Hello, Welcome Students.

We will be discussing the module

Titled, Concept of Convertibility of the

Rupee on Current Account and Capital

Account from the unit titled Balance of

Payments and Foreign Exchange Rates.

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Here's the module outline.

We shall begin with the meaning

of currency convertibility, then

Advantages of currency convertibility

then types of currency convertibility.

Convertibility of the Rupee.

Why India has not adopted full

capital account convertibility,

benefits and risks associated with

full capital account convertibility.

And then we will summarize and conclude.

On completion of this module,

you will be able to comprehend the

concepts of currency convertibility

and convertibility of the rupee.

You will be able to differentiate

between current and capital account

convertibility and understand the pros

and cons of rupee convertibility.

So let's begin by understanding the

concept of currency convertibility.

We all know that foreign trade and

investment involves foreign exchange.

That is,

the process of converting one currency

into another and transferring money

from one country into another.

Foreign exchange market is the

place where foreign currencies or

national currencies are bought

and sold against each other.

Currency convertibility means that

the currency of a country can be

freely converted into foreign exchange

without any restriction at market.

Determined rates of exchange.

Note - at market determines rate of exchange,

that is exchange rate,

which is determined by the forces of

demand and supply of the currency.

If you take the rupee,

the currency convertibility

of the rupee means that the rupee

can be freely converted

Into dollar, Pound, Sterling,

yen,

euro etc. and vice versa at the

rates of exchange determined by the

market forces of demand and supply.

Let's further understand currency

convertibility and look at its advantages.

Under convertibility of a currency

there are authorized dealers of foreign

exchange in the foreign exchange market.

The exporters and others

who received dollars,

pound sterlings etc can go to these dealers,

which are generally banks and

get their dollars exchange for

rupees at the market

determined rates of exchange.

Similarly,

under currency convertibility

importers and others who require

foreign exchange can go to this

Banks dealing in foreign exchange and get

rupees converted into foreign exchange.

Let's now understand the advantages

of currency convertibility.

Rupee convertibility promotes smooth

growth of international trade and

investment and attracts the trading

partners to trade with this country.

having good convertibility.

Currency convertibility

contributes to economic growth.

There is a correlation between

economic growth and currency

convertibility. Countries with stronger

economic growth tend to have more

easily convertible currencies.

And countries with poor convertibility,

they tend to impose restrictions

on currency convertibility because

they have low foreign exchange

reserves on account of low exports.

This deters the countries from

trading with the poor countries

and this further adversely

impacts their economic growth.

Therefore strong.

economic growth and a freely

convertible currency go hand in hand.

Thirdly, currency convertibility

provides automatic correction

mechanism for balance of payments.
Equilibrium. This

self-balancing mechanism, automatically tends to correct

the balance of payment disequilibrium; for instance,

if there is a deficit, the currency

tends to automatically depreciate,

thus, favoring exporters and encouraging

exports and correcting the deficit.

If there is a surplus,

then automatically the

currency tends to appreciate,

favoring the importers,

encouraging imports and reducing the surplus.

Another advantage of currency

convertibility is that.

it indicates good foreign

exchange position of a country,

so, it's an indicator that when a

country has good convertibility,

it also has satisfactory

foreign exchange reserves.

THE TYPES OF CURRENCY CONVERTIBILITY.

Currency convertibility is of two types,

-current account convertibility and

-capital account convertibility.

We know that the balance of

payments has broadly two components,

current account and capital account.

The current account consists of

payments for trade.

In goods and services,

payments for factors,

services such as interest and dividends,

remittances and unilateral payments

such as gifts and aid from one

country to another country.

Capital account consists of short

term and long term financial flows

like foreign direct investment,

foreign portfolio investment such

as foreign institutional investment,

debt flows etc.

What is current account convertibility?

Current account convertibility is

when a currency is convertible for

all current account transactions such

as export of goods and services and

unilateral payments and receipts.

On the other hand,

capital account convertibility refers

to the freedom to convert local

financial assets into foreign

financial assets and vice versa at

market determined rates of exchange.

So what does that mean?

It means that a currency is convertible

on the capital account related to

capital account transactions such as

investment in physical assets by

the citizen of one country into another country,

and other capital account,

transactions.

So, let's look at this further.

Current account convertibility of the

rupee is defined as the freedom to

buy and sell foreign exchange for the

following international transactions.

All payments due in connection

with foreign trade.

Other current business,

including services and normal short

term banking and credit facilities.

So, all the trade in goods and services,

the flows related to that can be

under current account convertibility.

Secondly,

payments as interest on loans and

as net income from other investments.

So, the annual income from foreign

direct investment or other investments.

In the form of interest, profits,

dividends so that is eligible to be

converted under current account.

Thirdly,

payments of moderate amount only

moderate amount of amortization of loans, that means periodic loan payments

of interest and principal over a

period of time or for depreciation

of direct investments and fourthly

moderate remittances for family

living expense.

Capital account convertibility

of the rupee is the freedom of

foreign investors to purchase

Indian financial assets,

including shares, bonds etc and

that of the domestic citizens to

purchase foreign financial assets.

It provides rights for firms

and residents to freely buy

overseas assets such as equity,

bonds, property and acquire

ownership of overseas firms through joint ventures,

subsidiaries, etc.and free repatriation of proceeds by foreign investors.

Let's see the process of

convertibility of the rupee in India.

Following the economic liberalization

policy adopted in 1991 in India,

the government announced

partial convertibility of the

rupee from March 1 1992.

Under the partial convertibility regime,

40% of the current account

transactions were convertible.

In rupee,

at officially determined exchange rate

and the remaining 60% could be converted

at market determined exchange rate.

So India had introduced the partial

convertibility of the rupee on

the current account in 1992.

It adopted full convertibility of the

rupee on current account in 1994.

Full convertibility means no

RBI dictated official rates and

there exist a single

Unified Market determined exchange rate

Regime. While India has not adopted

full capital account convertibility,

we've just noted that India has

adopted full current account

convertibility but has not gone in for

full capital account convertibility.

Now this is because full capital

account convertibility involves the

risk of accelerating the flight of

capital from one country to another, if

things are unfavorable.

For example,

an Indian can sell property here and

take the capital outside in no time.

Full convertibility on capital

account requires certain preconditions

which are not fully met by India.

And India has taken a very cautious

approach and till date has not

adopted full capital account convertibility.

Although many liberalization

measures have been introduced to

encourage foreign capital inflows,

there are a lot of controls and

restrictions on the movement of

capital to and from our country.

Therefore,

India is said to have partial

capital account convertibility.

Now let's look at some of India's

efforts towards full capital

account convertibility.

The Government of India appointed

a committee on Capital Account

convertibility under the chairmanship of SS.

Tarapore in 1997.

The committee’s report pointed

out that certain measures,

like fiscal consolidation

of mandated inflation

target and strengthening of the

financial system are essential

preconditions for full capital

account convertibility in India.

The Committee gave a three year

road map to adopt full capital

account convertibility.

However, there was the East Asian.

Crisis,

which happened in 1997 which

raised alarm bells in India.

RBI constituted a second committee

under the chairmanship again

of SS Tarapore in 2006.

The committee proposed relaxation of

capital controls in a phased manner

based on macroeconomic fundamentals.

This committee laid down three preconditions,

not more than 3% fiscal deficit,

not more than 3%.

current account deficit and

1% nonperforming assets.

None of these conditions existing

in the country and therefore.

India is not ready for full

capital account convertibility.

However,

the countries that adopt full capital

account convertibility can avail

the following benefits including

availability of large funds,

to supplement domestic resources and

thereby promote economic growth.

Improved access to international

financial markets, incentives

for Indians to acquire and hold

internationally diversified portfolio,

Improvement of the financial

system of the country,

Freedom to convert local financial

assets into foreign ones.

And it leads also to a free exchange

of currency at lower rates and an

unrestricted mobility of capital.

However, there are certain risks associated

with full capital account convertibility.

These are speculative activity

which can lead to capital flight

like how has happened in Southeast

Asian countries when they fully

liberalized during 1997-98.

In the absence of capital controls,

it becomes difficult to regulate short term.

also called as hot capital flows,

which can completely destabilize an economy.

It can lead to domestic savings,

leaving the country in the face

of any uncertainty or crisis,

thereby worsening the crisis.

It could result in violent

fluctuations in exchange rate.

which is not good for any country

Based on the Indian situation we

can point to three significant risk

that have to be considered before

adopting full convertibility.

First, the risk of volatile capital flows,

especially short term debt flows that

can completely destabilized an economy.

Second is the risk of outflows

from residents.

Third is the ability of a financial sector

to withstand global financial flows.

All we can say.

As of now,

we do not need capital controls

in India and there's a long way

to go before we can adopt full

capital account convertibility.

To summarize,

after liberal economic reforms

were introduced in 1991,

many significant developments occurred

that impacted the way foreign exchange

transactions were conducted in India.

Exporters and importers were allowed

to exchange foreign currencies

for trade in goods and services,

there was no easy access to Forex

for studying or traveling abroad,

there was relaxation on foreign

business and investments in India,

with some regulations. However,

Indians still require regulatory

approval if they want to invest abroad.

Similarly,

investments by foreigners in certain

sectors are kept at specific percentages,

and so we still have a lot

of controls on capital flows.

So we can conclude by saying that in India,

the rupee is fully convertible on

the current account but partially

convertible on the capital account.

This is all on this topic from me.

You can read further on this.

Thank you and all the best.