Policy Measures for Meeting Capital Inflow Surge

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I. INTRODUCTION

1. As a direct result of the 1997-98 budget and the confidence engendered by it, there is likely to be a sharp increase in capital inflows in the form of both Direct and Portfolio investment, during 1997-98. Though direct evidence is not available as yet (1st week of March), thus precluding an informed judgement, I would hazard a guess as follows: Portfolio flows could double, while direct foreign investment could increase by at least 50% from 1996-7 levels. This will mean an increase of over $3 billion in total equity flows. There will also be pressure on the debt side, with both international lenders and domestic borrowers pushing for higher ECB ceilings.

II. THEORY

A. REAL ECONOMY

2. An (exogenous) increase in the inflow of capital increases the availability of foreign exchange and savings to the economy. As a direct consequence the exchange rate should appreciate and real domestic interest rates decline. This would tend to reduce exports and domestic saving, and increase imports and domestic investment, compared to levels, which would have prevailed in the absence of the inflow. **The growth rate should therefore accelerate and the current account deficit widens**. The difference between the increased capital flow and the increased current account deficit would accumulate as foreign exchange reserves. Relative price of non-tradable goods would rise.

B. MONETARY & FINANCIAL

3. The decline in interest rates should be reflected in the entire portfolio of assets, and in money demand. Interest rates on both private and government debt should fall. The increase in foreign exchange reserves will be translated into an increase in reserve money, and increased money supply. The reduction in interest

rates and the increase in domestic assets/income should, however, increase the demand for money. Thus part of the increase in money supply will be offset by the increase in money demand, while the remaining part could raise inflation. The latter will, by bringing about real appreciation of the currency, reduce the extent of nominal appreciation. There would also be pressure on stock prices because of the time taken for primary issues to expand to meet the increased demand for equity assets.

4. There is therefore a trade-off between nominal appreciation and inflation. A free float would result in a sharp nominal & real appreciation. If the increase in flows were short term, this would be followed by gradual nominal depreciation. Though there would be changes in relative prices, average inflation effects would be moderate and no sterilisation required for short-term flows. The nominal appreciation and increased exchange rate volatility can however have a negative effect on exports till the situation returns to normal. If the exchange rate is kept fixed, reserves would accumulate, reserve money expands and inflationary pressures build up. Sterilisation measures to offset this will reduce inflationary pressures at the cost of higher interest rates and lower investment and growth.

C. OPPORTUNITY: Long term inflow

5. Investment flows are normally classified as "long term capital flows". This is true of Direct Foreign investment, Investment by foreign funds in primary and secondary equity markets, and equity linked Depository Receipts placed abroad by Indian companies (GDR, ADR etc.). Prima facie, these flows are directly or indirectly linked to Investment in Industry, Agriculture and Infrastructure.[1]

6. The reason portfolio investment is considered long term becomes clearer on comparison with FE/dollar denominated short-term debt or bank deposits. First is the nature of the asset in terms of known risk. By its nature, short-term debts and

[1] They can be seen as the counter-part of our debt management policy of shifting the structure of foreign liabilities from debt to equity.

bank deposits are viewed by investor as relatively risk-less investments. A set of events, which undermines this perception of safety and low risk, can therefore trigger an outflow. Similarly, equity is known by the investor to involve risk, which he is willing to bear because of the higher return. Thus the investor will have made a prior determination of the risks involved and will not be scared off by the actualisation of this risk. It would require a fundamental change in the nature of risk to trigger a major outflow from the country.[2]

7. The second difference between equity and short-term debt is the cost of withdrawal. The cost of withdrawal from guaranteed short-term debt is minimal. En masse withdrawal from the equity market would mean a reduction in capital gains income as the market falls precipitously. Further, compared to FE/dollar denominated debt, withdrawal from the local equity market would also entail exchange losses to the investor due to rupee depreciation.[3]

D. POLICY IMPLICATIONS

1 Slow Reserve Accumulation

2 Short Term Debt

8. Capital inflows provide an opportunity to accelerate the implementation of our international debt management strategy of shifting the structure of Public & related debt from short to long term, and to reduce the foreign debt to equity ratio. This can be done by changing the terms on which foreign currency deposits are accepted under various schemes like FCNR (B) and NR (E) RA. The first option is to increase reserve requirements on all these deposits. The CRR can be phased in by first imposing a very small reserve requirement on the shortest-term deposits. The reserve requirement can, if needed, be raised to the level applicable to

[2] For instance, major socio-political upheaval and widespread violence. This is exactly what I had said in a February 1994 paper. Events have fully vindicated this prediction, as there has not been a single month in which there were net outflows.

domestic deposits. The second option is to lower the maximum interest that banks are allowed to pay on foreign currency deposits. The third option is to eliminate deposits of shorter maturity, by raising the minimum term of these deposits from the current 6 months. The current minimum term is somewhat anomalous, in that the allowed maturity for ECB and Foreign Currency Convertible Bonds is 3 to 5 years. This discrimination should be corrected by raising the minimum term on FCNR (B) to one year. If capital inflows continue at a fast pace a further increase in the minimum term to three years would have to be considered. These measures will have the effect of slowing both inflows and reserve money growth from existing stocks.

3 Short Term Assets

9. Short-term inflows can also be met by increasing short-term assets of the banking system. Short-Term and Trade credit in foreign exchange is largely provided by external sources. Indian banks could provide this service to importers. Rules and regulations which constrain domestic banks from providing such credit (e.g. FE holdings abroad) must be urgently reviewed and rectified. Banks with experience of international trade should be encouraged to improve their systems and procedures for providing short term credit, so that they can compete with foreign parties who are currently providing this service. Banks' limits on foreign exchange holdings/short term investment abroad should be liberalised to facilitate this process.

4 Capital Outflow: Indian DFI

10. These inflows also provide an opportunity for faster removal of controls and restrictions on efficiency enhancing capital outflows. Restrictions on direct foreign investment by Indian companies abroad (DFI-out) can be dramatically reduced. The main remaining objective should be to ensure their bona fides. DFI-out in labour intensive industries (in which we have a comparative advantage) and

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[3] Unless RBI chooses to nullify the depreciation by running down reserves

high tech industries (in which the west has a technology denial regime), should be made fully automatic with no investment limits. Examples of the former are garments, textiles, Jewellery, leather goods/garments, shoes, software, toys and metallic/engineering goods. Examples of the latter are nuclear, aerospace, advanced materials and defence systems. The general automatic limit should be raised to $10 million, and should apply to trade/marketing and services. The limit for manufacturing industry could be set higher at $50 million. These may need to be progressively raised further.

5 Medium Term Debt

11. ECB guidelines have been liberalised over the years. It may not give the appropriate signals if these are tightened to stay within the overall Debt ceiling for the year. One way to slow down borrowing, while at the same time rationalising taxation, is to impose a 10% non-refundable TDS on all interest paid on foreign credit/debt of maturity of 5 years or less. This would equate tax paid by foreigners on lending to residents on par with the tax on Dividends, Global Depository Receipts and Foreign Institutional Investors. It would also level the field with respect to domestic lenders who pay the full income tax on receipt of interest. This would also apply to Foreign Currency Convertible Bonds as long as they are not converted into equity.

I. COUNTRY EXPERIENCE OF CAPITAL FLOWS

12. The increase in capital inflows was of the order of 3.3% points of GDP in Latin America and 2.7% points of GDP in Asia.[4] A net increase in capital inflows, must result in either, (a) an increase in reserves, or (b) an appreciation of the currency, or (c) an increase in the current account deficit, or a mixture of the three. In both sets of countries international reserves increased substantially with capital inflows. There were certain similarities and differences between these two sets of

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accumulated at the time of the inflow.

countries, with the latter related primarily to the greater success of Asian countries in responding to these flows and/or having a positive effect on their economies.

A. POTENTIAL PROBLEMS: Inflation & Appreciation

13. Capital inflows of this order of magnitude can lead to a sharp increase in stock prices. This has happened in both Latin America and Asia in the early phases of capital inflow. This is has also happened in India between October 1993 and September 1994, and is likely to be repeated in 1997-98.

14. Reserve accumulation, unless sterilised, expands the monetary base, and thus puts pressure on money supply and inflation. This is what has happened in Latin American countries. Asian countries (like Singapore) have been more successful in sterilising capital inflows.[5] At the other extreme, a highly aggressive monetary (sterilisation) policy as in Malaysia, can result in a sharp rise in real interest rates, aggravating capital inflows. Most countries tried to aggressively sterilise inflows in the first year of the inflow, and then gradually loosened/abandoned this policy.

15. In a freely floating rate regime, the currency would appreciate (nominal & real) sharply, reducing reserve accumulation and the need for sterilisation, and thus automatically limiting inflation. As appreciation in turn will have a negative effect on exports, and on customs revenues (even though imports will rise) none of the countries adopted a free float. Chile and Mexico widened the float bands, while Colombia, Malaysia, Singapore and Taiwan allowed for some nominal appreciation.[6]

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[4] Calvo, Leiderman and Reinhart(1993)

[5] This may have been partly due to the higher proportion of FDI in capital inflows, which not being intermediated through the banking system do not lead directly to credit expansion.

[6] In some Latin American countries inflows have been associated with real exchange depreciation, while this is much less common in Asia [Calvo et al (1993)].

16. In countries with level of output close to "potential output", non-sterilised intervention needs to be accompanied by a policy to restrain aggregate demand.[7] Low (& lower middle) income countries like India are not commonly thought of as being close to potential output. Fiscal policy did not, therefore, figure significantly in most countries' response to capital inflows, with the exception of Thailand. Although fiscal positions generally improved in the first year of the inflow episode, this was less a response to the episode than a continuation of policies, which attracted the inflow in the first place.

17. As certain areas of non-tradable infrastructure may be close to capacity production, for instance power, a targeted reduction of government expenditures on non-traded goods can help free up resources for productive use and restrain inflation. Investment in critical capacity constrained non-tradable infrastructure can have the same effect in a medium term perspective.

B. OPPORTUNITY: Investment & Growth

18. Capital inflows have been accompanied by an increase in economic growth in both Latin America and Asia. Such inflows can also provide both an impetus to and an opportunity for, higher investment. In Asian countries about 44% of inflows were in the form of Direct investment, and resulted in an increase in the Investment /GDP ratio by an average of 3% points. In Latin America, however DFI constituted only 17% of capital inflows, and there was no increase in the investment-GDP ratio as a result of this inflow. In India, DFI constituted a little less than half the equity inflow during 1995-6 and 1996-7.

II. POLICY IMPLICATIONS

A. DOMESTIC DOLLAR DEPOSITS

19. The monetary and exchange rate effects of capital inflows can be moderated by allowing Indian residents to open Foreign exchange (say dollar) denominated

[7] Corbo & Hernandez, "Macro adjustment to Capital Flows".

deposits in Domestic banks. The first step in this process would be to free exporters to hold 100% of their export earnings in FEECs. The next step would be to allow all importers (/companies) to purchase dollars and to have dollar accounts in Indian banks up to some limit (say $1 million), and all individuals to have accounts up to a limit of $10,000(say). This would be accompanied by explicit permission to banks to deploy these funds abroad up to some specified maturity [e.g. 6 months $\geq$ 50%, more than one year $\leq$ 20%]. As foreign exchange supply would be temporarily reduced the pressure on the exchange rate would be moderated. To the extent FE holding of banks' increases, the monetary effects would be reduced.

B. IMPORT CONTROLS & TARIFF RATES

20. As non-oil import growth was negative last year (10 months), and investment will take some time to pick up significantly, the initial reserve build up provides an opportunity to accelerate trade reform. Import licensing can now be abolished at one stroke, with the exception of goods whose import is to be restricted for health, environmental, safety and security reasons. Only a few other items, on which import duties are subject to very low duty rate constraints (GATT/WTO bindings), may be retained on the negative list (e.g. aeroplanes-3%). Further reductions can be made in customs duties. The peak rate on manufactured intermediate goods can be reduced to 30%.

C. FINANCIAL INER-MEDIATION

21. To get the full benefit of the increased availability of foreign savings, they must be channelled into the most productive areas. It therefore becomes even more urgent to reform the financial system to increase the efficiency of intermediation. Banking reform must be accelerated, by removing the plethora of RBI regulations and guidelines, which were accumulated over decades of micro-management on behalf of the central government. De-control of interest rate must

be completed, and oligopolistic collusion among nationalised banks discouraged. A credit bureau must be set up immediately as a joint venture of all the banks, to take care of the co-ordination problem of bad loans and fraudulent borrowers. Bank management must be strengthened by the introduction of fresh managerial blood from outside the nationalised banking system.

22. As the interest rate on government treasury bills and securities is an important public indicator of real interest rates, reform of the government securities market must be expedited. My paper on the subject is with the Standing advisory committee of the RBI headed by Deputy Governor (Dr Reddy]. The committee can be urged to expedite its first report.

D. FISCAL POLICY

23. A shift of government expenditures from public consumption and subsidies to investment in non-tradable infrastructure can help in meeting both the short and medium term effects of inflows. In the short term, reduced government demand for non-tradable goods, by freeing these resources, will ease the inflationary pressures, which arise from this sector. Investment will reduce supply constraints in the medium term.

III. POLICY MEASURES

A. BOP & FOREIGN DEBT

1 FCNRB & NR(E)R

a) Raise CRR
b) Lower interest rate ceiling
c) Equalise maturity term floor with ECB.

2 Import De-Licensing

a) De-license manufactured goods imports.
b) De-license Gold and other precious and semi precious metals.

c) De-license all agriculture goods (except ordinary wheat, rice and coarse cereals).

d) De-license all imports.

With appropriate adjustment in tariffs where necessary.

3 Indian Investment Abroad

a) Raise automatic investment limit to $50 million for Indian investment in Labour intensive (exportable) and high tech manufacturing.

b) Open automatic investment window for retail investment in exportable goods.

4 Non-refundable TDS

Impose a non-refundable TDS of 10% on all interest paid to foreign residents (TDS on residents would be 20% & this could be offset against normal income tax liability).

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