

d.i.e



Deutsches Institut für
Entwicklungspolitik

German Development
Institute

CAPITAL CONTROLS – Comment on Jonathan Ostry & Abhijit Sen Gupta

**Ulrich Volz, German Development Institute (DIE)
ICRIER-InWEnt-DIE-Conference on “Policies for Growth and Financial
Stability beyond the Crisis”, Mumbai, 27-28 October 2010**



- Two quotations from yesterday's *Financial Times*
- India's policy choices
- What to do?



“Was it really just over a decade ago that the International Monetary Fund and investors howled when Malaysia imposed capital controls in response to the Asian financial crisis? We ask because suddenly those times seem so distant. Today, the IMF is not just sitting on its hands as country after country resurrects capital controls, it is actually going as far as to promote their use. What about the investors whose freedoms are eclipsed by the new controls? Well, their enthusiasm for foreign lending and investing has not been damped in the least. So what is going on here? In our view, nothing short of the most significant transformation in global financial management of the past 30 years.”

Ilene Grabel & Ha-Joon Chang, “The World Should Welcome Capital Controls”, *Financial Times*, 26 October 2010, p. 11



Economists warn India over risks of ‘hot money’

“Economists are warning that New Delhi may be underestimating the risk of excessive capital inflows, as huge foreign portfolio investment into India has helped push both the stock market and the rupee to pre-crisis levels.

Since January, India’s equity and bond markets have attracted a record \$33.8bn in foreign funds on the back of the country’s robust economy [...].

However, during the same period foreign direct investment – which tends to be more long term than inflows into the stock market – dropped 35 per cent, down to Rs976bn (\$14.3bn) from Rs976bn.”

Financial Times, 26 October 2010, p. 2



In its April 2010 *Global Financial Stability Report*, the IMF lists a number of policy options available to policymakers of liquidity-receiving economies in response to capital inflows:

- A more flexible exchange rate policy, in particular when the exchange rate is undervalued
- Reserve accumulation through sterilised or unsterilised currency intervention
- Reduction of domestic interest rates if the inflation outlook permits
- Tightening fiscal policy to allow for less restrictive monetary policy
- Strengthening prudential regulation
- Liberalisation of outflow controls

“When these policy measures are not sufficient and capital inflow surges are likely to be temporary, capital controls may have a role in complementing the policy toolkit.”



- The appropriate policy mix will depend on country-specific conditions, the exchange rate regime and capital account provisions in particular
- Potential frictions since policy responses could have adverse multilateral effects by affecting the trade and capital flows of other countries:
 - The adoption of controls on capital inflows in one country can divert capital flows to other countries
 - Currency intervention and a reliance on capital controls may delay necessary macroeconomic adjustments and prevent a rebalancing of demand



India's policy options

Allow rupee appreciation:

- India's current account deficit has been steadily rising
- Rupee has already appreciated considerably against the USD (by 4.8% since 1 July; note that it has not appreciated much on a trade-weighted basis)
- Further appreciation of the rupee against the USD would considerably erode India's external competitiveness vis-à-vis competitors like China

Reserve accumulation:

- Would further inject liquidity unless sterilised
- Fiscal cost of sterilised intervention run contrary to aim of fiscal consolidation



Reduction in interest rates:

- No option since India needs monetary tightening to contain inflation, which is already high and rising

Fiscal tightening:

- Fiscal consolidation has already begun but is unlikely to lead to the reduction in interest rates needed to dissuade capital inflows since monetary tightening will have to continue

Strengthening prudential regulation:

- India already has a prudent regulatory regime, hence little room to further strengthen prudential regulations that could help deal with surging capital inflows and their associated financial risks

What to do?



- Combination of strengthening capital controls – unremunerated reserve requirement or a tax on capital inflows – and rupee appreciation might be sensible
- Danger of “competitive non-appreciation” (Subramanian 2010)
- Yuan appreciation would allow other emerging economies (not only India!) to appreciate their currencies
- China’s fixed exchange rate imposes large systemic costs of global overheating and excess liquidity creation
- Coordination needed between emerging economies on managing capital flows and exchange rate appreciation, with China being key to such coordination

d·i·e



Deutsches Institut für
Entwicklungspolitik

German Development
Institute



ulrich.volz@die-gdi.de