Capital Account Liberalization and Management of Capital Flows in India

Mohammad Shuheb Khan (ICRIER New Delhi, India)

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Outline of Presentation

1. **Phases of Capital Account Liberalization in India**
2. **Review of Capital Account Liberalisation in India**
3. **Conclusion**

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1. Phases of Capital Account Liberalization in India

1.1. A Period of External and Internal Disequilibria (July 1991 - September1992)

1.2. Aftermath of Asian Crisis (April-August, 1998)

1.3. Liberalization to Support Growth (March-September, 2001)

1.4. A period of Inflow Surge (May –September, 2007)

1.5. Global Financial Crisis Period (April-October, 2008)

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1. 1. A Period of External and Internal Disequilibria (July 1991 - September1992)

- In 1991 Indian economy experienced a classic external and internal disequilibrium i.e. high fiscal deficit, inflation, rising debt service ratio and deteriorating current account.

- **Intent of The Reform:** As a part of reform process which started in 1991 several policy measures related to capital inflow were announced in order to stabilize the economy.

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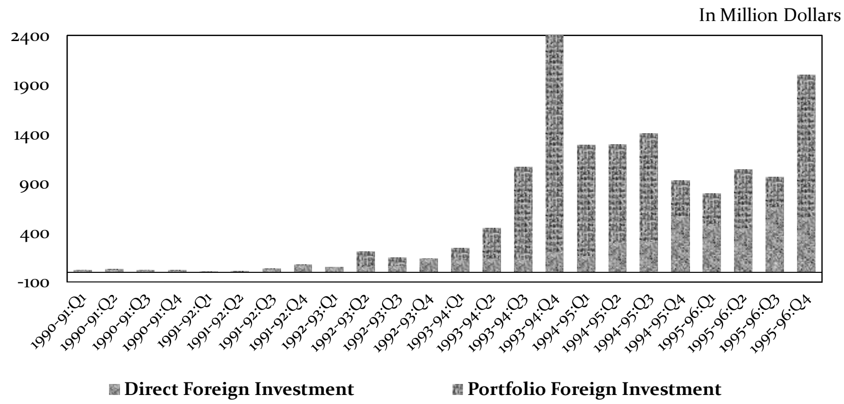
1.1. A Period of External and Internal Disequilibria (July 1991 - September1992)

- **Impact of the Reform:**



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1.2. Aftermath of Asian Crisis (April-August, 1998)

- Effects of East Asian Crisis and economic sanctions following nuclear test reduced the capital inflow in India.
- **Intent of the Reform**: Generate enough capital to finance current account deficit and repayment obligations.
- **Impact of The Reform**: Policy measures were not successful in attracting more capital given the negative sentiments and low sovereign credit rating.
- Anticipating the ineffectiveness of policy measures, government introduced Resurgent India Bonds (RIBs).

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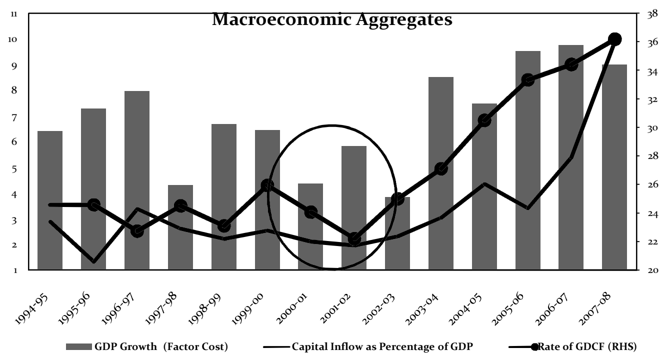
1.3. Liberalization to Support Growth (March-September, 2001)

- While, external sector was in comfortable position, other macroeconomic variables were showing signs of deceleration.



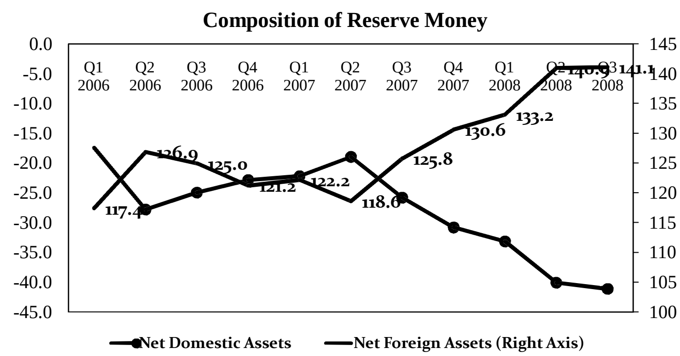
1.3. Liberalization to Support Growth (March-September, 2001)

- **Intent of Reform**: To push the GDP growth by supplementing the domestic resources base with capital inflow.

- **Impact of the Reform:** While, the benefits of foreign capital, in pushing investment and growth are debatable, huge capital inflow coincides with the increased GDP growth and improvement in Gross Domestic Capital Formation (GDCF).

1.4. A period of Inflow Surge (May –September, 2007)

- In 2007-08 economy received $107 billion dollars of net capital inflow against $45 billion in 2006-07 and $ 25 billion in 2005-06.
- To contain the appreciation of Rupee against Dollar, RBI purchased (net) $78 billion from the market.



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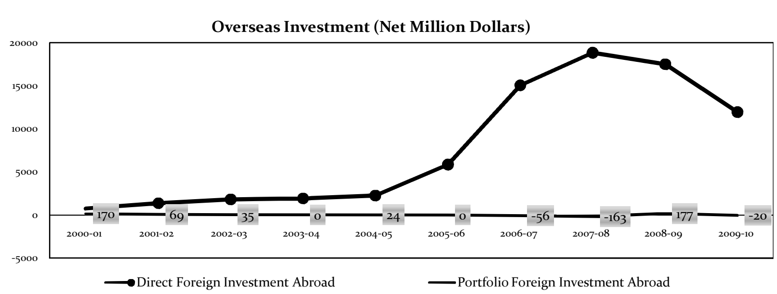
1.4. A period of Inflow Surge (May –September, 2007)

- **Intent of the Reform**: Create outward investment(portfolio investment) in order to minimize the cost of the sterilization.
- **Impact of the Reform**: Portfolio Investment abroad is still around $100 million per annum.



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1.5. Global Financial Crisis Period (April-October, 2008)

- Capital Inflow declined from $ 107 billion 2007-08 to $ 7 billion in 2008-09.
- Capital outflows led to substantial downward pressure on Rupee and it depreciation by 23% between March 2008 and March 2009.
- **Intent of Reform:** Government took several measures to liberalize capital account in order to reverse the trends in capital flows.
- **Impact of the Reform**: Capital inflow (net) in India in 2009-10 was $ 53 billion. However, it is difficult to disaggregate the effect of reform and recovery of the economy on capital inflow.

2.Review of Capital Account Liberalisation in India

1. **Sequencing of the Reform Process**
2. **Capital controls in India**
3. **Impossible Trinity and India**
4. **Exchange Rate and Foreign Exchange Reserve Management**

2.1. Sequencing of the Reform Process

- Except in 2001 in all the episodes liberalization measures related to capital flows were taken to manage the external sector.
- In 2001 the liberalization was voluntary and mainly driven by expected benefits of external capital inflow in terms of supplementing domestic resources and thereby higher GDP growth.
- In initial part of the liberalization era, emphasis of liberalization was capital inflows, particularly on non-debt and long-term components (such as FDI), debt inflows were discouraged.
- Continuously declining debt service ratio (from 35.3 percent in 1990-91 to 5.9 percent in 2004-05) and adequate foreign exchange reserve gave policy makers confidence to exploit the positive aspect of debt flows.
- Till 2001, focus of liberalization was on inflows. Indian government was apprehensive about liberalizing the outflows.

2.2. Capital Controls in India

- Capital control measures can be divided into two broad categories.
- **Direct or administrative control**, it involves outright prohibition, explicit quantitative limit and approval procedure.
- **Indirect or market based controls** which comprises explicit or implicit taxation of cross-border capital flows and dual or multiple exchange rate regime.
- **Administrative controls are more effective** in terms of controlling capital flows.
- However, they are **not market friendly** as investors cannot build their cost into their portfolio calculation
- **India has preferred administrative measures** over market based methods to capital control flows.

2.3. Impossible Trinity and India

- Impossible trinity theory says that the combination of an open capital account, a fixed exchange rate and an independent monetary policy is not possible.
- India's management of openness of capital account and exchange rate is different from the premises of impossible trinity theory.
- Given the increased integration of Indian economy, business cycles are synchronised with the world economy. Hence, policy rate changes move in similar direction. However, monetary policy is independent.
- Independent monetary policy does not mean it is effective.
- Ineffectiveness during the recession (figure)
- Ineffectiveness in tackling inflation

2.4 Exchange Rate and Foreign Exchange Reserve Management

Exchange Rate (Figure)

Deployment Pattern of Foreign Currency Assets (at the end of March)					
					(In $ Billion)
	2006	**2007**	**2008**	**2009**	**2010**
Foreign Currency Assets	**145**	**192**	**299**	**241**	**255**
a) Securities	35	53	104	135	132
b) Deposits with other central banks, BIS & IMF	65	92	190	102	118
C) Deposits with foreign commercial banks/funds placed with the EAMs	**45**	**47**	6	5	5

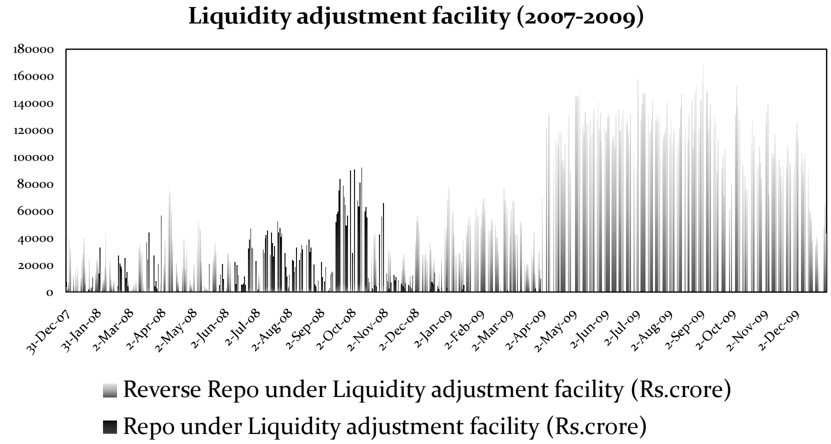
Return on Foreign Currency Assets and Gold, after Accounting for Depreciation (July-June)			
2005-06	**2006-07**	**2007 - 2008**	**2008 - 2009**
3.9	**4.6**	**4.8**	**4.16**

3. Conclusion

- India has adopted a gradualist approach to capital account liberalization.
- Most of the liberalization measures were taken under pressure to manage the BoP.
- India has managed impossible trinity through an intermediate ground, i.e. with partial opening of debt flows, managed exchange rate flexibility resulting in huge accumulation of international reserves and synchronized but independent monetary policy.

Thank You

A. Utilization of Liquidity by Banking System



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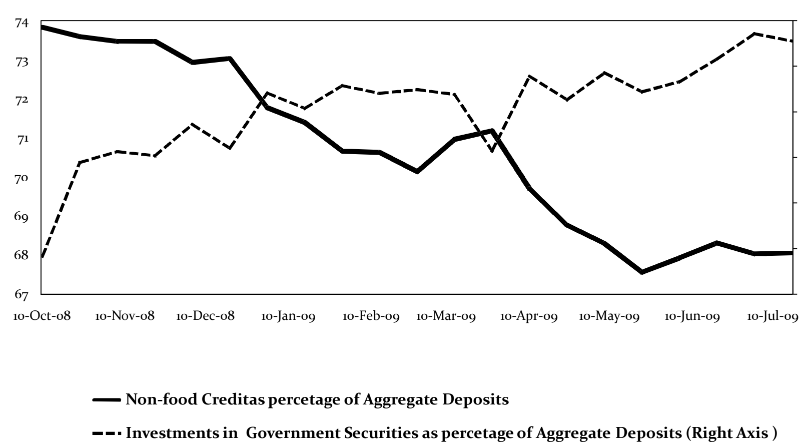
B. Utilization of Liquidity by Banking System (Text)



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C. REER and RBI Intervention in the Foreign Exchange Market (Table)