

Y V Reddy: Management of the capital account in India – some perspectives

Inaugural address by Dr Y V Reddy, Governor of the Reserve Bank of India, at the Annual Conference of the Indian Econometric Society, Hyderabad, 3 January 2008.

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Guest of Honour Respected Professor C. R. Rao, Vice Chancellor Dr. Hasnain, President Professor Radhakrishna, Emeritus Professor Dr. Bhalla and distinguished participants,

I am honoured by the kind invitation to deliver the inaugural address of the Annual Conference of Indian Econometric Society. It is a pleasure to be meeting friends in the profession, more so in my home town, Hyderabad. I have little to add to the themes covered in the papers. I thought that it may be of interest to participants if I present before you some perspectives on a subject that has recently gained prominence in policy circles and also academia, namely management of the capital account in India.

I. Background

I would like to recall that in the invited lecture (on Parameters of Monetary Policy in India) at your annual Conference in Chennai, in January 2002, I made a brief reference to the issue when I said: "while the twin objectives of monetary policy of maintaining price stability and ensuring availability of adequate credit to productive sectors of economy have remained, capital flows and liberalisation of financial markets have increased the potential risks of institutions – thus bringing the issue of financial stability to the fore".

You will recall that we had introduced two innovative measures, namely, the Liquidity Adjustment Facility (LAF) and the Market Stabilisation Scheme (MSS), to manage the challenges of monetary policy in the context of large and volatile capital flows, to assure macro-stability and, in particular, financial stability.

While releasing the India Development Report of the Indira Gandhi Institute of Development Research and speaking on the "Indian Economy – Current Status and Select Issues", (January 2005) I had mentioned "the possible issues that need to be considered if one were to achieve a better management of non-debt components of capital flows that will address emerging concerns."

At the current juncture, there are several compelling circumstances, both global and domestic, that demand a revisiting of the issues, that we discussed earlier, and an elaboration of the emerging concerns in the current context.

II. Global context

Let me first briefly refer to the global context. There are unprecedented developments in global financial markets. There are pressures in money and credit-markets which are sought to be addressed through coordinated actions by several leading central banks to inject liquidity into the overnight as well as term money markets. The impact and outcomes of these recent actions of monetary authorities still appear unclear, for the immediate future on the financial markets and for the longer term on the real economy in terms of growth rate as well as price stability. In the meantime, the equity markets in most economies are buoyant but are far more volatile over longer periods than in the recent past. There is a widespread concern among several central banks in emerging market economies about the added pressures on monetary management due to the prevailing extraordinarily strong and volatile cross-border capital flows. The concerns cut across continents, irrespective of the size of economies, the degree of openness, the monetary arrangements and the exchange rate

arrangements. While the actions arising out of the concerns are varied, they normally involve a combination of monetary policy measures, both direct and indirect, and often involve management of the capital account in several ways without excluding, in some cases, administrative actions. Some countries, recognising the pressures due to large capital inflows, have taken recourse to countervailing policies in current account, mainly through greater recourse to stabilisation funds.

Our Finance Minister stated, while referring to "Managing Capital Flows" in the Mid-Year Review 2007-08, dated December 7, 2007:

"While there are international experiences in this regard with some successful and painful adjustment process, the specific Indian context requires innovative policy responses. Going forward, this would be a major challenge." (Page 57)

III. Mainstream academic thinking

There is extensive academic work on the capital account but, for convenience, I will source a recent comprehensive study on the subject reflecting a discernible fresh thinking among the academics. Professor Barry Eichengreen, who admits to seeing "both sides of this coin" and is a well respected authority on the subject, wrote a paper titled "The Cautious Case for Capital Flows" for Rating Agency Malaysia's conference on "Free Capital Mobility: What's in store for Asia" held in Singapore on August 01, 2007. In this paper, he refers to four schools of thought on free capital flows, and it is instructive for us to consider them in some detail.

The first school is in favour of an open capital account and is based on the text-book case for a more efficient allocation of capital. Professor Eichengreen expresses doubts about this interpretation and argues that recent experience does not suggest that capital is flowing from developed, where it is relatively abundant, to developing countries, where it is scarce. He adds:

"A further problem is that liberalizing equity market flows is not the same as liberalizing all capital flows. Experience shows that investment in equities has more favorable effects than investment in debt but that governments are more inclined to liberalize debt flows."

The second school argues that even if the expectations of the first school are not fulfilled, there are corollary benefits since foreign capital comes packaged with technological and organisational know-how. These benefits may be true of equity and foreign direct investments; but not true of debt finance. Professor Eichengreen adds "More generally, evidence of the corollary benefits of capital account liberalisation is open to alternative interpretations." He says "Moreover, there are reasons to worry that capital account liberalisation adopted with an eye toward forcing reform can have costs as well as benefits."

The third school emphasises the association of capital account liberalisation with crises, and Professor Eichengreen mentions that this view "unites such otherwise diverse minds as Joseph Stiglitz and Jagdish Bhagwati." Based on recent developments, he notes two interpretations on this aspect, namely, (a) that the world is being made safer for capital flows; and (b) the volatility has been temporarily suppressed, warranting a caution to emerging markets. He considers that the recent rise in volatility associated with the sub-prime mortgage problem in the U.S. is open to both interpretations and concludes as follows: "The bottom line is the importance of properly sequencing capital account liberalisation with other policies" and in this context he refers to the "need to open trade before opening to capital flows" and the need for "sound and stable monetary and fiscal policies and the more flexible exchange rate regime appropriate to an environment of open capital markets."

The fourth school of thought refers to the difficulty that Asian countries are having "in managing capital inflows and the problems this has created for their competitiveness." There

is an extensive treatment of strategies adopted so far, including adoption of measures to limit inflows, their impact, and objectives, etc. The most significant comment in this regard relates to the need for fiscal actions and he says:

"Again, the message is that capital account openness is beneficial when it is appropriately teamed with other policies. And the implication is that countries that are unable to use fiscal policy in this way, perhaps for political reasons, should go slow on capital account liberalization."

Summing up, Professor Eichengreen refers to the two challenges, going forward, that the authorities in Asia face in regard to current problem associated with capital flows. The first relates to the upward pressure on currencies as private capital continues flowing into the region. He comments,

"The main tool for countering appreciation of the currency will be fiscal policy, ... If currencies are too strong for comfort, then Asian governments need to raise taxes and cut public spending. This is politically challenging, but it is a necessary corollary of the decision to free capital flows."

The second relates to limiting the risks of instability. On this, he comments,

"If Asian stock and bond markets fall sharply, the negative shock could spread quickly from leveraged investors to the property sector, from there to the banks that have lent to them, and ultimately to the real economy."

To sum up, the first and second schools of thought which were dominant till recently have now been supplemented, or perhaps supplanted, by the third and fourth schools. Further, in the second school, there is recognition of difference now between equity and debt flows in the context of downside risks. The third school focuses on the importance of proper sequencing of liberalisation of capital account with other policies. The fourth school elaborates on issues relating to management of capital account and takes a more nuanced approach to it. In brief, the third and fourth schools that are of more recent origin, and are gaining respectability, are closely aligned with the approach that India has been following.

IV. The current Indian context

The Ministry of Finance placed a review of the trends in receipts and expenditures at the end of second quarter of the financial year 2007-08 on December 7, 2007. In the document, there is exhaustive analysis of several contemporary issues relating to macro-economic environment. The status and issues relating to management of capital account do find a prominent place in the discussion and refers to the challenges for monetary management and the complexities in managing capital flows in the following passages:

"The predominant issue that continues to confront the monetary authority during the current year has been the steady increase of forex flows and the policy response thereto." [Para 3.1.12 (Page 37)]

"The management of capital flows is a complex process encompassing a spectrum of policy choices, which inter alia, include: the appropriate level of reserves; monetary policy objectives related to liquidity management and interest rates and maintenance of healthy financial market conditions with financial stability." [Para 3.1 (Page 56)]

The Eleventh Five-Year Plan (2007-2012) as approved by the National Development Council on December 19, 2007 makes several observations in this regard. Some of these are reproduced here.

"The problem posed by having to manage large inflows has been discussed in Chapter-10. It arises because of the well known "trilemma" that it is not possible to achieve three objectives simultaneously, i.e. free capital

mobility, an independent monetary policy and a stable exchange rate. Attention should be given to measures to restrain these capital flows and enhanced the absorptive capacity in the economy to avoid running into the classical "Dutch Disease" situation where non-tradeables become over-priced and erode the competitiveness of the economy in the tradeable sector." (Para 2.30)

"The cautious approach to opening the capital account followed thus far as a conscious act of policy has given the government some leeway in limiting inflows of certain categories." (Para 2.33)

"These problems illustrate the merit of the cautious approach adopted by the government in the matter of liberating capital inflows. The advantages of accessing pool of capital to finance development are recognised in the commitment to move gradually to fuller capital account convertibility. But the move is to be made gradually at a pace which enables the authorities to deal with unexpected volatility. In controlling capital flows it is important to recognise the relative attractiveness of different types of flows. In this regard direct foreign investment is the most preferred form of flow. Investments in Indian firms through the stock market and by venture capital funds in unlisted companies are also potentially beneficial. External commercial borrowing and other short term flows are areas where one can introduce an element of control to moderate sudden surges. However, even with capital calibration it is not easy to manage a surging capital inflows, if it occurs. In such situations, it is necessary to explore ways of limiting the fiscal cost of sterilising large growth of reserves: either by making these flows less attractive or by means that do not require costly sterilisation." (Para 13.72)

It is noteworthy that there is recognition of the more immediate challenges due to the recently observed financial turbulence in the global markets, necessitating a focus on the domestic factors in the process of growth and stability in our country. The Prime Minister in his opening remarks at the 54th meeting of the National Development Council, on December 19, 2007, *inter-alia* said:

"There are some clouds on global financial markets following the sub-prime lending crisis. There are worries that the growth of the U.S. and other leading economies may slow down and some may even go into a recession. This may impact both our exports as well as capital flows. Our economy is now increasingly integrated into the global economy with the external sector now accounting for almost 40% of GDP and hence, we cannot be fully immune to international developments. This is not to say that one must be pessimistic and must be less ambitious in our growth targets. It only implies that we need to redouble our efforts to maintain the domestic drivers of growth and ensure that policy facilitates even faster growth."

To sum up, the public policy in India recognises that

- (a) appropriate management of capital account is critical for both growth and stability;
- (b) the cautious approach to capital account has given us leeway;
- (c) there are preferences in regard to different types of capital flows;
- (d) some fiscal costs are consciously incurred as necessary on account of sterilisation;
- (e) monetary and exchange rate management are very complex in the context of well-known trilemma, and in the current complex global environment, Indian cannot be immune to global development but we should maintain domestic drivers to growth.

V. Policy perspectives

Admittedly there are several dilemmas, trade-offs and judgments in the process of managing capital account. The intensified pressures due to large and volatile capital flows in an atmosphere of global uncertainties make the task significantly complex and critical. I propose to summarise the possible approaches in this regard, mainly in terms of analysis.

First, a view needs to be taken, though difficult, as to whether the capital flows are of enduring nature or temporary. Prudence demands that, in terms of initial reaction, all large capital inflows are treated as temporary, and if these flows result in excess volatility in the forex markets, some intervention becomes necessary. The judgment about excess volatility will depend not merely on the quantity of the flow, but, to some extent, on the quality in terms of components of the capital flow. While the flows on account of equity, foreign direct investment (FDI) into green field issues may be considered to be of a more permanent nature, flows on account of buy-outs through channels that are only technically FDI may not constitute a stable element. Overall, the portfolio investments could be expected to be less stable than FDI. The market participants' views on what constitutes excess volatility are also critical in this regard.

Second, large and lumpy quantities, even when expected, tend to disturb the markets and hence, there is a need to even-out the impact of such lumpy flows through policy interventions and statements, appropriately managing the expectations in the market.

Third, while interventions are with the objective of containing volatility in the forex market, intervention over a long period, especially when the exchange rate is moving in one direction, could make interventions less effective. However, a critical question is what would be the impact on expectations about future movements in forex markets if no intervention takes place. The challenges of intervention and management of expectations will be particularly daunting when financial contagion occurs, since such events are characterised by suddenness, high speed and large magnitudes of unexpected flows, in either direction. The quintessence for a relevant monetary policy is the speed of adjustment of the policy measures to rapidly changing situations.

Fourth, a related issue is whether there should be sterilised intervention and if so, the timing and quantum of such interventions. There is usually a cost attached to sterilisation operations. At the same time, it is also necessary to assess the indirect cost of not sterilising if there are signs of a "Dutch disease" caused by flows in the capital account. Most often, it is not a question of whether to sterilise or not, but how much to sterilise. That is an important issue of judgment that needs to be made in conjunction with domestic monetary and liquidity conditions.

Fifth issue, relates to the choice and an appropriate mix of instruments for sterilisation. Each instrument, namely, Market Stabilization Scheme (MSS), Liquidity Adjustment Facility (LAF) and Cash Reserve Ratio (CRR), has different features and interactions. Utilisation of each of these will also depend on what is the permanency of the components of the flows and how they should be sterilised in the aggregate. Further, each instrument can be used in different ways. The LAF is able to take care of very short period flows. The MSS handles the longer term flows slightly better than the LAF, and the CRR is more appropriate for addressing fairly longer term flows. However, effectiveness of the MSS will depend more on the initiatives of the market participants than on the decisions of the Reserve Bank. Operationally, the issue is often not "which" instrument but "how much" of each instrument needs to be utilised, with due regard to the capital flows, market conditions, and monetary as well as credit developments.

Sixth, the market interventions for containing volatility in exchange rate and the consequent sterilisation operations may need to be complemented by measures for effective capital account management, as needed. Just as stabilisation funds take care of current account shocks, capital account management and market interventions are justifiable to take care of capital account shocks.

Seventh, the continued focus on financial market development would mitigate the challenge of capital flows, in the medium term. However, it is important to recognise that maturation of financial markets takes time. Hence, the capital flows have to be managed through other tools in the short term, while continuing to work on development of the financial markets. Our preference has been for the time tested and proven “gradual” approach. In brief, the issue is not either financial market development or management of capital account, but how much of each approach should be adopted in a given situation and over time.

Eighth, increase in absorptive capacity of the economy could be another mitigating factor. But, it is not easy to develop absorptive capacity of an economy in the short run and in any case it is very difficult to calibrate the absorptive capacity of an economy to match the volatile capital flows. Further, the level of current account deficit that is considered generally sustainable by global financial markets in respect of emerging market economies is currently lower than the large amounts of capital inflows. Hence, enlargement of absorptive capacity is an appropriate approach, but only up to the limit of sustainable levels and is achievable over the medium term under normal circumstances.

Finally, it is, sometimes, suggested that encouraging outflows would be a good solution to manage surging inflows. Liberalising outflows may not be of great help in the short run because a greater liberalised regime generally attracts more inflows. Hence, while recourse to some encouragement to outflows such as the liberalisation of overseas investment by our corporates in the real sector is helpful, it has to be combined with other measures to manage the flows depending on their intensity.

VI. A pragmatic approach

It should be evident from the description of policy perspectives in managing external sector that it is essentially pragmatic, iterative and evolving. I propose to briefly narrate some of the reasons for what may appear to be a more pragmatic but less clearly defined policy of management of the external sector.

Firstly, international financial markets do not treat Emerging Market Economies (EMEs) like India as full-fledged market economies but only as economies in the process of marketisation. Hence, financial markets respond differently to the same macroeconomic or political development depending on whether it is an EME or an advanced economy. Hence, EMEs have to follow a more pragmatic and contextual policy.

Secondly, the self-correcting mechanisms in markets, particularly the financial markets, are expected to operate smoothly in the absence of capital controls. But, such mechanisms happen to operate more efficiently in advanced economies and far less efficiently in the EMEs. While there is an advantage in developing the financial sector with appropriate self-correcting mechanisms, it is not possible to achieve this in the short term, and is particularly difficult to achieve during highly uncertain global economic conditions. Hence, the extent of or lack of self-correcting mechanisms in an economy should be treated as given, in the short term, and a suitable policy of intervention has to be pursued accordingly.

Thirdly, the real sector flexibilities may be far less in EMEs. For example, opening a business or closing a business in India requires a considerable amount of time. Hence, the real sector responses to exchange rate movements are not likely to be as flexible as in the advanced economies. One has, therefore, to make a judgment on the extent of existence of such flexibility in the real sector. No doubt, the policy makers have to encourage the real sector to change and become more and more flexible to cope with the exchange rate dynamics. At the same time, the pressure for change cannot be to such an extent that the volatile exchange rate movements seriously disrupt the business environment.

Fourthly, there is a problem in differentiating between the flexibility and the volatility in exchange rates, in view of the evolving situation in EMEs. The distinction has to be based on the preparedness of the markets and the market participants. It is necessary to encourage

expectations of greater flexibility and give notice to the market participants about increasing flexibility so that they are prepared, equipped and enabled to adjust to greater flexibility. Over a period, what was volatile yesterday becomes flexible tomorrow. This is the process by which we, in India, have been moving gradually to greater flexibility in exchange rate.

Finally, generalisation on the effectiveness or otherwise of capital control may not be entirely appropriate. The effectiveness of capital account management should be viewed from several angles. Let me mention a few. First – impact on exchange rate expectations. Second – the counterfactual, namely what could have happened without capital controls at a particular juncture? Third – the short term impact versus the long term effectiveness. Fourth – the overall regime of current account management in the country concerned, to thwart capital account transactions in the guise of current account. The regimes governing repatriation and surrender are also relevant here. Fifth – the administrative framework and overall effectiveness of administration in the country, in a given legal and institutional framework. Finally, by all accounts, in terms of both growth and stability, China and India, who do manage capital account rather actively, have performed exceedingly well in all the recent years.

The Committee on Global Financial System and the Bank for International Settlements have constituted a Working Group to report on the issue of capital flows to emerging market economies, in view of their implications for overall financial stability. It is commendable that Dr. Rakesh Mohan, Deputy Governor, Reserve Bank of India has been chosen to head the Working Group. We hope to gain from the deliberations of the Group in evolving our policies to meet the emerging challenges.

VII. Conclusion

In conclusion, I would like to submit that management of capital account has become an important element of public policy in India.

The emerging challenges to the management, both in the short and over the medium-term have been recognised by the policy makers at all levels.

While the immediate focus is on managing the excess capital inflows and some volatility in regard to the excess, I believe that it will be prudent not to exclude the possibility of some change in course, due to any abrupt changes in sentiments or global liquidity conditions, despite strong underlying fundamentals of the Indian economy. Strategic management of capital account would warrant preparedness for all situations, and the challenges for managing the capital account in such unexpected turn of events would normally be quite different.

The Reserve Bank considers it prudent to continue to analyse and monitor different scenarios and possible contingencies so that capital account and monetary management continue to facilitate high growth, while maintaining price and financial stability.

I have great pleasure in inaugurating the annual conference of Indian Econometric Society and I wish you all the best.