# Y V Reddy: Issues in managing capital account liberalisation

Presentation by Dr Y V Reddy, Deputy Governor of the Reserve Bank of India, at Commonwealth Secretariat - World Bank Conference on Developing Countries and Global Financial Architecture, held in London, on 23 June 2000.

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The objectives of this presentation are:

(i) to suggest the need of some of the developing countries for managing capital account, implying elements of control, regulation and liberalisation as appropriate;

(ii) to emphasise the importance of both international and national context in the management of capital account;

(iii) to outline the contours of control and regulatory framework and the possible use of these in prioritising capital flows while suggesting the dynamic elements needed to enable liberalisation;

(iv) to elaborate the linkages with other external sector policies, while considering the appropriate control and regulatory framework or liberalisation;

(v) to highlight the complementary policies that are necessary while considering liberalisation of capital account.

This presentation is from the perspective of policy making in developing countries, and is drawn mainly from the Indian experience.

**Need**

It is currently well recognised that although global capital flows have a potential for improving efficiency and growth prospects, they can also trigger instability, due to a variety of reasons. The objective of current deliberations on the international financial architecture is to enhance efficiency of such flows while avoiding, to the extent possible, instability, and managing instability if and when it occurs. These issues are assessed essentially from the view point of developing countries, which, as a group has tended to be more vulnerable to instability arising out of capital flows.

Though there are some differences of opinion as to whether liberalisation of capital account would necessarily add to growth prospects of developing countries, there are several developments in regard to international trade in goods and services, international business, technology, cross-border flows of capital, etc. that would necessitate a more active management of capital account, with a view to continuously assessing the costs and benefits of liberalisation vis-à-vis control or regulation.

In the current debate on international financial architecture, there is no settled position on several of the actions being considered. In respect of liberalisation of capital account, however, there appears to be a broad consensus, viz. such a liberalisation is desirable, should be gradual, well-sequenced and undertaken in conjunction with several other measures at micro and macro level. In most cases, the desirability of limiting total external debt, especially short-term is generally advocated.

In other words, there is need for developing countries to choose or prioritise alternative forms of capital flow on the basis of costs and benefits. In choosing the alternative forms, the costs and benefits of a variety of instruments by which each of the forms of flows can be influenced should also be assessed. The need for prudent limits on short-term debt is universally acknowledged in the current debate. The treatment of individual components of the capital account and the pace of liberalisation need to vary. Briefly restated, the components of the capital account needs to be managed by each country taking into account country specific characteristics.

It is also clear that while several initiatives are proposed at the global level, the task of preventing a crisis is essentially a national responsibility though an enabling international environment is sought to be put in place to facilitate action by individual countries. No doubt, in today's globalised world, prevention of crises as well as mitigating the effects require multilateral efforts, but the social consequences of such crises are to be met by the national governments concerned. In this sense, the ultimate responsibility in regard to crisis prevention and management rests primarily on the policy makers of the countries concerned.

The policy makers in developing countries, therefore, have to manage their capital accounts to ensure an orderly process of liberalisation. In this context, management of the capital account involves management of control, regulation and liberalisation. Gradualism in liberalisation implies that the mix between controlled, regulated and liberalised capital transactions keeps changing gradually in favour of the latter. In fact, if the option of re-imposing controls to meet an emergency is contemplated, the management of capital account should always contain control, regulatory and liberalisation options.

In India, capital account liberalisation is treated as a process. The medium-term objective is orderly liberalisation, while the short-run challenges are met by flexible use of the control and regulatory framework In other words, there may be occasions when the pace of liberalisation needs to be temporarily slowed down or halted, though in some rare cases the process has to be reversed, albeit for a short period.

**Context**

Industrial and developing countries do have a common interest in encouraging larger but less volatile global flows. Since the policy-making in developing countries involves gradual liberalisation, the pace and sequencing would also depend on the international context as appropriate to the country. Among the relevant international factors are the following.

Firstly, the state of global arrangements for prevention of crises.

Secondly, the extent, nature, anticipated promptness, and apolitical element in liquidity support from international financial institutions.

Thirdly, the arrangements in international financial architecture for burden-sharing between domestic and global as also between private and public sectors.

Fourthly, the perception of a developing country on the potential for magnification of possible inadequacies in domestic policies by the international financial community.

Similarly, the country-context is important in managing capital account.

Among the relevant aspects are:

First, size and structure of economy, especially the share of external sector.

Second, socio-political orientation to risk-taking or risk-aversion or the societal weights to efficiency vis-à-vis stability.

Third, the potential benefits of liberalisation. For example, in some low-income developing countries, the capital flow may be restricted to official flows, Foreign Direct Investment and trade related flows. The immediate benefits of liberalisation in terms of private flows are, therefore, not evident.

Fourth, the level of development of financial markets and consequently the possible responses of domestic financial institutions to the liberalisation may be such as to indicate relatively more or less efficiency gains, compared to the costs of instability.

Briefly stated, in the absence of effective lender of last resort at the international level, and perceived benefits and cost of liberalisation vis-à-vis regulatory framework and controls on capital flows, a developing country may have to keep choosing from time to time a capital account management regime appropriate to itself.

In India there is a significant opinion in favour of cautious liberalisation, but at the same time there are understandable fears of destabilisation. In India there is perhaps a greater weight attached to stability. This may be in view of the size and structure of the economy and the uncertain comfort level on international official, and private sector response to a crises on an apolitical basis. Thus, the policy in India is to approach liberalisation on capital account cautiously, gradually, in a well-sequenced manner, treating it as a process and responding to domestic monetary and financial sector developments as also the evolving international financial architecture.

**Control and regulatory framework and liberalisation**

The mainstream thinking till the Asian crisis was averse to capital-controls, but in the recent past, such aversion has yielded to a lively debate on the efficacy of such controls, and consequently the framework and operation of such controls. The control-framework can be viewed from different angles. Basically, the control instruments are quantitative or price-based, including price ceilings or floors and possibly a combination of the two. Controls or lack of controls may be based on size of a transaction, purpose, or category of participant. Asymmetrical treatments in regard to applicability and nature of controls are common between inflows and outflows; between outflows associated with inflows (i.e. principal, interest, dividend, profits and sale proceeds) and other outflows; resident and non-residents; and between individuals, corporates, banks and other financial intermediaries. The instruments of control do vary from non-applicability, to total prohibition with intermediate regimes, say of approval on an automatic basis, case-by-case or simply price-based. The control may also differentiate financial instruments by their nature or ratings.

In managing the capital account through control framework, there could be a prioritisation of capital flows - in terms of their desirability or otherwise. Thus, for example, a higher preference could be to Foreign Direct investment and long-term debt compared to portfolio flows and short-term debt.

It must be recognised that the efficacy of control depends, among many other things, on the category of flows or participant. For example, it is less complex to control the inflows from non-residents, since non-residents are keen to have a legal title to their asset. Empirical evidence indicates that the control over outflows from residents is facilitated more by the appropriate tax regime and acceptable exchange rates, than through the control framework.

It is necessary to make a distinction between control framework and regulatory framework. An important component of regulatory framework relates to prudential regulation on banks vis-à-vis the external sector. They may include provisioning requirements for net external positions; limits on open positions, and limits on investments in foreign currency denominated assets. There could also be differentiated tax regimes affecting the maturity pattern. Monetary measures such as reserve requirements have both an external sector and monetary angle. These regulatory instruments are part of the package available for influencing the size and composition of capital flows. Similarly, regulatory restrictions on portfolio investments by a securities regulator would also provide for different degrees of openness from time to time.

While controls may have a potential to be inefficient, there is considerable merit in using the regulatory mechanisms for moderating the ebb and flow in capital movements. The gradual movement towards liberalisation can be operationalised through a change in the mix and rigour of controls or regulatory framework, especially taking into account the tendency towards perceived excess in inflows or outflows.

In regard to the dynamic of control or regulation vis-à-vis liberalisation, it is clear that a workable framework appropriate to each country is necessary. The more important aspect of management of capital account is the flexibility available in the framework to progressively liberalise the capital-account transactions, depending on the domestic and international developments. At the same time, such a flexibility could permit quick responses to changes in magnitudes, direction and composition of flows that may appear to be inappropriate to the circumstances. This flexibility in operations may, for success, warrant complementarity with other policies. Finally, there may be a case for retaining the freedom to re-impose controls or tighten regulations as long as the vulnerability to highly speculative or motivated attack on the currency exists, since market corrections may be more destabilising to the economy. Thus, it may be wise, even in the liberalised framework in capital account to retain an option to impose controls or tighten regulations.

In India, regulatory framework has been used in several combinations to address problems of excessive inflows and pressures towards outflows, during the reform-period, implying short-term movements bi-directionally, i.e. tightening or loosening controls as also regulations, while maintaining medium-term progress in liberalisation. Controls, however, continue to apply mostly to residents.

A qualitative change, however, has been brought about in the legal framework for management of foreign exchange in June 2000 by which the objectives of regulation are redefined as facilitating trade and payments as well as orderly development and maintenance of the foreign exchange market in India. The legal framework envisages both a developmental dimension and orderliness or stability. The legislation provides power to the government to reimpose controls if public interest warrants it.

**Linkages**

It appears that the porous nature of capital controls is minimised if the dangers of capital flows occurring in the guise of current account transactions are avoided. Among the measures adopted in India are the twin requirements, viz. repatriation and surrender of current receipts of the residents (which includes entities) and restricting foreign currency payments only to genuine transactions, and in reasonable amounts. Furthermore, serious distortions in trade policy could make the management of capital account difficult. Thus, liberalisation of the import of gold to officialising inevitable import of gold to satisfy the domestic demand was considered essential to enable liberalisation of capital account in India. Moreover, if there is a commodity-concentration in exports or imports (oil in the case of India), careful monitoring is required to assess the impact and respond, if need be, with changes in management of capital account.

Experience indicates that foreign currency denominated assets within the country and trading of domestic currency outside the country could have destabilising effects on the balance sheets and currencies for reasons essentially external to the domestic economic factors.

The adequacy of forex reserves is yet another important consideration in the management of capital account. First, adequacy has to be viewed not only in terms of trade needs but also other short-term liabilities. Secondly, it is not merely the long-term or short-term debt in terms of *original* maturity that is relevant for reserves, but the *residual* maturity. Thus, in managing the capital account, the maturity profile of debt, including short-term debt becomes important. Thirdly, a trade-related debt which is in the nature of collateralised debt may be less severe on reserve-requirements. Fourthly, any addition to portfolio-flows may warrant comfort through some additions to reserves, which implies that the net contribution to investment in the country through portfolio flows is, in effect, less than what the magnitudes indicate. This is not to deny the indirect effects on competition of enhancing efficiency through portfolio flows. Fifthly, there is usually a cost of maintaining forex reserves and the net cost would depend on the difference between the marginal cost at which the reserves have been built and the marginal return from deployment of reserves. The liquidity management including level of forward liabilities is also relevant. Disclosures of such liabilities, as in India, have proven to be effective. Finally, while the optimal level of reserves is difficult to quantify, attention to level of reserves and their management are critical to overall capital account management, especially to the sentiments prevailing in forex markets. Often, the incremental changes in level of reserves rather than the level seem to be of significance to market perceptions. Further, the market perceptions appear to be more sensitive to downward movement in reserves than upward movements. To the extent that management of capital account tries to influence the size and composition of capital flows impacting on meeting the current account deficit as well as movements in reserves, the adequacy of level of reserves is a relevant factor.

In India the level of forex reserves is so maintained and increased from year to year as to cover adequately not only imports but also the short-term liabilities, especially short-term debt and portfolio investment. Further, the level of reserves also takes into account the operational need to enable the

Reserve Bank to even out the mismatches between supply and demand in forex markets and thus ensure orderly conditions in a less developed market characterised by lumpy demands.

On exchange rate, the possibility of persistent misalignments due to reasons other than domestic factors cannot be ruled out and correction cannot be left entirely to the market. The developing countries do need some armoury to address such issues. It appears almost certain that capital controls would be ineffective if, in popular perception, the exchange rate does not appear to be realistic. In other words, there is considerable merit in the argument that capital controls are not substitutes for an appropriate exchange rate regime even though capital controls facilitate avoidance of excess volatility in the exchange rate that may be caused by destabilising capital flows.

Finally, an integrated view of the state of development of and activities in financial markets is appropriate. The activities in forex markets and its linkages with other markets, especially money-market, debt market, especially government securities market, and equity markets, have to be identified and monitored while managing capital flows. Recognition of linkages, monitoring the developments, and willingness to intervene credibly in any or all of these markets as appropriate may be essential. Perhaps markets should be aware of the broad objectives of such intervention. As each of the financial markets develop and get integrated with others, measures to increasingly liberalised capital account could be considered. Indeed, it is possible to argue that liberalisation of capital account would aid the process of development of financial markets, but this is valid only when some informed judgements are made in respect of each country on the interactions between the management of capital account and the financial markets. In any case, capital control or regulatory framework or liberalisation would be ineffective or unstable in the absence of proper appreciation of such linkages among financial markets.

Above all, irrespective of the extent of liberalisation, official monitoring and surveillance of large international transactions and players would be helpful in effective and credible management of capital account.

In India, during periods of surges in capital inflows or pressures on outflows, operations in the external sector were coordinated with actions by the Reserve Bank in the money and government securities market to ensure stability.

**Complementary policies**

There are several policy areas that have been identified as being critical to the health of global monetary and financial systems in future. Many of them fall within the jurisdiction of the countries concerned. There is certainly an implicit recognition that the net benefits from liberalisation of capital account in respect of any developing country would be enhanced if the complementary policies are followed. Among the more important of these are: first, strengthening the banking system, diversifying financial intermediation through both banks and non-banks, and developing as well as regulating financial markets in a sound manner.

Secondly, the regulatory practices and the coordination between regulators as the national level and among the national level regulators at the international level are also attracting attention.

Thirdly, monitoring the balance sheets of large banks, large corporates and even governments in terms of their growth, quality and vulnerability to shocks is considered important. This monitoring may have to cover stocks and flows, as also foreign currency exposures hedged or otherwise and direct or indirect.

Fourthly, there is a fiscal burden in case there are systemic problems, especially in the banking sector, irrespective of whether banking is in the public or private sector. The health of the banking sector is critical for many reasons, one of them being stability in the external sector.

In India, the complementary policies considered essential have been identified by the *Committee of Capital Account Convertibility* (1997). The Committee observed that while there were benefits of a more open capital account, it could also impose pressures on the financial system. Hence the

Committee indicated certain sign posts or preconditions for a more open capital account and these are: fiscal consolidation, inflation-mandate and strengthening the financial system.

Of particular significance in regard to complementary policies that are relevant to management of capital account are standards and codes being evolved and monitored by several agencies, including in particular IMF, World Bank, BIS, Financial Stability Forum etc. (Dr. S.N. Acharya has made an excellent presentation on this at this Conference).

Each country will no doubt benchmark their existing practices against the international codes and standards, and consider their appropriateness, extent of application, nature of adaptation needed, relative priorities, etc. Several of the actions suggested require tremendous effort in regard to many developing countries and if full compliance is desirable for further liberalisation of capital account, the pace of such liberalisation may not be rapid.

In India, several *Advisory Groups* have commenced a review of the international standards and codes and an assessment insofar as India is concerned; some of these reports are expected to be released for public debate during the next 6 to 9 months.

## Outlook

It is clear that avoiding crises is ultimately a national responsibility. The impact of instability in times of crisis appears at this stage of global environment to be borne largely by the home or domestic public sector rather than the global private sector. Moreover, the burden of such an asymmetrical impact is more painful on developing countries, especially the poorer ones. Hence, in this context, the distinct preference for stability, on the part of some developing countries needs to be appreciated. Such a preference towards stability also argues for managing their capital account regime. Such regimes could have a mix of control, regulatory and liberal elements as appear most appropriate from time to time, to the national authorities who are accountable to the people for possible crises. In such a mix, there is merit in avoiding controls, but taking recourse to regulatory measures, while pursuing the liberalisation objectives.

Within this overall framework, the progress in capital account liberalisation would perhaps depend on several international and domestic factors. Some of them are: first, the progress in global cooperation and understanding on relevant codes and practices to assure financial stability. Secondly, the quality of assurances and support from the international financial community in general and International Financial Institutions in particular, if crises were to occur. Thirdly, the nature of burden-sharing arrangements with private sector in case of crises. Fourth, the progress of institutional and financial market developments in the country concerned.

In India, it is recognised that the pace of liberalisation of the capital account would depend on both domestic factors, especially progress in the financial sector reform and the evolving international financial architecture.