Shyamala Gopinath: Approach to capital account management – shifting contours

Keynote address by Ms Shyamala Gopinath, Deputy Governor of the Reserve Bank of India, at the Annual Conference of the Foreign Exchange Dealers' Association of India (FEDAI), Thimpu, 18 February 2011.

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Thank you for inviting me to this forum once again and that too in these sublime environs. Only in such sublimity could the deeply spiritual concept of "Gross National Happiness" have been crystallised into a national policy mission. The theory of Gross National Happiness (GNH) established by His Majesty the King of Bhutan in 1972, defines Bhutan's development objective as improvement in the happiness and satisfaction of the people rather than growth of Gross National Product (GNP). Included in GNH is a "middle path" approach in which spiritual and material pursuits are balanced. I can only hope that after a deep, long standing relationship with Bhutan over the last several years, we are able to incorporate at least the spirit of this approach in our economic policies.

I have been a inaugural speaker at the FEDAI conferences during past few years, in person or in *absentia* and it is always a challenge to select an appropriate topic in line with the overall theme of the conference. I felt really relieved that the theme for this Conference attempts to capture a broader canvas, revolving around long-run growth cycles. I hope the deliberations enable us to focus more closely on the relationship between the cart and the horse so that foreign exchange flows do support growth.

There are several ways in which capital flows and growth are related. First, growth expectations drive capital flows. In turn, capital flows accelerate growth. If capital flows are well absorbed by the real economy and do not generate macro-economic or financial instabilities, they stay. Such capital flows augment growth over the long-run and may help income levels in developing economies converge towards the income levels in advanced economies. Second, capital is likely to be attracted towards countries with high productivity growth and higher marginal productivity of capital. However, in practice this is found to be not necessarily true. Third, what is generally missed is the fact that it is not just the net capital flows that drive growth, but also the gross capital flows contribute to growth. Gross capital flows contribute immensely to diffusion of technology and international knowledge flows. Fourth growth augmentation can also take place because capital flows enforce macro-economic discipline and force firms to improve governance. However, the impact of capital flows on growth ultimately depends on their being stable and less volatile. Durable capital flows bring durable growth, while non-durable and volatile capital flows not only bring about non-durable growth but also large output losses in cases of currency or banking crisis. This however does not make a case for capital controls as in a globalised world capital account liberalisation is seen as a plus-sum game.

According to IMF's World Economic Outlook (October 2010), private financial flows to EMEs are projected to increase to USD 339.6 billion in 2010 as compared to US 234.8 billion in 2009 accounted for mainly by equity flows. Growth in bank lending, after the rebound since the crisis lows, is expected to slow down. Going further, however, the improved growth scenario in developed markets (DM) and the rising concerns regarding inflation in the EMs has created uncertainty in regard to the quantum of flows to EMEs. Global imbalances, which have been the driver of capital flows over the past several years, are expected to continue.

Given the inherent uncertainties, most of the capital recipient EMEs are going to find it challenging to respond dynamically. If the tide of global flows changes, it may not be easy to change policy gears swiftly though magnitude of impact would depend on the specific macroeconomic situation, particularly the current account position. Over a longer horizon, therefore, it makes sense to have a broad framework for capital account management from a macroprudential perspective.

It is this post-crisis shift in regard to the approach to capital account that I intend to talk about today. Beyond the immediate impact of capital flows on exchange rate dynamics, the procyclicality of such flows and implications for financial stability are being clearly recognised. In this context, the underlining theme that I want to bring out is that irrespective of the stage of liberalisation of capital account, there seems to be an imperative need for a framework for capital account management which gives the policymakers sufficient space and instruments to be able to modulate policy to the different characteristics of capital flows. Not having such a framework only enhances the disruptive impact of sudden capital control measures when they are announced.

Shift in the approach to capital account management

The recent crisis has clearly been a turning point in the world view on capital controls. The issue of regulation of capital flows has slowly but steadily moved to the centrestage from earlier being confined to the periphery of the mainstream policy discourse. The hesitancy of policymakers at the helm in discussing this openly earlier has given way to a welcome openness.

Even the Bretton Woods institutions have revisited their earlier approach on the issue of management of capital flows. There was a time in the nineties that, backed by the intellectual force of the "Washington Consensus", the IMF at one point was considering including liberalization of international capital movements as a central purpose of the Fund. The subsequent crisis in East Asia in 1997, however, halted such moves of the IMF.

It seems to have come full circle now. The experience of many EMEs during the crisis underlined the financial stability implications of volatile capital flows. At the G-20 Seoul Summit in Nov 2010, the Leaders agreed "*to work on financial stability issues that are of particular interest to emerging market and developing economies and called on the FSB, IMF and World Bank to develop and report before the next Summit. These issues include the management of foreign exchange risks by financial institutions corporations and* households..........."

A recent policy note prepared by the IMF Staff[1] puts the issue of cross-border capital flows in perspective. It recognises the destabilising impact of capital floods and droughts particularly on emerging economies, noting that volatile capital flows played a key role in the recent crisis, both in increasing vulnerabilities and in transmitting shocks across borders. Recently a group of more than 250 economists have written an open letter to the US Government, explaining the benign influences of capital controls and stressing the need for the US to dilute the capital control covenants in the U.S. trade and investment treaties. Increasingly many EMEs are beginning to impose capital controls and regulations, both of the traditional kind such as reserve requirements, URR and restrictions on investment in debt including minimum investment period but also more innovative ones such as prudential measures, administrative measures, tax measures and quantitative limits, particularly targeting the derivative positions held by banks. Indeed, many of these derivatives were initially invented to avoid precisely regulations on capital inflows or other types of financial activity.

The key elements of this shift have been the following:

- *Ex-ante* management of capital flows is now accepted as a legitimate instrument of macroeconomic policy and financial stability. Though exchange rate appreciation is still considered the preferred *ex-post* policy option in dealing with inflows,

1 "*The Fund's role regarding cross-border capital flows*", IMF, November, 2010.

intervention is now justified if there is major veering away of the currency from its fundamental value.

- The limitations of individual country-specific measures are being articulated. The IMF policy note seeks to address the issue through development of rules of the game for global capital flows and in fostering multilateral, non-discriminatory, approaches that look to the interest of both the originators and recipients of capital. Is such a framework possible? I am not sure but till then countries impacted by this would need to continue to find their answers.
- It is increasingly being recognised that it is gross flows that determine risk exposures and are therefore important for financial stability. Netting of cross-temporal flows does not capture the real impact of gross capital flows on exchange rate as well as asset price impacts.
- Capital control measures are being designed more innovatively for effectiveness. Derivative transactions are increasingly being specifically targeted and many countries are resorting to enhanced supervision and data reporting to monitor the build up of currency positions in the books of banks.
- The issue of capital flows is getting factored in the macroprudential framework being envisaged for financial institutions globally. Procyclicality of capital flows and of wholesale market funding can engender vulnerabilities. Prudential measures to address asset market volatility such as risk weights, provisioning, LTV ratios, margin requirements and the build up of foreign currency liabilities in the financial system are also considered as legitimate instruments to respond to destabilising capital flows.
- There is greater recognition of the insurance needs of countries. While it was commonly argued before the crisis that many Asian countries were incurring avoidable costs in accumulating large foreign currency reserves, it has been widely noted that countries with large reserves fared relatively well during the crisis. Forex reserves have provided self-insurance during the global liquidity crisis. Those countries that built up precautionary reserve holding were able to avoid large depreciation in the “Panic of 2008” (Obstfeld, Shambaug, and Taylor, 2009).
- The argument for compositional irrelevance of capital flows stands questioned. A recent IMF paper[2] has concluded that the appreciation effect of private flows differs by type of flow. Portfolio investments, which are more volatile, have the highest appreciation effect, followed by FDI and bank loans. Since these flows are potentially related to an increase in productive capacity, the real appreciation associated with FDI and bank loans is barely one-seventh of the real appreciation due to portfolio investments. Private transfers (mainly remittances) are the flows that have the least appreciation effect. This may suggest that remittances are not procyclical.

The cross-country experience of controls on inflows and outflows provides some conjectures for policy purposes. These are summarised below:

- It is evident that while the *controls on capital inflows* have proved somewhat effective in containing pressures on foreign exchange markets, the experiments with *controls on outflows* by the EMEs, particularly in crisis situations did not help in alleviating the exchange market pressures.

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[2] Jean-Louis Combes, Tidiane Kinda, and Patrick Plane: “*Capital Flows, Exchange Rate Flexibility, and the Real Exchange Rate*”, IMF Working Paper, 2011.

- While controls to limit short-term inflows could be helpful in specific circumstances, such restrictions in force for longer-term entail costs. However, temporary uses of controls are more effective and can even improve the financial environment.
- It is important to recognize that neither the use of capital controls is uniform nor the results are identical. In addition, their impact can be subdued by global conditions.
- In case of pressures arising out of capital outflows, the controls in the form of numerous restrictions on the banks' external transactions were not fully effective as they were circumvented in many instances.
- Moreover, the various instruments of controls provided only temporary relief or contained the initial pressures on forex markets when there were internal or external imbalances (*i.e.*, high fiscal deficit, weaknesses in the financial sector, high current account deficit).
- Offshore markets for the domestic currency (*e.g.*, NDF markets) proved to be an important source of speculation and in some instances control measures could not succeed.
- In case of crises countries, the instruments deployed to control outflows were ultimately replaced by the abandonment of exchange rate band/peg in favour of float.

Indian context

The policy approach in India to the issue of capital flows has evolved from the broader objective of maintaining financial and macroeconomic stability and not merely addressing the singular variable of exchange rate. The salient elements of this framework have been:

i. an explicitly stated active capital account management framework, based on the policy stance of encouraging non-debt creating and long-term capital inflows and discouraging debt flows;

ii. having the policy space to use multiple instruments – quantitative limits, price based measures as well as administrative measures, particularly for foreign currency borrowing by corporates;

iii. short term debt permitted only for trade transaction;

iv. avoiding the "original sin" of excessive foreign currency borrowings by domestic entities, particularly the sovereign;

v. prudential regulations to prevent excessive dollarization of balance sheets of financial sector intermediaries, particularly banks;

vi. cautious approach to liability dollarisation by domestic entities and

vii. significant liberalization of permissible avenues for outward investments for domestic entities.

Recent trends

During the past five years, like other Emerging Market Economies (EMEs), India has been experiencing consistently strong capital flows, barring the crisis year of 2008–09. During the crisis year of 2008–09, net capital flows plummeted to USD 6.8 (0.5 per cent of GDP) from USD 106.6 billion (8.7 per cent of GDP) in 2007–08. The net capital flows again surged to USD 53.6 billion (4.1 per cent of GDP) during 2009–10. During the first half of 2010–11 (April–September 2010), the net capital flows were USD 36.7 billion, which was 59.6 per cent higher than the net flows during the same period of the previous year (USD 23.0 billion).

The latest trends in capital flows indicate that the net capital flows during 2010–11 are expected to be higher than in 2009–10. FII investment, ECBs and trade credit dominate capital flows with FIIs flows remaining as the major driver of capital flows during the current year so far. During the period up to February 4, 2011, the net FIIs flows stood at USD 29.6 billion as against USD 22.4 billion during the corresponding period of 2009–10. The ECBs registered during April–December 2010 amounted to USD 15.8 billion as against USD 13.8 billion during April–December 2009.

Table 1- Volatility of Capital (USD Billion)

Items	2006-07	2007-08	2008-09	2009-10	2010-11 (April-Sept.)
FDI (net)	22.8	34.7	37.07	33.1	12.6
FIIs (net)	3.2	20.3	-15.0	29.1	22.3
ECB (net)	16.4	22.6	6.7	3.3	6.3
Trade Credit (net)	6.6	15.9	-1.9	7.6	6.8
Banking Capital (net)	1.9	11.8	-3.2	2.1	0.8
NRI Deposits (net)	4.3	0.3	4.3	2.9	2.2

FCCBs have constituted a significant part of the ECBs raised during the last few years, except for the sudden decline in the immediate aftermath of the crisis.

Table 2 : Issuance of FCCBs (USD million)

Year	**Total FCCBs**	**Total ECB**	**Share of FCCB to total ECBs (in per cent)**
2004-05	470	11,490	8
2005-06	2402	17,175	28
2006-07	5,736	25,352	20
2007-08	5,854	30,959	20
2008-09	27	18,362	1
2009-10	3,274	21,678	15
2010-11*	1,265	15,994	8
	19,028		**100**

However, with focus on capital flows on a net basis, it is often not realized that portfolio flows were US$174 billion a year over last three years on a gross basis, far outstripping FDI flows at US$37 billion a year. In gross terms, over the last five years (2005–06 to 2009–10) FII flows have accounted for 47% of the gross capital inflows to India as against 9% for FDI inflows. This of course has more to do with the nature of these flows with a much larger churn for portfolio capital. High gross flows make economy more susceptible to such reversals and as such we need to continue to maintain adequate buffers.

In the current context, a high CAD has been absorbing much of the capital flows in aggregate terms. The concerns, however, arise on account of the composition of flows coupled with lower order of reserves accretion and faster increase in external liabilities.

The enhanced exposure to external liabilities is reflected in the sharp increase in the ratio of external debt to foreign exchange reserves from 89.1 per cent of GDP in 2008–09 to 99.1 per cent as at end June 2010. Moreover, the ratio of short-term debt to reserves has increased from 17.2 per cent to 21.0 per cent during the same period. Another issue that may come up going forward relates to repayment of FCCBs. The redemption pressures on account of FCCBs would start building up from 2010–11 and peak in the next couple of years till 2012–13.

Table 3: FCCBs redemption profile (as on December 31, 2010)

Year	**FCCBs due for redemption (USD million)**
2010-11	1,169.24
2011-12	3622.7
2012-13	3757.74
2013-14	828.11
2014-15	2451.85
2015-16	482.5
Beyond 2016	699
Total	**13,011.14**

The relaxation of buy-back guidelines and refinancing has helped the corporates to better plan for the impending repayments. The lessons of the crisis will hopefully lead to better management and accounting of such liabilities by the corporates.

As is evident from the accretion to reserves and given the current account deficit, unlike other central banks from emerging markets, RBI has been the least interventionist. India’s foreign exchange reserves (excluding valuation effects) increased by US$ 7.0 billion during the first half of 2010–1. Foreign exchange reserves as on January 14, 2011 stood at US$ 297.4 billion. Though it is recognized that foreign exchange reserves can only be partial antidote to capital flow volatilities, they indeed work as comfort buffers during times of crisis.

Key issues and road ahead

Going forward, the issue in our context is not really about the limited context of capital flows but a more fundamental one of the capital account management architecture which is responsive to the needs of the real economy and maintaining financial stability. The issue of opening up of the capital account fully has become, so to speak, the last frontier in reforming the financial sector. In some quarters, the capital account constraint has come to be perceived as impacting other elements, particularly the development of markets. However, what such arguments fail to recognise is that the macroeconomic framework is an intricately inter-connected model with several cross-impact elements. One can't touch just one element without disturbing some other.

It thus becomes necessary to progress with liberalisation of different elements of the capital account within the overall context. We have been measuring our readiness in terms of certain metrics but these have proved to be contextually variable. The practical approach seems to be to move towards further liberalisation but retain the broad principles of the approach pursued hitherto. In this context, let me touch upon the key issues in regard to major elements:

FDI flows

- FDI contributes to stable growth through transfer, diffusion and spill-over effects and it is considered stable. Except for a few sectors the policy is liberal and investments can be made under the automatic route. There have been some concerns on the declining FDI flows in the recent past though as stated earlier it has little to do with the regulatory framework per se except in certain sectors. The moderation in FDI inflows to India during April–November 2010 has been driven by sectors such as construction, mining and business services. Certain structural factors, if addressed expeditiously, could raise the share of India in the projected FDI flows to EMEs in the near future. According to the IIF, net FDI flows to EMEs are forecast to increase by 11 per cent in 2011.

  In this context, it may need to be recognised that FEMA, in terms of its scope, is concerned only with the transactions, both capital and current account, and not with the economic activity *per se*. FDI policy is not just a capital account issue but is linked to Government's regulatory policies governing specific sectors that are much broader in nature. This too needs to be addressed appropriately.

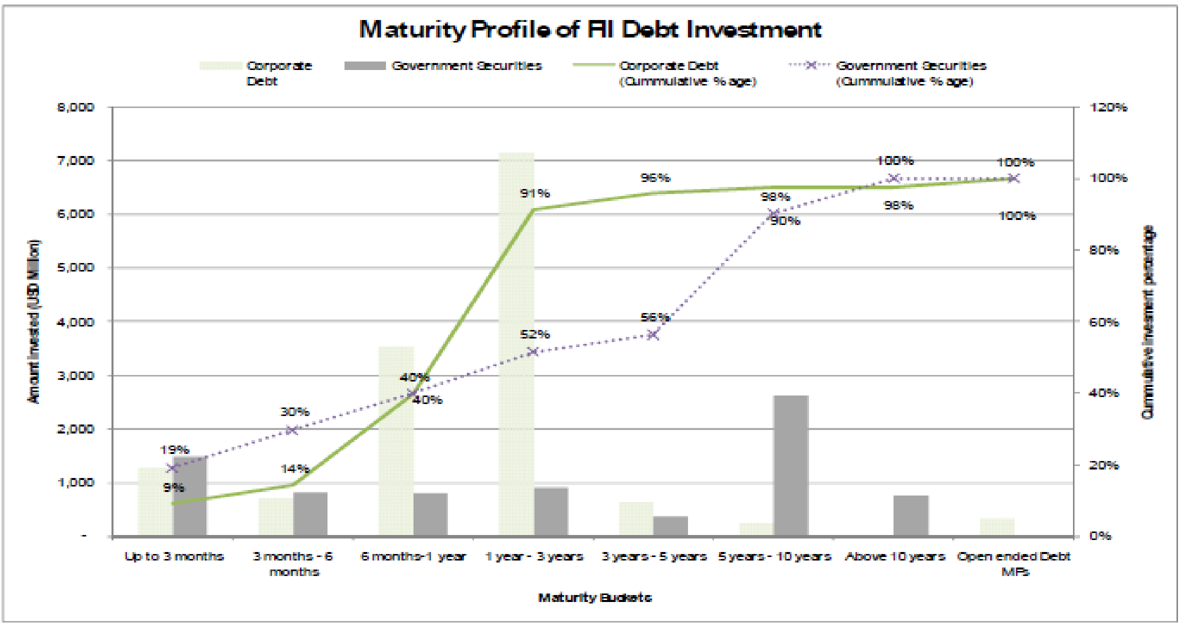
Portfolio flows

- The Report of the Committee on Foreign Investment has recommended introducing a single channel of foreign investments, QFI, for all foreign investors. While the regulations for various channels is well appreciated, the Committee has suggested opening up the QFI route to all foreign investors, including individuals, subject to compliance with KYC requirements. The issue here is not merely access to stock markets but has much larger implications. In effect, it would imply permitting all foreign residents to open accounts in India for their transactions and permitting them access to other market segments for their hedging requirements. The entire gamut of ramifications needs to be thought through carefully as this would result in full capital account convertibility.

Investments in debt

- The recent experience of many countries during the crisis as well as the worsening external sector ratios for India preclude any case for further liberalising the debt

Having a dominant investor class in the short term segment, susceptible to sudden stops and reversals, is clearly a risk from macroeconomic perspective. As illustrated by the chart below, FIIs have demonstrated a clear preference for short term tenors, with 40% each of the investment in government and corporate debt in tenors up to one year.



The time honoured principles that underlie opening up of debt markets to foreign investment are convergence in nominal and real interest rates on sustainable basis, low debt/GDP ratio and low fiscal deficit to GDP ratios on a consistent basis. In case of sovereign borrowing, given the huge market borrowing requirements, there will be increased susceptibility to global market developments and rating changes if there is increased participation of foreign investors. In the recent market turmoil, while the private sector did feel the adverse impact of worsening global credit conditions, the sovereign borrowing program was largely unaffected from direct impact on this count.

Outflows

- The regime for outward flows by individuals, mutual funds as well as corporates, has been significantly liberalised over the years. The most visible manifestation of this policy has been the increasing cross-border acquisitions by Indian companies (Table 2).

Table 4: Outward FDI from India (USD MIO)

Year	Equity	Loan	Guarantee Issued	Total
2007-08	11291.92	2718.88	6959.97	20970.76
2008-09	10730..00	3313.86	3104.87	17148.74
2009-10	6738.85	3627.19	7603.79	17969.83
2010-11 (*till 17.02.2011)*	8445.53	6609.73	25233.16	40288.42

Liberalising outward flows may not be a solution to offset large portfolio inflows as is often recommended. The modus operandi of overseas acquisitions is to undertake acquisitions through SPVs overseas. The funding is often arranged through overseas banks backed either by shares or assets of the target company and/or guarantees by the Indian parent. The actual outflow in the form of equity and loans is therefore not equivalent to the actual value of the deals. Similarly, we have allowed mutual funds to invest unto USD 8 billion overseas; only around USD 1 billion of this limit has been used. Such outflows may potentially take place at inopportune times from a systemic perspective. It this becomes imperative from a financial stability perspective to have some prudential limits in place.

Access to financial markets

- One of the key arguments favouring a more open capital account has been the attendant benefits it brings to the development of domestic markets. It was believed that free capital flows into the financial markets are necessary for efficient allocation of resources and for completion of markets by providing more liquidity. The potency of this argument has at least partly been dented by the crisis which has demonstrated that pursuit of development of financial markets *per se* cannot be an end in itself.
- However, trying to balance all objectives does bring its own challenges for policymaking. It has been argued that in today's financial world of complex derivatives, it is really not possible to have restrictive policies for flow of capital. The significant increase in the NDF volumes involving INR is a case in point. The recent BIS Triennial Survey was pretty revealing in this regard. From a regulatory perspective, the real issue is the impact of this market on the onshore markets.

  Our preliminary estimates have not been able to establish a causal relationship between the NDF and onshore markets but going by the experience of other countries, the NDF market can indeed be a source of vulnerability. It does raise certain issues particularly regarding the nature of operations of banks as well as corporates having cross-border presence which may need to be looked into. Recently, there were reports that Korea has a similar audit of some overseas banks over trading in currency derivatives which are suspected of being "speculative moves".

  It is often suggested that the way to deal with the NDF market is to bring it onshore. In other words allow non-deliverable forwards in the Indian market with free access to all non-residents which have the same impact as full capital account convertibility.

- Another related issue is that of use of Rupee for trade invoicing. It is argued that rupee invoicing may be a preferred option to help domestic exporters and importers to deal with currency volatility. Even now, there are no regulatory restrictions coming in its way. The issues are twofold: first, the acceptability of rupee invoicing to the overseas trade counterparty; and two, the attractiveness of rupee for credit facilities. Acceptability may be increased by devising a mechanism to permit the overseas party to hedge its rupee exposures onshore. The RBI is willing to examine this and I would urge FEDAI to come up with feasible suggestions in this regard.
- The guidelines on CDS will be released shortly. One of the issues is the access to this market for FIIs. RBI is examining the suggestion to allow them to hedge the credit risk in India provided they have invested in the underlying bonds.

Conclusion

The balance of costs and benefits of capital flows for recipient countries has started getting reassessed in the aftermath of the crisis. A similar reassessment happened after the Asian crisis. Many studies have since concluded that the cross-country evidence on the growth benefits of capital-account openness is inconclusive and lacks robustness. The present crisis, however, has led to a shift in the approach to capital account from its narrow exchange rate implications and management of capital flows is now accepted as a legitimate instrument of growth, macroeconomic policy and financial stability. The role of forex reserves in providing insurance is also recognized particularly since countries with large foreign exchange reserves were better positioned to weather the liquidity crisis.

India has now had some experience with the above model of a framework and the way forward seems to be continuing liberalisation within this framework.

To conclude, I would like to flag a few issues from a systemic perspective:

- In an open economy like ours, there is need for greater recognition of currency and interest rate risks and the risk management in banks and corporate firms need to gear up their risk management practices further in this area. It is our experience that a large number of corporates still do not have well-designed risk management policies and practices to take care of volatile exchange rate movements and give scant regard to tail risks. There is also need for greater disclosure and adherence to accounting standards for financial instruments.
- There is also need to more comprehensively qualitatively assess our external liabilities to also encompass liabilities of subsidiaries and branches of Indian financial institutions overseas, not in nominal terms but through a risk-based approach on the probability of recourse to parent bank liquidity support.
- Operations of foreign financial entities in domestic markets also have implications on capital account due to cross border fund flow and derivative positions. During the crisis period, funds were held abroad temporarily to support parent bank liquidity. In India. there are prudential regulations on banks' recourse to overseas funding markets, including for foreign banks. More local funding of local assets reduces systemic risk and helps to curb excessive risk taking and credit growth.

I hope that we will continue to have constructive engagement with FEDAI and I wish the conference all success.