Reserve Bank could not countenance repeal: that it would only accept a replacement of complete prohibition of capital transactions by their conditional approval. The finance ministry no longer wanted to be involved in such detailed approvals. So Reserve Bank drafted a replacement called Foreign Exchange Management Act (FEMA) which Parliament passed in 1999. It made two principal changes in FERA. First, it turned infringement of foreign exchange regulations from a criminal to a civil act, and punishment for their infringement from a prison sentence to a fine; imprisonment could follow only if the charged person did not pay the fine. Second, it devolved the administration of the act to Reserve Bank.

Following its enactment, Reserve Bank issued 30 regulations in 2000 specifying the conditions and limits for various foreign exchange transactions. These underwent frequent small changes in the ensuing years. The net outcome was reviewed by a second Tarapore Committee appointed in 2006 (RBI 2006); we shall refer to it as STC. It compared the recommendations of the FTC with the subsequent relaxation of capital controls by Reserve Bank. In general, Reserve Bank implemented fully only the recommendations on Indian mutual funds and foreign portfolio investors. Here we summarize the action it took in various areas.

Corporates*:* Reserve Bank implemented the FTC's recommendations allowing earners of foreign exchange to keep accounts in foreign exchange. It also followed the FTC on borrowings from abroad, but introduced restrictions on what the money so raised could be used for. It ignored the FTC's recommendations on allowing Indian companies to access foreign capital without going abroad; presumably it felt that the permission given to foreign institutions to invest through the Indian stock markets was enough. But it allowed both partnerships and companies to invest abroad up to twice their net worth. It allowed firms to open offices abroad without any restrictions, but restricted the expenditure on them that could be remitted from India to 5 per cent of domestic sales.

Foreign investment inflows: Reserve Bank did not have to be active in this area. The government divided control of foreign inward investment between Foreign Investment Promotion Board for direct investment and Securities and Exchange Bureau of India for portfolio investment; only the residual cases, of which there must have been few, went to Reserve Bank.

Banks: were allowed to invest in money and security markets abroad, but their banking business abroad continued to be subject to Reserve Bank's control. This control also extended to their taking deposits from or giving overdrafts to foreign banks.

Resident individuals: As recommended by the FTC, Reserve Bank allowed resident individuals to remit up to US$25,000 abroad for any purpose. But it restricted domestic accounts in foreign currency to nonresident Indians and Indians returning from abroad after a stay of more than one year.

Markets: The FTC's recommendations on markets were ignored. No new markets emerged. Reserve Bank did not extend access to existing markets, so while their volumes increased, they remained confined to ADs.

As these changes show, Reserve Bank considerably relaxed restrictions on Indian businesses and banks doing business abroad; and it made it easier for individuals to travel abroad. But within the country, it confined foreign exchange to banks and entities that possessed or earned foreign exchange; it prevented foreign currencies to spread to or be used by the rest of the country. And it prevented currency and related interest markets from emerging within the country; those who needed them had to use markets abroad, and had to do so through ADs.

Reserve Bank's partial implementation of the FTC in the eight years after it reported was consistent with the "graduated" approach envisaged by the committee. In the view of both, the attainment of capital account convertibility was to be spread out over a number of years. The FTC laid out a number of preconditions. Reserve Bank would review them periodically, and depending on the progress made towards their fulfillment, would decide on the degree of relaxation.

VI Tarapore on macroeconomic requirements

Apart from the preconditions discussed above on the financial sector, the FTC specified three macroeconomic conditions to be met before adopting full capital account convertibility.

1. The gross fiscal deficit of the government should be brought down and kept down. The FTC specified a modest reduction from 4.5 per cent in 1997-98 to 3.5 per cent of GDP two years later. It did not consider the states, whose deficit was much larger; nor did it set any goals for the centre's and the states' total debt. (In the event, the government went on a spending spree, and the fiscal deficit target was not reached till 2006-07.)
2. Interest rates should be freed of controls, and Reserve Bank should be given the mandate to use them to keep inflation in lower single digits – that is, in the 1-5 per cent range.

3. Banks' bad debts should be brought down from 13.7 per cent in March 1997 to 5 per cent in 1999-2000. As they came down, the cash reserve ratio should be brought down from 9.3 per cent in April 1997 to 3 per cent in 1999-2000. The FTC was much concerned about the management of government banks and their readiness to face competition. So it made many recommendations on imposing uniform prudential norms and risk management practices on both banks and nonbanks.

On reviewing these conditions in 2006, the STC realized that it had been naïve in recommending an immediate reduction in the fiscal deficit. The government had liabilities that were not reflected in the budget; it was necessary to think in terms of the public sector borrowing requirement. A reduction in the deficit would not be sustained if interest payments went up later; the target had to be set in terms of a lower total public debt. And the debt had to encompass the liabilities of both the centre and the states.

In banking, it felt that there was a need for more fundamental structural changes. If government banks, which accounted for three-quarters of the business, were to be able to expand, the central government had to infuse more equity into them as they grew or reduce its share of equity; the STC was against the government's practice of issuing bonds to them in lieu of equity. There were too many banks – it counted 85. Many would not be able to withstand competition and needed to be merged. Reserve Bank had promised to give licences to foreign banks after April 2009, but had given none to Indian private banks after a few it gave out in the early 1990s. Those private banks that had been licensed then were well run on the whole; more licences needed to be given, especially to stronger Indian business groups.

As regards inflation and interest rates, the STC reiterated that Reserve Bank should be given autonomy, and proposed that the powers be vested in a monetary policy committee; it appeared to be in favour of the British model, which entails a committee consisting of Bank of England representatives and outside experts. However, it did not specify what an independent monetary policy meant. The major reason for Reserve Bank's lack of autonomy is not that the finance ministry exercises control over it, but that Reserve Bank is the manager of the public debt. As such it has taken on the duty of finding a market for the debt of the centre as well as the states, and if funding their borrowing requirements at low interest rates.

VII An alternative view

While Reserve Bank progressed on its gradualist path, the UPA government came to power in Delhi in May 2004. P Chidambaram became finance minister, and Rakesh Mohan finance secretary. They decided to appoint a committee on how to make Bombay an international finance centre. Since no one in India had the necessary experience, they decided that the committee should be headed by Percy Mistry, a London financial consultant. Reserve Bank, which was wedded to the Tarapore strategy of gradual liberalization, was cold towards the idea, if not hostile. Yet, if the report was to have acceptability in India, it had to have representatives from the Indian financial sector, and especially from government-owned banks. Hence the constitution of the committee posed delicate problems. Rakesh Mohan left the finance ministry after five months to join

Reserve Bank as deputy governor. As a result, it was almost two years before the committee was finally appointed, and March 2007 before it submitted its report.

Although the STC had submitted its report in July 2006, the Mistry Committee referred to it only briefly, and only to say that capital account convertibility should be achieved within 18-24 months, must faster than the STC envisaged. It listed 13 regulatory requirements of an international financial centre, and rated existing IFCs against them. London scored 9, other IFCs 6-8, and Bombay 3. Thus it singled out financial regulation as the crucial hurdle to capital account convertibility. It raised two issues: confusion of Reserve Bank's roles, and Reserve Bank's style of regulation.

Reserve Bank has traditionally been both the manager of government debt and regulator of banks. The borrowing requirements of the centre and the states have grown so much since independence that the only way the debt could be sold was by compelling banks to buy it; Reserve Bank did this was by imposing the statutory liquidity ratio (SLR) on banks and making them invest a certain proportion of their deposits in government bonds. After 1993, the central government stopped resorting to the SLR, since it has a captive market in pension funds and insurance companies. It expected SLR investments to be made entirely in state government bonds. But in the late 1990s, when Reserve Bank forced banks to bring down their bad debts, they came to prefer riskless government loans and began on their own to invest more in government debt than they were required to. Thus, banks remained the largest financiers of government deficits.

In the Mistry Committee's view, Reserve Bank's role as debt manager was in conflict with its role as maker of financial policy. As debt manager, it tried to minimize the cost of government borrowing. At the same time, the government fixed a high floor for some of its borrowing rates – for instance, on small savings, and on pension funds' investment in government debt. The government's and Reserve Bank's need to influence interest rates made them control financial markets and prevented their development and diversification. The Mistry Committee wanted the government to eliminate this need by bringing down its borrowing requirements, and selling its debt to new buyers. A market for government bonds should be developed which would voluntarily absorb debt issues, and Reserve Bank should cease to force banks to buy government debt. Here the Committee endorsed the Tarapore Committee's recommendations, that the public debt should be properly estimated so as to include the states' and public enterprises' debts and pension liabilities, its ratio to GDP should be brought down to 50-65 per cent, if necessary by selling off some government assets, and the gross fiscal deficit should be brought down to 4-5 per cent of GDP.

The government's borrowing requirements could be reduced by using private-public partnerships for infrastructure investment, where the private sector brought in the funds as well as the management expertise, and the state only funded the viability gap – the difference between the actual cost and the level of cost that would make the project attractive to the private sector. New demand for government debt should be created by opening investment in debt to everyone, and in particular to international investors; the debt would continue to be denominated in Rupees, and foreign investors would bear the exchange risk. There would nevertheless be a sizeable demand from them because they would wish to hold a certain proportion of their assets in Indian debt as part of a balanced portfolio.

The Mistry Committee wanted Reserve Bank to be divested of debt management, but that does not mean that it wanted Reserve Bank to concentrate on bank regulation. It called the style of Indian regulators, which include Reserve Bank but also presumably Securities and Exchange Board of India, Forward Markets Commission and Insurance Regulatory and Development Authority, rule-based regulation. Each of these regulators was created and governed by an enabling act, and each licensed and regulated a designated group of firms distinguished by their product. They developed a corpus of rules their subjects had to follow, policed their subjects' behaviour, and admonished or punished them as necessary.

In the Mistry Committee's view, this division of regulation by financial service had frozen the products of the regulated firms and prevented product innovation. Banks provided only banking services, stockbrokers only stock trading and insurance companies only insurance. The Committee listed 19 different businesses that could be carried on by ten different types of institutions. Of the 190 combinations, 74 were not relevant. Of the remaining 116, 104 were prohibited in India, seven were permitted and five permitted with restrictions. The freedom to provide and combine services was so limited that there was no scope for product innovation. The segmentation also separated and limited the number of firms in the permitted industries, and thereby reduced competition. It also thereby prevented the emergence of new firms and closing down of inefficient firms.

Once Reserve Bank was divested of its role as debt manager, it could concentrate on its role as the authority responsible for monetary stability. The Mistry Committee's conception of this role was also very different from that of the STC. The STC expected Reserve Bank to hold the exchange rate stable within 5 per cent of the real effective exchange rate. In the Mistry Committee's view, capital account convertibility would lead to such large foreign exchange flows that stabilizing the exchange rate would require unrealistically large reserves. Instead, Reserve Bank should do what central banks of countries with convertible currencies do: it should use interest rates to target the rate of inflation – raising them or lowering them as inflation is above or below the target rate.

The Mistry Committee did not say so explicitly, but if product-specific regulation was abandoned, there would be no need for product-specific regulators; in fact, they were counter-productive in the Committee's view. So they must be wound up; there was scope for only one financial regulator, like Britain's Financial Services Authority (FSA), which also confines itself to targeting inflation. The Bank of England no longer regulates any part of the financial industry. Its principal function now, delegated to it by an agreement with the British Treasury, is to control inflation by means of interest rate policy.

The FSA is not a toothless institution. The law gives it considerable powers, especially to impose fines and of bans, both of which it exercises extensively. But instead of setting rules that financial firms must follow, it sets the outcomes they must achieve. It monitors the outcomes through considerable interaction with and intrusion into financial firms. And it employs staff that are comparable with those in financial firms in their training, understanding and emoluments.

Reserve Bank is well aware of the FSA; its governor attends meetings of the International Monetary Fund as well as Commonwealth Central Bank governors where he meets the chief executive of the FSA. Since, however, it cannot reproduce the unitary regulatory structure of the UK, Reserve Bank has instead set up a High-level Coordination Committee on Financial Markets. It brings together all the financial market regulators –

Reserve Bank, Securities Exchange Board of India, Insurance Regulation and Development Authority, Pension Fund Regulatory and Development Authority, together with a representative of the finance ministry. However, each regulator keeps its autonomy, and every one of them is ruled-based. So the simplification of regulation that the FSA achieved cannot happen in India.

VIII Inadequacies of the current regulatory system

The Mistry Committee's case for a reform of the regulatory system can be reinforced by the defects of the present system that have come to the fore in the last two years. The surge in foreign exchange reserves has persuaded Reserve Bank to explore relaxation of capital account controls, but it has been impeded by the difference between domestic and international interest rates. On the other hand, the regulatory style of SEBI has led markets to emerge and develop abroad. Finally, its restrictions on capital issues have prevented portfolio inflows from going into new issues and led to an excessive rise in stock and property prices. That rise has tempted Reserve Bank to restrict capital imports into these sectors.

Holding companies: ICICI was originally a 'development bank'; it gave long-term loans for industrial and infrastructure projects. Banks were not allowed to give such loans; ICICI was entitled to borrow from banks and lend the money for such projects. This business became unviable when, in 1993, Reserve Bank allowed banks to give long-term loans. For diversification, ICICI took a licence and started a bank, which grew rapidly. ICICI had two options at that stage: either to merge the bank into itself, or to merge itself with its bank. The first would have attracted capital gains tax on the capital value of the bank, whereas there would be not tax if the loss-making ICICI, with its modest market value, was taken over by the bank. So the second solution was adopted. In 2002, ICICI Bank set up set up subsidiaries for life insurance, general insurance, asset management and trust management. Reserve Bank's rules limited ICICI Bank's investment in subsidiaries to 20 per cent of its own equity. As their business grew, however, these subsidiaries required more capital, and Reserve Bank 20 per cent limit did not allow ICICI Bank to provide them with enough.

In March, ICICI Bank decided to break this deadlock by adding a layer: ICICI Bank would invest in a holding company called ICICI Holdings, to which its stakes in the various subsidiaries would be transferred. It would then be able to take outside investment in the holding company as well as in the subsidiaries. That would remove the capital bottleneck, and bring ICICI Bank considerable capital gains. Reserve Bank, however, did not approve this plan. It did not like a bank to own non-banking businesses because that would create confusion over which regulator would regulate which business, and it would make it difficult to impose capital adequacy and liquidity requirements. Reserve Bank preferred a structure in which the holding company was not a bank and a bank did not have substantial stakes in non-banking businesses. It did not categorically reject ICICI Bank's plans, but put them in cold storage by issuing a discussion paper (RBI 2007).

P-notes: As mentioned earlier, the government permitted portfolio investment in Indian quoted companies in 1992 and defined limits for investment by a single FII and total FII investment. The task of policing the two limits was given to Reserve Bank; when the total foreign holdings approached 20 per cent (later, 24 per cent or a limit set by the company's board), it would ban further investment.

The limits were soon reached in the scrips of those companies whom FIIs fancied. After that, an FII that wanted to buy into a company had to wait for one of the shareholding FIIs to sell and Reserve Bank to relax its ban on further FII purchases. At that point, the FII that got first to the market could get shares; the rest remained frustrated, intending buyers. The shares were usually sold through one of the bigger FIIs. Apart from buying shares in their clients' names, these intermediary FIIs began to hold shares in their own names and give clients Participatory Notes or P-notes certifying that they were holding those shares for the client. They would take orders from their clients for purchase of shares, inform them when one of their clients wanted to sell shares and arrange a transaction between two clients. The clients naturally preferred this arrangement to having to take a chance on being in the market at the precise moment when an unknown FII was going to sell shares; an increasing number of FIIs began to use the big FIIs' internal markets and avoiding the market in Bombay.

Reserve Bank was in any case hostile to the free flow of portfolio investment, which was an unpredictable element in its management of foreign exchange; it was also suspicious of the FIIs. It believed that they could harbour undesirable investors – for instance, Chinese or Pakistani investors. It became even more suspicious after the government permitted high-net-worth individuals and non-financial companies to invest in February 2000. So in the High-level Coordination Committee on Financial Markets over which it presided, it began to press for restrictions on FIIs. Under its pressure, SEBI stipulated in January 2004 that only entities registered with another regulator could make portfolio investment, and that if they were not registered with SEBI and invested through another FII, it had to know its client (Ministry of Finance 2004).

The FII investment limits made it more convenient to invest through a big FII than directly; SEBI's intrusiveness made it even more desirable, and an increasing proportion of investment was made in the form of P-notes. In March 2004, 14 FIIs were issuing P-notes; the P-notes they had issued came to 20 per cent of assets under custody of all FIIs. By August 2007, 34 FIIs were issuing P-notes, and their P-note issues came to 52 per cent of assets under custody. (SEBI 2007). FIIs were turning increasingly to their own OTC markets, and abandoning the stock exchanges in India.

First, SEBI tried to lure them back to India. It thought that they had moved offshore because the intermediary FIIs offered them investment combinations better suited to their requirements. So on 10 June 2007, SEBI announced that it would allow seven new types of products "as a step intended to progressively encourage markets to move onshore". They were "(1) mini-contracts on equity indices, (2) options with longer life/tenure, (3) volatility index and futures-and-options contracts, (4) options on futures, (5) bond indices and futures-and-options contracts, (6) exchange-traded currency futures and options, and (7) … exchange-traded products to cater to different investment strategies. What it did not realize, however, was that even when traded products were available in India, FIIs often preferred markets abroad. For instance, financial institutions in Singapore, Dubai and Hong Kong operate OTC markets in Rupee non-deliverable futures; their average daily volume of transactions has grown from US$100 million in 2003 to US$750 million in 2007 – which is roughly a quarter of the volume in Bombay (Chakrabarti 2007). So in December, SEBI banned the issue of fresh P-notes. Next, it is likely to persuade National

Stock Exchange to start trading in more complex derivatives. But it has ignored the reason why FIIs moved trading offshore: that it makes it easier for them to live with restrictions on FII investment in Indian companies. These restrictions are likely to keep offshore trading alive; it does not need P-notes to survive.

Hedge funds: The policy-makers' original distinction between direct and portfolio investment related more to their concern over managerial control than to investors' objectives. While direct investment continued to be governed by sectoral limits and the need in many cases to get the approval of the Central government, portfolio investment was so structured as to eliminate any possibility of the investors sharing in the company's management. The government was quite unaware of the fact that there are portfolio investors who trade in control over corporate management, and that portfolio investors in developed countries operate in a rich variety of markets that enable them to slice primary investments into elements varying in risk and reward. Often, where such markets were not available, investment funds created them: funds themselves were internal markets.

As it gained experience, SEBI realized that much investment was made by funds that its regulations kept out of the Indian market. It did not have any rules to do so, but it routinely refused registration to any fund that described itself as a hedge fund. Some escaped its scrutiny and invested through sub-accounts with other FIIs. SEBI estimated their share in FII investment to be 8 per cent of the historical stock of investment, and 5 per cent of its market value in 2004. The total assets of hedge funds were, however, estimated to be US$750 billion in 2003; they had grown at 24 per cent per annum in the previous 15 years. SEBI was tempted by these huge amounts of money, and proposed allowing them in on certain conditions: that 20 per cent of the fund's corpus should have come from funds SEBI considered safe and respectable, and that its investment manager was registered in an advanced country and had three years' experience (SEBI 2004). But the initiative was wasted; SEBI either could not carry Reserve Bank or did not have the courage.

IX Conclusion

The debate on capital account convertibility has gone on for a decade. There has been progress towards it on the scale of Reserve Bank, which conceives of reaching convertibility by many, slow, deliberate steps. But the convertibility that it favours differs from the present state of affairs only by degrees. Outside India, convertibility is defined as absence of controls on international capital transactions – a state in which all transactions are permitted except a predefined list.

This is the kind of capital account convertibility that the Mistry Committee advocated. Its preconditions were far less rigorous than those of Reserve Bank; but even they required reforms far outside the capital account. They involved a complete overhaul of the financial regulatory system. In comparison, the benefits it lists were modest. Its estimate of $13 billion for Indian imports of financial services in 2005 gives an idea of the scope for import substitution. The figure is modest; even the estimate of $48-70 billion for 2012 is not such as to make the dismantling of the present regulatory system attractive. The Committee's case is that India would have an international financial centre which would attract considerably more business. But the quantum of that business is uncertain.

This is one reason why the case made by the Committee has not proved persuasive enough.

The case could be made far more persuasive if the Mistry Committee's ideas about regulatory reform were applied to the domestic economy. They may, for instance, involve delicensing of banking, and allowing anyone to start a moneylending business provided he meets certain standards. It may involve the end of approvals for public share issues; the number of quoted companies may increase vastly, as may the number of stock exchanges, and equity investment may become localized. Once they are deregulated, interest rates may fall, and their dispersion may increase. Principles-based regulation has wide-ranging implications for the financial sector. Working them out would, however, require another paper.

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