G Padmanabhan: Is India ready for full capital account convertibility?

Address by Mr G Padmanabhan, Executive Director of the Bank of India, at the MSNM Besant Institute of PG Management Studies, Mangalore, 16 May 2015.

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Esteemed members of the Governing council of the MSNM Besant Institute of PG Management Studies, banker friends, faculty and students of the institute, ladies and gentlemen,

1. Thank you for inviting me to speak this evening. I am truly impressed by the rich tradition of this institution and congratulate all those associated with it for rendering yeomen service to the society. This part of the country has always boasted about the educational institutions and is home to some great bankers who have shaped the financial sector history of this country. I feel humbled standing before this august audience.

2. The topic I have chosen for discussion today is capital account convertibility. There is a buzz around this concept in recent weeks. Some section of media has reported on the subject in recent weeks as this being next on the wish list of RBI Governor; whereas all he was doing was to answer a question posed by a student in an educational institution! Today, I shall pose and endeavour to answer the question: Is India ready for full capital account convertibility? As you are aware, the question of capital account convertibility has been a recurrent theme in the discourse on public policy both in the Indian and the global arena for close to two decades with periodic spurts in the zeal and vigour in the debate followed by a lull or even regression on the credo. We, as I stated earlier, stand at a juncture when the debate has gathered some momentum again and the issue has been brought to the front burner with some apparent imminence in attaining the goal. Standing as I do at the end of my long association with the external sector management, I shall try to take an objective and dispassionate view on the issue. I must make it clear upfront that what I say does not necessarily represent the views of the Reserve Bank of India.

Current account convertibility vs capital account convertibility

3. International trade by which we shall mean trade amongst nations in goods, services, and assets (or in popular parlance, capital) has perhaps been as old as human civilisation itself, as would be evident from archaeological finds of Indus valley coins in the Middle East. This trade and interaction down the centuries till industrial revolution was dictated by the compulsions of geography and geology: certain commodities-coveted items of consumption everywhere-were available only in some parts of the world. The idea of trade in goods (and services) across borders even when the commodities concerned could be produced in the economies of both the trading partners as an efficiency and welfare increasing engagement for both, dates back to Adam Smith (the principle of absolute advantage, 1776) and to David Ricardo (the theory of comparative advantage, 1821). There has been extensive research on the theory of international trade during most of the last century and there is now a general consensus among economist that free trade amongst nations improves global welfare. As Gregory Mankiw observes, "Economists are famous for disagreeing with one another, and indeed, seminars in economics departments are known for their vociferous debate. But economists reach near unanimity on some topics, including international trade." Promoting free trade has been a stated global policy priority during the post second world war period. Article VIII; sub-section 2 of the Articles of Agreement of the IMF states that "......no member shall, without the approval of the Fund, impose restrictions on the making of payments and transfers for current international transaction." Similarly, the objectives of WTO include, "to provide a forum for negotiating and monitoring further trade

liberalisation." Though, every now and then, we come across modern mercantilism in objections to imports, these are often driven by political considerations and not based on economic logic. Be that as it may, India accepted the Article VIII obligation as early as in 1994 and has been an active member of the WTO. So the public policy view on free trade in goods and services or current account convertibility is settled.

4. What about capital account convertibility? Capital account of the balance of payments, as you know, comprises a summary of cross border transactions in assets. Assets in the context of international transactions mean investment assets: equity, debt, immovable property or any combination or hybrid of these. Thus capital account convertibility would mean that there is no restriction on conversion of the domestic currency into a foreign currency to enable a resident to acquire any foreign asset or on conversion of a foreign currency to the domestic currency to enable a non-resident to acquire a domestic asset. Assets are diverse. If a foreign company sets up an Indian subsidiary, say, to manufacture automobiles or aircrafts that is also capital account transaction and so is if a hedge fund buys treasury bills to book a profit out of expected movement in interest rates. Similarly capital flows may finance a metro project or fuel a real estate boom. Therefore, capital flows cannot be viewed as a homogeneous phenomenon with identical economic consequences. Capital flows can be conceptually classified into two broad categories. Those that imply long term engagement without any incentive to exit at every provocation – and those that are motivated by disinterested profit – those that buy at every low and sell at every high, as it were. A full capital account convertibility will open the door to both without any discrimination. In this backdrop, is capital account convertibility as much a public policy priority as current account convertibility?

Capital convertibility and Internationalisation of the currency

5. Before I elaborate my views, it is useful to understand the distinction between capital account convertibility and internationalisation of the currency. The relationship between capital account convertibility and currency internationalisation is quite intrinsic but it is important to distinguish between the two. According to Kennen (2009), an international currency is one that is used and held beyond the borders of the issuing country, not merely for transactions with that country's residents, but also, and importantly, for transactions between non-residents. In other words, an international currency is one that is used instead of the national currencies of the parties directly involved in an international transaction, whether the transaction in question involves a purchase of goods, services or financial assets. An international currency has to be capable of playing roles of store of value, medium of exchange and unit of account for both residents and non-residents. More specifically, it can be used for trade and financial transaction invoicing and denomination, official reserves, vehicle currency for foreign exchange intervention and anchor currency for pegging. An international currency has to be essentially a freely convertible currency with the ability to attract significant volumes of international trades across regions by way of invoicing. In addition, the currency has to possess a greater degree of stability in its exchange rate determined by the market forces and a deep and liquid market with availability of wide range of hedging products with easy accessibility to both residents and non-residents. Needless to add, it would also require to be supported by an efficient banking system and world class market infrastructure. Full capital account convertibility and development of offshore centres are other enabling conditions for internationalisation. According to the IMF (2011), economic fundamentals such as the economy's size and trade network, depth and liquidity of capital markets, as well as the stability and convertibility of the currency are important determinants that support currency internationalisation.

Why capital convertibility?

6. Let me now return to the question that I had raised regarding the need for capital account convertibility. While trade liberalisation and current account convertibility were the

central themes of IMF's mandate in 1945, liberalisation of capital account transactions as a policy objective entered public discourse only in the 1990's. There is a reason for it. Throughout the Breton-Woods regime, which was essentially a fixed exchange rate regime, full capital account convertibility was the left out part of the "impossible trinity". It is noteworthy that in his classic paper, Robert Mundell qualifies the assumption of 'extreme degree of mobility of capital' an 'overstatement'. It is also to be noted that most of the western countries, baring a few exceptions, had some form of capital controls which would be wound down only in the early 1970s. It is then that the mainstream economics started discussing the counter-productivity of capital controls. The 1990's saw significant increase in global capital flows, presumably following the triumph of market capitalism, and advocacy of capital account convertibility as a policy goal, particularly for the developing countries, started gaining momentum. In fact, the Interim Committee of the IMF in its meeting in Hong Kong in September 1997, adopted a statement on liberalisation of capital accounts that essentially sought to incorporate unrestricted capital account transactions into the Articles of the IMF. This was after the outbreak of the Asian Crisis; such was the force of the idea of capital account convertibility.

7. Why capital account convertibility was advocated so forcefully?

Let me list some of the benefits envisaged.

a. The most obvious argument is that all developed countries are capital account convertible; hence this is an inevitable destiny of the developing countries in their path to development.

b. Free global capital flows bring about better and more efficient allocation of the global pool of savings to the more productive uses. From the developing country's viewpoint, free access to global capital markets increases available investible resources which augments domestic savings, reduces marginal cost of capital, accelerates investment and growth.

c. According to Stanley Fischer, '....open capital accounts support the multilateral trading systems by broadening the channels through which countries can finance trade and investment."

d. Open capital accounts facilitate portfolio diversification by investors in developed as well as developing countries.

e. Because the feasibility of capital account convertibility rests on sound macroeconomic policy, it creates a sort of commitment for the country concerned to ensure better macroeconomic management, lest it is punished by the investors. As Rudiger Dornbusch puts it, "The capital market fulfils an important supervisory function over economic policy"

Downsides of capital convertibility

8. Unlike current account convertibility, capital account convertibility does not come without a downside. But before we discuss the downside it will be in order to point out that reservations have been expressed about the most important contribution of capital account convertibility, that is, its role in better allocation of global savings. It has been pointed out that often capital movement is guided by considerations such as tax savings which improve the returns to the investor but does not contribute to increased productivity. Secondly, neither open capital account constitute sufficient conditions to ensure capital flows into a country nor do capital flows, in absence of appropriate institutional framework in the receiving country, contribute to growth and welfare. On the other hand, it has been argued that free capital accounts were not necessary for the phenomenal growth recorded by countries in the diverse parts of the world. As Jagdish Bhagwati observes in his celebrated 1998 paper, "After all, China and Japan, different in politics and sociology as well as historical experience, have registered remarkable growth rates. Western Europe's return to prosperity was also

achieved without capital account convertibility.” Elsewhere in the same paper he remarks, “Substantial gains (from capital account convertibility) have been asserted, not demonstrated, and most of the payoff can be obtained by direct equity investment.” (emphasis added), a theme to which I shall return shortly.

9. Let us now look at the specific downsides of full convertibility in the capital account:

a. It is recognised that capital flows are sensitive to macroeconomic conditions. Any deterioration in fiscal conditions, inflation management, balance of payments, or any other macroeconomic shock may cause a cessation or reversal of capital flows

b. Capital flows, inasmuch as they result essentially from trade in financial assets, are prone to volatilities derived from information asymmetries, herd behaviour, panics etc., which may be far divested from the fundamental macroeconomic strengths. I resist the temptation to tangentially sail into a discussion on the vagaries of the financial markets. Suffice to quote Keynes’s famous words: “when capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill done.”

c. As a consequence of impossible trinity, an open capital account demands a complete ‘let go’ of the exchange rate management and volatile capital flows and can therefore lead to extreme volatility in the exchange rate and large departures from its equilibrium value.

Views of Bretton woods institutions

10. It is also important to note the significant shift in the view of Bretton Woods institutions on capital account liberalisation. IMF, which was a strong votary of capital account liberalisation in the pre global financial crisis period, adopted a new institutional view in December 2012 on capital account liberalisation and the management of capital flows. The institutional view recognises that full capital account liberalisation may not be an appropriate goal for all countries at all times, and that under certain circumstances capital flow management measures can have a place in the macroeconomic policy toolkit. It has done much to change the public image of the Fund as a doctrinaire proponent of free capital mobility. The Fund thus now endorses, though in a limited way, the perspective of many emerging and developing countries. The IMF now recognises that capital flows carry risks, and that the liberalisation of capital flows before nations reach a certain threshold of financial and institutional development can accentuate those risks. It also acknowledges that under certain circumstances, cross-border capital flows should be regulated to avoid the worst effects of capital flow surges and sudden stops. It further says that nations that are the source of excessive capital flows should pay more attention to the potentially negative spillover effects of their macroeconomic policies. Finally, the IMF notes that its new view on capital flow management may be at odds with other international commitments, such as in trade and investment treaties that restrict the ability to regulate cross-border finance. The World Bank has also advocated the use of capital control measures as a last resort to help mitigate a financial crisis and stabilise macroeconomic developments.

11. It may be contextual to recall that when the Asian crisis broke out, some economists advocated imposition of temporary capital controls as a policy tool to steer the affected economies out of the crisis. In fact Malaysia did precisely this to check deepening of the crisis with success. However at that time it was considered an unorthodox and anti-market policy prescription. But in September 2008, when Iceland faced a similar crisis, capital controls implemented through stringent exchange control regulations were a key component of the policy package. As pointed out, the use of capital controls in times of currency and banking crisis is now part of the accepted wisdom. It may also be noted that India has been using capital controls to effectively manage the flows. While on the subject, let me point out that imposition of capital controls by one country can have significant negative externality; it

can generate a flight of capital from other similarly situated countries for fear of capital controls there too.

12. Though the debate on capital account convertibility has moderated and its advocacy qualified, it is generally accepted that sooner or later all countries have to be there and the question is when, how and at what pace. Are there preconditions to be created so that the benefits of capital account convertibility outweigh the costs, as Tarapore Committee advocated or should we rush to it in anticipation of the promised land and leave it to the financial markets to discipline economic management into good behaviour? Is the slow progress to capital account convertibility "a case of undesirable procrastination or wisely heeding the precautionary principle" as Arvind Subramanian puts it? This leads me to examine the Indian situation.

India and liberalisation – the approach thus far

13. As you are aware, during the two-and-half decades of the FERA regime, there were severe restrictions on all cross-border transactions. Leave aside capital account, the current account transactions were also subject to stringent exchange control regulations. Following the economic liberalisation process that started in the early nineties, several measured steps were taken to unshackle India's external sector. The first and most important step was to move to a flexible exchange rate regime and allow the hugely overvalued Rupee to float, though somewhat managed down the years – sometimes actively and sometimes passively. The next important step was to declare compliance with Article VIII obligations of the IMF – that there will not be any unreasonable restriction on current account transactions – good half century after the Articles was penned. And the last milestone was putting in place a new statute – the Foreign Exchange Management Act, 1999 that recognised and discriminated between current and capital account transactions, the former unrestricted and the latter subject to regulations. While the overarching framework has not changed during the last 15 years, there have been significant changes in the operating procedure. The process has been mostly in one direction; the capital account transactions have been progressively liberalised without any significant pause or regression.

14. What does the regime for capital account transactions look like today? In drawing a broad-brush picture, I shall follow the familiar taxonomy.

a. There is virtually no restriction on Foreign Direct Investment (FDI). Any foreign individual or firm or any other association of people can invest in any Indian company or set up an Indian company through FDI which essentially means long term engagement with influence on management. There are some restrictions on the extent of entry into select sectors, but that is motivated by social, stability or strategic interests. For instance, restriction on entry into socially sensitive print media sector, strategically important defence sector or bubble prone real estate sector cannot really be faulted on economic logic.

b. There are some operational restrictions on FDI in so far as the universe of instruments of investment is rather narrow comprising mostly equity instruments and that these instruments have to be sold and bought at fair value. The logic is fairly simple. An instrument of FDI should not be a camouflage for debt. In normal times and for traditional industries, these provisions are fine. But of late, we are increasingly being made aware that richer instruments with more structure may be needed for investment in, say, infrastructure sector where cash flows are typical. Similarly, there may be need for some flexibility in valuation in, for example, start-up technology firms. We are seized of the problems and working towards a solution to remove the irritants.

c. In this context I return to Bhagwati's comment I mentioned earlier. If growth and welfare are the ultimate objectives, as they indeed are, FDI is the best instrument to achieve this. The advantages of FDI – better access to technology, management practice, and so on – have been chronicled in detail. The 'Make in India' program is indeed based on this principle. It is true that making in India for the world may not be easy, for that would mean outcompeting the existing incumbents. But making in India for the large and latent domestic demand is surely a possibility – just look at the automobile sector – though it would pose difficult, but manageable problems relating to demand management.

d. It is true that FDI flows have not been as robust as buoyant as we would have wished it to be. But surely, the capital account regulations are not the cause. As you are aware FDI has a nexus with a whole lot of other issues including taxation, domestic investment climate, infrastructural support, ease of business and so on. It can perhaps be said that the productivity gain from addressing these issues will be far more that any liberalisation of capital flows into Indian financial markets.

e. The regime for Foreign Portfolio Investment (FPI) has also been fairly liberal. The two principal areas of FPI are equity and debt. As far as equity is concerned, portfolio investment has virtually unrestricted access. The access to both sovereign and corporate debt is wide enough. There are aggregate limits on FPI in sovereign as well as corporate debt but these limits are progressively increased over time in keeping with the volume of capital flows and macroeconomic conditions. In recent times, we have been adopting a policy of nudging FPI into debt instruments of a certain minimum maturity so that the investment assumes credit risk and does not involve mere interest rate arbitrage.

f. Usually, portfolio investment is viewed as hot money which exhibits volatility. It has been argued that fear of sudden cessations and reversals on account of portfolio flows are highly exaggerated. I am inclined to agree with this observation on two grounds. First, experience shows that though the aggregate portfolio investment at any point of time may have a volatile periphery, it does have a significant stable kernel. Secondly, since the instruments are rupee denominated, any sell-off involves a loss on account of fall in both the price of the instrument as well as the rupee which can be expected to have an equilibrating effect.

g. Now I come to the most critical component of capital flows, viz., foreign currency denominated debt. It is a matter of great comfort that there has not been any sovereign market borrowing in a currency other than rupee. The foreign currency borrowing is mostly by the corporate sector. The inclination to resort to foreign currency borrowing is seductive. Usually, debt is cheaper than equity. Secondly, it is tempting to borrow in a low-interest rate currency and leave the liability un-hedged. The currency crisis in Latin America as well as in the Far East had, in addition to other problems, implosive and indiscriminate foreign currency borrowing at the heart. In the interest of financial stability, it is necessary to monitor and regulate the foreign currency loan liability. The regulatory regime so far has had the following broad components:

    i. Restriction on short term (less than three years) borrowing

    ii. a loosely monitored overall aggregate limit on foreign currency liability,

    iii. a discriminatory regime channelling flow into the priority sectors and disallowing flow into sensitive sectors such as real estate and

    iv. a cap on the overall cost of borrowing, as a tool to address the adverse selection problem,

h. It is true that the ECB regime has evolved in response to the investment needs of the economy as well as that of specific priority sectors and in the process has perhaps become more discretionary than necessary. There is a need to consolidate the regime. The guiding principle ought to be that no socially useful venture goes unfinanced and at the same time ensuring that burgeoning foreign currency debt does not pose stability problems. This is easier said than done.

i. Globally, presumably because of the prolonged soft interest rate conditions in the west, there has been a significant increase in the debt component of the capital structure of the corporate balance sheet. The foreign exchange risk inherent in cross border borrowing raises stability concerns. In India, we have for some time been concerned about the unhedged exposures relating to the external commercial borrowing. There are several disincentives for hedging; cost of hedging, comfort drawn from accounting accommodation, etc. Active volatility management by the Reserve Bank also may contribute to the process. An orthodox solution is to mandate compulsory hedging by all foreign currency borrowers. There are several practical difficulties, though. First, a central authority mandating how an entrepreneur should manage the risk smacks of a regression to the command and control economy. Second, do we have a market that can support hedging by all foreign currency borrowers? Third, hedging is essentially transfer or parcelling of risk. Where are we transferring the risk in this case? To the banks' books? Faulty mechanism design can create perverse incentives and lead to inefficient outcomes. A saner approach would perhaps be to create an atmosphere and incentives for recognition of risk and to make available a wide range of hedging instruments.

j. While on the subject of borrowing, let me mention an important and encouraging development. In economics, the term 'original sin', coined by Barry Eichengreen and others, has been used to describe the inability of countries to borrow abroad in their own currency which lies at the heart of currency crisis and financial fragility. As Krugman points out, :....Beyond that, however, even if a sudden loss of confidence does take place, countries that have their own currencies and borrow in those currencies are simply not vulnerable to the kind of crisis so widely envisaged. Remarkably, nobody seems to have laid out exactly how a Greek-style crisis is supposed to happen in a country like Britain, the United States, or Japan (that borrow in their own currency) – and I don't believe that there is any plausible mechanism for such a crisis." It is heartening therefore that there has been considerable global interest in recent times in Rupee denominated Indian sovereign and more important, corporate debt. A few multilateral agencies have successfully issued Rupee debt in international financial centres last year. There is a need to expand and encourage this development and we are in the process of putting the necessary framework in place. In this connection, it is also important to put in place stable policy for sovereign debt with necessary checks and balances rather than a complete ban or total openness.

k. What I have dealt with so far relate mostly to the corporate sector. As far as Individuals are concerned, I must add the caveat that any liberalisation for individuals has to be guided and circumscribed by the spectre of 'black money'. Even with those limitations, we have progressively increased the limit for capital account transactions for Individuals on a per annum basis and are in consultation with the Government to increase it to USD 250,000 per year per individual. The experience so far has been that most of this is used for permissible current account transactions, presumably because of the ease.

l. The last issue that remains to be discussed is derivatives. Before I discuss the existing regime and its philosophy, it would be necessary to appreciate the nature and dynamics of the currency market. I have dealt with this issue in detail elsewhere. As the literature and experience attest, the downside of capital account convertibility can be summed up in two words: currency crisis. Not only does the currency market ultimately capture the dynamics of cross border asset transactions, it also is treated as an asset with its own dynamics. FEMA mandates the Reserve Bank to maintain orderliness in the currency markets, the society disapproves of heightened volatility and economists warn of its adverse consequences. In this backdrop, our approach has been guided by two-if I can use the word- axioms: Anyone anywhere in the world with an exposure to the Rupee should be able to enter into a derivative transaction to hedge the currency risk, and the transaction should be in the on-shore market. Beyond that, we have been endeavouring to expand the set of derivative transactions. We are not ready yet to allow unfettered trading of the rupee for pure speculation.

Are we ready?

15. Now let me come back to the question I posed at the beginning of my discussion. Are we ready for capital account convertibility? Sometimes I ask myself rhetorically, if a similar question had been asked in 1991 “Are we ready for flexible exchange rate?” what the considered answer would have been? These questions are difficult to answer. In 1991 our hands were forced by many developments. A currency crisis, global acceptance of the free market philosophy and so on. Is capital account convertibility predicated by any such developments or events?

16. As I mentioned earlier, capital flows, first and foremost, are sensitive to macroeconomic policy. Therefore, a freely convertible country must have sound, credible, and time consistent macroeconomic policy. What does that translate to, operationally? Fiscal prudence and low inflation. Where do we stand in respect of these parameters? I wouldn’t think we are very comfortable here. Both fiscal management and inflation have their own logic and dynamics in a large, diverse, developing country like India. How optimal will it be to throttle social expenditure and blow up interest rates just to attain capital account convertibility? The second threat emanating from capital account convertibility is contagion of disturbance in the global financial markets. The brunt of this has to be borne by the domestic financial system. Though tightly regulated, the financial sector, particularly the banking industry is surely not in the pink of heath.

17. Therefore the question of readiness for full convertibility has to be expanded to several related questions: Is capital control retarding investment and growth of the economy? Is any socially useful project unable to proceed beyond the drawing board because the entrepreneur is unable to raise resources either domestically or in offshore markets? What will be the incremental benefit of full convertibility that we are denying ourselves? What are the institutional and infrastructural developments we must have to reap the full benefits of further liberalisation of capital account? There is an enormous literature and a wealth of experience to provide the answer. The answer should be based on economic logic and on evidence and not derived from evangelism or what Bhagwati calls “banner-waving”.

Concluding thoughts

18. To conclude, there is no denying the fact that sound capital controls have hitherto worked well in the Indian case and helped in protecting the economy from the vagaries of international capital flows and in insulating the economy from the contagion effect of various currency crises but the time has probably come to revisit the issue of greater capital account liberalisation. So what should India do or how should it proceed further on this path? The first obvious question has to be why does India need capital account convertibility when empirical evidence regarding its impact on growth is mostly negative? The indirect effect, as argued by some researchers, is also not well established. The answer, to my mind, lies in fact that greater opening of capital account is inescapable as the Indian economy grows further and becomes global in dimension. A truly globalised economy, which the Indian economy is likely to become in the not too distant a future, cannot afford to remain isolated for a very long period of time. Sooner than later, it will need to get closely integrated with the rest of the world. While there are risks associated with full capital account convertibility, resisting liberalisation over an extended period may prove futile and counterproductive. As the

economy gets more globalised, it will become harder to maintain closed capital accounts. Increasing openness to international trade may create opportunities for circumvention of capital account restrictions through under-and over invoicing of trade transactions and the increasing sophistication of investors and global financial markets makes it much easier to do so. Transfer pricing is one of the methods which corporates may employ to get around capital account restrictions. In any case, keeping any restriction for too long is self defeating as people end up finding new methods of bypassing that restriction. So, India needs to continue moving towards full capital account convertibility. There is simply no escape from it. It is a moot question as to how fast the movement should be. That will depend on how fast we can meet the most important preconditions like fiscal consolidation, inflation control, low level of NPAs, low and sustainable current account deficit, strengthening of financial markets, prudential supervision of financial institutions, etc. India has already made visible progress on these fronts. There are of course risks, but we need to accept these risks and move forward boldly while controlling the risks as far as practicable. If the experience of developed countries is any pointer, sound policies, robust regulatory framework promoting a strong and efficient financial sector, and effective systems and procedures for controlling capital flows greatly enhance the chances of ensuring that such flows foster sustainable growth and do not lead to disruption and crisis. India has all these in place and we need to keep on strengthening them. As I step aside, I wish all the actors in this story the best of luck.

19. Thank you for your attention.