

## Capital Account Management: Lessons from the Comparative Analysis

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### A Quote....

- “Regaining (*national*) policy space from the stranglehold of finance is a basic challenge in many middle-income developing countries, where high interest rates and overvalued exchange rates have damaged investment prospects”

- Kozul-Wright and Paul Rayment (2007) in “The Resistible Rise of Market Fundamentalism”, p.307

## One more Quote....

- “Research on (*policy-*) and institutional change must consider the evolving relationship between international market expansion and a social order that is still largely national”

- Max Planck Institute, Germany (2010): “Research Agenda for the Study of Societies”

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## Outline

- Liberalizing the Capital Flows: A Comparison
- How Effective was the Capital Account Management?
- Lessons for Emerging Market Economies
  - What has changed in the financial environment?
  - Lessons *for* emerging economies
  - Lessons *for* advanced economies
- Institutional Embeddedness: A Pre-requisite for Effective Capital Account Management

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## Liberalizing the Capital Flows: A Comparison

	Germany	Japan	India
<b>Period of Liberalization</b> <i>(de jure)</i>	1957 - 1973	1964 – 1980	1991 - Ongoing
<b>Capital Account Management</b> <i>(de facto)</i>	Continued between 1973 and 1984	Continued between 1980 and 1992	Active Management
<b>Liberalization Approach</b>	Initial “Big Bang” (completed in 1959)	Gradual	Gradual
<b>Sequencing</b>	Not a significant Issue	Important	Strong emphasis

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### Effectiveness of the capital account management: Germany Focus on Monetary Stability worked!

- Several restrictions were imposed in the 1960s to discourage speculative and short-term inflows
- Under the Bretton Woods system, Germany tried both exchange rate management as well as monetary management (revalued DM in 1961 and 1969)
- The successive abolition of capital controls after that was accompanied by money-supply targetting in 1974.
  - The new monetary policy orientation was effective in fostering the acceptance of price stability as a primary goal
  - Linkage between goals of independent monetary policy and capital account management was important for Germany
  - The institutional independence of central bank has always got more attention

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## Effectiveness of the capital account management: Japan

### Focus: Exchange Rate and Industrial Policy

- A well-functioning administrative system effectively protected the domestic industry through controls on inward direct investment
- Liberalization of capital/exchange controls (to stabilize the exchange rate) in one area created momentum for further change and met with limited success (Fukao 2003)
  - e.g., real-demand principle lost its effectiveness after 1980 because borrowing, lending and depositing in foreign currency was liberalized at free market rates was liberalized in that year
- The Japanese experience post-Bretton Woods indicates that attempts to shield the domestic financial sector from the impact of liberalization may not have been successful
  - International expansion of Japanese banks in the 1980s was partly in response to the slow removal of domestic controls (Arora 1995)

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## Effectiveness of the capital account management: India

### Focus: Intermediate Regime Policies

- Capital controls gave India's macroeconomic policy an extra degree of freedom and has insulated the country from the Asian crisis and current global financial crisis.
- Controls helped to shift the composition of inflows from debt to non-debt flows and increase loan maturities
- Controls (and other instruments used by RBI) were effective in:
  - keeping exchange rate of rupee mildly undervalued to promote exports;
  - Accumulating foreign exchange reserves in periods of strength;
  - Preventing a collapse of the exchange rate in times of weakness; and
  - Containing the international exposure of Indian banks
- Controls on capital outflows, liberalized later, have not been very effective

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## Lessons from the Experience of Germany, India and Japan:

- What has changed in the global financial environment?:
  - The financial markets have become more complex
  - The financial markets are more integrated
  - The boundaries between short- and long-term financial markets are increasingly being blurred
  - Speculative attacks on financial markets are more frequent and extensive
  - Financially active MNCs move around their idle cash to reap the benefits of arbitrage
  - Improved communication and information flow has made financial markets dynamic and transparent

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## Lessons from the Experience of Germany, India and Japan: Lesson for Emerging Economies

- Relationship to Policy Goals:
  - Capital controls do help in avoiding short-term fluctuations of the exchange rate (Japan)
  - Capital controls do provide for moneuvering the monetary policy (Germany/ India)
  - Capital controls can support the industrial policy though selective FDI (Japan / India)
  - Capital controls help in changing the composition of flows away from debt flows (India)

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## Lessons from the Experience of Germany, India and Japan: Lesson for Emerging Economies

- Links to Financial Stability:
  - Controls on inflows are more effective than controls on outflows, particularly, controls on volatility of short-term inflows (Germany and Japan)
  - A well-developed financial system helps mitigate the effects of volatile capital flows on the real economy (Japan)
  - Prudential supervision of the financial derivatives markets improves risk management (Regulatory Framework for OTC derivatives market in India)

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## Lessons from the Experience of Germany, India and Japan: Lesson for Emerging Economies

- Reference to effectiveness:
  - Capital controls of shorter duration are more effective than long-term controls (Signaling effect)
  - Capital controls more effective if combined with exchange controls (Japan / India)
  - Cooperation of the banking system essential for enforcing capital controls (Authorized foreign exchange banks as vehicle of exchange control management in Japan)
  - Regional cooperation can improve the effectiveness (Germany)

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## Lessons from the Experience of Germany, India and Japan: Lesson for Advanced Economies

- Reference to Reregulation:
  - International banking (foreign currency transactions of residents and local currency transactions of non-residents) activities of banks should be supervised and controlled (e.g., limits on overall exposure, India)
  - Capital account management should be countercyclical (India)

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## Institutional Embeddedness: A Pre-requisite for Effective Capital Account Management

- What is institutional Embeddedness?
  - It refers to the nature of the national institutional system and its role in shaping economic policy and action
  - Four competing and mutually complementary forms of governance define the nature of institutional embeddedness:
    - governance by state control;
    - governance by the market;
    - governance by regulation; and
    - governance by supranational interdependence

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## Institutional Embeddedness and Sequencing

- Importance of carefully sequencing capital account liberalization with other policies associated with the larger process of institutional development.
- Kaminsky and Schmukler (2008, p.25) suggest that discussion about sequencing may be irrelevant if institutional changes are:
  - Not undertaken by the governments independently; or
  - Introduced only in response to certain shocks; or
  - Never predate liberalization; or
  - Happen mostly as a result of the existence of deregulated financial markets

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## Institutional Embeddedness for Effective Capital Account Management: Comparative Analysis

- Germany has had a preference for liberalization *with* institutionalization. Abdelal, 2007 believes that it appears to be a function of ideology and not of power
  - The institutional significance and the role given to German Bundesbank until the creation of ECB!
- The problems in the Japanese experience of liberalization appear to be related to weaker institutional embeddedness.
  - the reluctant/delayed liberalization of the domestic financial system and protection of the domestic institutions
- In the Indian context, RBI and SEBI's position offers an interesting example of embeddedness
  - RBI is not only the custodian of the monetary policy but also supervises banks/other financial institutions, and is the primary regulator of the financial markets.
  - SEBI has the mandate of supervising and regulating the capital markets

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## Conclusions

- The debate on capital controls is not over!!
- Usefulness of capital controls for advanced economies diminished gradually, particularly after the changover to a floating exchange regime
- For developing economies, liberalization process has not been without difficulties
- Liberalization of capital account without institutional embeddedness can be highly damaging
- The present global financial crisis has proved that international finance is still “under-regulated”

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We thank you for  
your attention!

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