Convertibility of Indian Rupee

What is Convertibility?
Rupee convertibility means the system where any amount of rupee can converted into any other currency without any question asked about the purpose for which the foreign exchange is to be used. Though impressionistic reports suggest that the rupee is already convertible in the unofficial markets, this is an fact not the case Free convertibility refers to officially sanctioned market mechanism for currency conversion. Non-convertibility can generally be defined with reference to transaction for which foreign exchange cannot be legally purchased (e.g. import of consumer goods etc), or transactions which are controlled and approved on a case by case basis (like regulated imports etc). A move towards free convertibility implies a reduction in the number / volume of the above types of transaction.

Convertibility is a two-step process- current account and capital account. Current account convertibility refers to freedom in respect of Payments and transfers for current international transactions. In other words, if Indians are allowed to buy only foreign goods and services but restrictions remain on the purchase of assets abroad, it is only current account convertibility. As of now, convertibility of the rupee into foreign currencies is almost wholly free for current account i.e. in case of transactions such as trade, travel and tourism, education abroad etc.

The government introduced a system of Partial Rupee Convertibility (PCR) (Current Account Convertibility) on February 29,1992 as part of the Fiscal Budget for 1992-93. PCR is designed to provide a powerful boost to export as well as to achieve as efficient import substitution. It is designed to reduce the scope for bureaucratic controls, which contribute to delays and inefficiency.

Government liberalized the flow of foreign exchange to include items like amount of foreign currency that can be procured for purpose like travel abroad, studying abroad, engaging the service of foreign consultants etc. What it means that people are...
allowed to have assess to foreign currency for buying a whole range of consumables products and services. These relaxations coincided with the liberalization on the industry and commerce front which is why we have Honda City cars, Mars chocolate and Bacardi in India.

The objective of the entire trade policy reforms go far beyond mere balancing of imports and exports or a favorable balance of trade (BOT). There is growing inter-dependence among technology, Investment and production. Trade Policy, therefore, becomes the spearhead for better technology, greater investment and more efficient production.

To prepare roadmap towards Full Capital Account Convertibility (FCAC), Tarapore Committee was setup at the behest of Prime Minister Dr. Manmohan Singh. In Mumbai, on March 18, 2006, while addressing the audience at the Reserve Bank of India (RBI), he said Given the changes that have taken place over the past two decades, there is a merit in moving towards fuller capital account convertibility within a transparent frame work, I will, therefore, request the Finance Minister and the Reserve Bank to revisit the subject and come out with a roadmap based on current realities.

**Partial Convertibility:**

Considerable evidence has accumulated over the years that for most countries, deregulation of foreign trade transactions must precede deregulation of international capital account flows. For an economy in transition from a controlled to a market based one, international capital movements can be highly destabilizing and disruptive. It is essential that capital flows be regulated under a separate controlled regime during the initial movement towards convertibility. The PCR system introduced to combine the advantage of relatively suitable managed float and the BOP-balancing property of a freely floating rate. This involves creation of two exchange rate channels:

a. A market channel in which the exchange rate is determined by market forces of supply and demand of foreign exchange where access is free for all transactions (other than those specified as not free).

b. An official channel where the exchange rate continues to be determined by RBI on the base of the value of rupee in relation to the basket of currencies and fixed, but access to the market is restricted.

With view to giving effect to the PCR, RBI introduced a system called the Liberalized Exchange Rate Management System (LERMS) effective from 1st March 1992.

Till 1st March 1992 all foreign exchange remitted into India was implicitly handed over to RBI by Authorized Dealers (ADs) and then RBI made a Foreign exchange available for approved purpose. Under new system, the RBIs retention ratio has been reduced from 100% to 40% of all foreign exchange remittances received with effect from 1.3.1992. The ADs apply the official exchange rate in calculating the value of rupees to be paid to the remitter for this 40% and surrender the exchange to the RBI. The remaining 60% of the value of the remittance is purchased by AD at a market-determined exchange rate. ADs, retain this 60% portion for sale to other ADs, authorized broker or buyer of foreign exchange.

**Transactions at official rate:**

The government has notified that payment obligations for the import of the items specified below to the extent authorized by the Ministry of Finance can be made available at the official exchange rate:

1. Import for Government departments needs.
2. Crude Oil.
3. Diesel.
iv. Kerosene.
v. Fertilizer.
vi. Import of Life-saving drugs and equipment.

In respect of imports under advance licenses and imprest licenses and import for replenishment of raw materials for
gem and jewellery exports.

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All transactions relating to official grants and relating to the IMF.

All Other payment transactions for import of goods and services will have to take place exclusively at the market
exchange rate.

The rational for treating certain import items to qualify for official rate of exchange are Two-fold:

- Some of the above types of transaction are in the nature of non-commercial operations of the
  Government, which are relatively inelastic from the Domestic supply/demand perspectives. Thus,
purchase of public goods like departmental non-commercial imports, defence equipments
equipment, space research etc come under this category.

- Some other items covered under the special set of transaction at the official rate have a potentially
  significant cost-push effect on the economy like Crude oil and fertilizers. These are goods whose
domestic demands and supply price elasticities are low and which from a significant input to an
economy.

Full Capital Account Convertibility:

Capital Account convertibility in its entirety would mean that any individual, be it Indian or Foreigner will be allowed to bring in
any amount of foreign currency into the country.

Full convertibility also known as Floating rupee means the removal of all controls on the cross-border movement of capital,
out of India to anywhere else or vice versa.

Capital account convertibility or CAC refers to the freedom to convert local financial assets into foreign financial assets or vice
versa at market-determined rates of interest. If CAC is introduced along with current account convertibility it would mean full
convertibility.

Complete convertibility would mean no restrictions and no questions. In general, restrictions on foreign currency movements
are placed by developing countries which have faced foreign exchange problems in the past is to avoid sudden erosion of their
foreign exchange reserves which are essential to maintain stability of trade balance and stability in their economy. With India’s
Forex reserves increasing steadily, it has slowly and steadily removed restrictions on movement of capital on many counts.
The last few steps as and when they happen will allow an Indian individual to invest in Microsoft or Intel shares that are traded
on NASDAQ or buy a beach resort on Bahamas or sell home or small industry to Mr. James bond and invest the proceeds
abroad without any restrictions.

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