Chapter 7

Some Policy Implications for the Indian Economy in the Context of our Analysis

CHAPTER 7: SOME POLICY IMPLICATIONS FOR THE INDIAN ECONOMY IN THE CONTEXT OF OUR ANALYSIS

We have witnessed rapid stock market development in India over the last 15 years, as the Government of India undertook various measures under the aegis of financial liberalization. This has resulted in rapid increase in the stock market valuation, where we have witnessed that the Sensex has crossed record levels to over 14,000 points in a very short span of time. However, this development has not affected the level of real investment significantly. Our preceding analysis confirms this.

Given the fact that capital inflows, precisely FII (in the form of portfolio flows) are of short maturities, investments takes place in the stock market rather than in real capital formation. We have witnessed precisely this phenomenon in the Indian context, where the rapid increase of the market capitalization of the BSE did not have any effect on the real capital formation of the economy.

Under these circumstances, there is hardly any rationale to project the stock market as a new engine of growth in the context of the developing countries. This issue is all the more relevant in the context of India as the government is in the process of establishing full CAC. In the following sections we are going to discuss the issue of CAC and try to figure out the policy with regard to capital account that is in tune with our development goals.

7.1: THE DEBATE ON CAPITAL ACCOUNT CONVERTIBILITY (CAC)

The issue of CAC, in addition to being of interest in its own right, is also significant for present multilateral discussions in international policy context on the New International Financial Architecture (NIFA). We are interested in finding the kind of global economic order in relation to capital flows which can best serve the interests of developing countries, in general and India, in particular. CAC is the area where there is the greatest disconnection between economic theory and actual events in the real world. In analyzing liberalization of capital flows, it is customary to distinguish between short-term (e.g., portfolio flows and short-term bank loans) and long-term flows (e.g., FDI). Neoclassical theories suggest that free flows of external capital (including short-term capital) should be equilibrating and help smooth a country's consumption or production paths. However, in the real world, exactly the opposite appears to happen (Singh, 2005).

Several issues that have a bearing on development strategies, liberalization patterns and experiences have been brought to the fore by the currency and banking crises in several countries of East Asia in 1997, as well as those in Russia in 1998 and later in Brazil. In the past few decades with increasing globalization it has been observed that more and more countries, especially emerging market economies, are opening up their capital accounts either partially or totally to avail themselves of the benefits of burgeoning international capital flows. This is all the more apparent at present in India, where we have witnessed a huge influx of FII in the recent past.

There is no specific definition of CAC. But the Tarapore Committee (1997) defines CAC as "the freedom to convert local financial assets into foreign financial assets and vice-versa at market determined rates of exchange". In other words, CAC implies complete mobility of capital across countries.[53] In a country's balance of payments, the capital account features transactions which lead to changes in the overseas financial assets and liabilities of the country. These include investments abroad and inward capital flows. CAC implies the freedom to convert domestic financial assets into overseas financial assets at market determined rates. It can also imply conversion of overseas financial assets into domestic financial assets. Broadly it would mean freedom for firms and residents to buy overseas assets such as equity, bonds, property and acquire ownership of overseas firms besides free repatriation of proceeds by foreign investors.

Stanley Fischer (1997), the former Deputy Managing Director, IMF, suggests that at a theoretical level, CAL would lead to global economic efficiency and allocate world savings to those who are able to use them most productively. The free capital movements would enable corporations in the developing countries to raise capital in international markets at a lower cost. Moreover, he suggested that such liberalization leads to further development of a country's financial system which in turn is expected to enhance productivity in the real economy by facilitating transactions and by better allocation of resources. According to the Tarapore Committee, the rationale behind full CAC is efficient

[53] It is different from current account convertibility, which allows free inflows and outflows for all purposes other than for capital purposes such as making investment and loans. It allows residents to make and receive trade-related payments and receives dollars (or any other foreign currency) for export of goods and services and pay dollars for import of goods and services, make sundry remittances, access foreign currency for travel, studies abroad, medical treatment, etc.

allocation of global capital which not only equalizes the rates of return of capital across countries but also increases the level of output.

However, the problem with such an argument, which broadly follows the approach suggested by Stanley Fischer, is that it implicitly assumes an economy where full employment prevails. The rate of interest is then seen as equilibrating savings and investment within each country.

The decision to allow the free flow of direct and financial foreign capital across national boundaries can also have serious implications for the national sovereignty of a country as control over its national capital is put in doubt. For example, a country acquires foreign exchange when a MNC invests within its national boundaries, but this investment is in terms of the MNC buying land, houses, productive plants, etc. Similarly, when international investors acquire shares in a country, it involves the transfer of financial assets (Damodaran (1999). Capital account transactions can therefore involve changes in the composition of the national capital of a country.

Damodaran (1999) argues that the inflow of foreign capital to finance current account deficits can be beneficial to a country, and not undermine the viability of it balance of payments in the long run, if borrowing from abroad is used to finance capital formation in productive assets rather than for consumption purposes. Foreign capital, through making real investments can also be used to enhance export earnings in excess of debt-servicing requirements, or even for productive investment that does not generate foreign exchange, if there are accompanying policies that enhance export earnings in excess of debt-servicing requirements.

The higher levels of international capital flows, in the form of FDI, going to developing countries in recent decades are expected to be beneficial as it is believed that they will contribute to capital accumulation and technology transfer. These processes will lead to increased growth, with all people eventually benefiting from the resulting increased prosperity. This is possible due to the fact that it is expected that they would be able to diversify their portfolios and thereby increase their risk-adjusted rates of return. However, in reality, whether private capital can substitute for development aid will depend on how individual developing countries manage the integration process and what policies they have in place to attract, manage and direct flows. The distribution effects of financial opening will likewise depend on the nature of liberalization and who can benefit from it. While empirical evidence on the gains from financial integration in developing countries is hard to find, the recent financial crises in East Asia, Russia, and Brazil have made the risks all too apparent.

7.2: POLICIES PERTAINING TO THE CAPITAL ACCOUNT IN INDIA BEFORE AND AFTER THE ERA OF FINANCIAL LIBERALIZATION

Before going further into this issue we must look at the policies that were adopted in India before the era of financial liberalization. From the period after Independence to the early 1980s, the policy adopted by India was one of inward orientation and self-reliance. The capital account was important only as a financing function, as the current account deficits in the balance of payments were restricted and their financing being controlled, coming mainly from official sources, i.e. bilateral and multilateral agencies, that fell within the broadly defined category of foreign aid. However, till that time restrictions were imposed on private capital flows.

In the 1980s, however, this form of external financing dwindled and capital flows other than those through official bilateral and multilateral channels, accounted for a growing share of total flows into India. Commercial loans and autonomous flows of foreign direct and portfolio investment became the main mechanisms for recycling funds from the surplus to the deficit countries. Capital inflows were also obtained through two Non-Resident Indian (NRI) deposit schemes: Non-Resident External Rupee Account (NRERA) scheme and the Foreign Currency Non-Resident Account (FCNRA) scheme.

But the problem associated with such capital flows is that though the developing countries could now finance a much higher current account deficit than they could in the past (when the current account deficit was restricted), there is no *a priori* definition of the current account deficit that is 'sustainable' over time. So in a situation where the current account deficit widens to such an extent which may undermine the 'investor confidence', financial flows diminish or dry up, necessitating exceptional financing and a process of adjustment. Furthermore the capricious nature of 'investor confidence' implies that even a relatively innocuous level of the current account deficit relative to the GDP often proves unsustainable (Chandrasekhar, 1995). The Indian economy which had run into a balance of payments crisis owing to the sudden withdrawals from the NRI account was forced to accept the IMF conditionalities which insist upon a 'liberalization of imports'. Such 'liberalization' has an effect which is the very opposite of what is required to ward off a recession: instead of lowering the *ex-*

post import intensity compared to the pre-adjustment situation, it actually increases this intensity, which enforces a further reduction in output in order to balance the payments (Patnaik, 1995a). India had to undergo such an adjustment process in the early 1990s, when its current account deficit relative to the GDP was deemed to be unsustainable. According to the conditions put forward in respect of the adjustment process of the IMF, this deficit was made to adjust to the autonomously given level of foreign exchange access, which resulted in a curtailment of investment and growth.

However, more substantive, albeit gradual, progress towards CAC started also in 1991. The outline for reforms in the external sector was provided in the report of the High Level Committee on Balance of Payments headed by Dr. C. Rangarajan. Though the Committee recommended complete current account convertibility, yet it suggested a very gradual approach towards capital account liberalization. The report emphasized the need to shift away from debt creating to non-debt creating inflows, with emphasis on more stable long-term inflows in the form of FDI and portfolio investment.[54] It also advocated a very gradual liberalization of capital outflows from India.

Based on the recommendations of the Committee, many steps have been taken by the Government of India since 1991 to promote non-debt creating flows and reduce reliance on debt creating flows. A major development that has taken place has been regarding the foreign institutional investors, who were allowed to invest in Indian equity and debt markets in 1992. The following year foreign brokerage firms were also allowed to operate in India. Prior to the reforms, NRIs and overseas corporate bodies (OCBs) were allowed to hold about

[54] However, portfolio investment is not necessarily long-term as asserted by the committee.

1 per cent individually and 5 per cent jointly of the paid-up capital of Indian companies. In 1992, this ceiling was raised to 24 per cent, and subsequently to 40 per cent in 1998. These limits have been raised even further since then. At present, investment by FIIs is allowed in different sectors up to the sectoral limits set for FDI investments. Since 2001, FIIs have also been allowed to invest in equity derivatives in India.

A Committee on CAC appointed by the RBI under the chairmanship of Dr. Tarapore has also recommended for a phased liberalization of controls on capital outflows over the three year period, ending March 2009. While some of these preconditions have almost been attained, others are far from reaching their prescribed levels. The gross fiscal deficit as well as the gross NPAs of public sector banks, as a per centage of total advances, though on the decline are nowhere near the stipulated levels. In fact it seems difficult to realize some other condition, such as a legislatively determined inflation target, especially in the light of globally volatile crude prices. The purpose of these conditions was obviously to make India's macroeconomic situation stable enough to meet the vulnerabilities endemic to a free foreign exchange regime. Thus, going by the pre-conditions laid down by the Tarapore Committee, the economy is in a position to move towards CAC.

India did not implemented CAC as per the schedule envisaged in the report. It was felt that greater caution had to be exercised after the onset of the Asian currency crisis in 1997, which saw the economies of many of the Southeast Asian countries that had embraced CAC crumble as the contagion spread. However, the spread of the crisis did not imply a complete reversal of the liberalization trend or a halt in the move towards CAC.

While the inflows from abroad have been freed to a large extent, outflows associated with these inflows, such as interest, profits, sale proceeds and dividends, are completely free of any restriction. All current earnings of NRIs in the form of dividends, rent and others have been made fully repatriable. In line with the recommendations of the report, convertibility in terms of outflows from residents, however, remains more restricted. Residents are not allowed to hold assets abroad. However, direct investment abroad is permissible through joint ventures and wholly owned subsidiaries. This is encouraged since it helps India to earn foreign exchange through earnings such as dividends, royalties and fees for the transfer of technical know-how. Such ventures also encourage the export of Indian goods and technology to the rest of the world and lead to the dissemination of Indian technical know-how.

An Indian entity can make investments in overseas joint ventures and wholly owned subsidiaries to the extent of US$ 100 million during one financial year via the automatic route. At the same time, investments in Nepal and Bhutan are allowed in the order of $ 7.8 million in one financial year. Units located in Special Economic Zones can invest out of their own balances in the foreign currency account. Such investments are, however, subject to an overall annual cap of US$ 500 million. Indian companies are also permitted to make direct investments without any limit on the funds raised through ADRs/GDRs. Indian entities engaged in health services, information technology and entertainment software services, chartered accountancy and legal and other related activities are allowed to invest in overseas ventures of a similar nature subject to a limit of US$ 1 million for a given financial year. Recently, mutual funds have been allowed to invest in rated securities of countries with convertible currencies within the existing limits.

Nevertheless, convertibility of capital for non-residents has been a basic tenet of India's foreign investment policy all along, where only the residents, both individuals and corporates, who have been and continue to be subject to capital controls. However, buoyed by India's healthy foreign exchange reserves, comfortable external debt position, improved showing on the fiscal front, strong GDP growth and the fact that progressive relaxations on the foreign exchange front have not led to a flight of capital, the government now seems to be in a position to move to regime of full CAC by March 2009, as has been recommended by the Tarapore committee[55], which submitted its report on July 31, 2006.

7.3: BENEFITS OF "CAC" FOR INDIA

CAL has led to the surge of cross-border capital flows over the past two decades. The increase in these flows since the mid-1980s, both between industrial countries and from industrial to developing countries, is supposed to have been associated with a number of benefits, which will be briefly discussed here.

It is argued that one of the benefits associated with convertibility is that the asset holders in India would be able to diversify their portfolios internationally. Instead of being constrained to hold only Indian real estate,

[55] S. S. Tarapore, the former deputy governor of RBI was the chairman of the earlier committee as well set up in 1997. However with the onset of the East Asian financial crisis, the government's plan of implementing full CAC was put on hold.

equity and debt, introduction of CAC would reduce the risk of asset holders by diversifying their portfolio internationally. This means that in a bad year in India, when Indian financial assets generate a poor return, foreign assets owned by Indians would continue to generate good returns. This reduction in the variability of returns would make the asset holders in India better off.

With convertibility the households and firms of India would not be forced to meet each other through India's financial system. The GDR market is one example of the alternative, where Indian firms chose to meet with foreign investors through the markets outside India. This market arose in response to weaknesses of existing markets in India. For example, with convertibility, it will be possible for Indian firms to interact with Indian households in say, the markets of Singapore. This would provide alternatives for India's households and firms, generate competition for India's financial industry, and elevate the urgency of reforms in the financial sector. For example, if derivatives on the dollar-rupee are traded in Singapore or Chicago, convertibility means that the asset holders in India would be able to use them.

However, it is quite interesting to note that China, which is the biggest recipient of FDI in the world, has not embraced CAC. So the argument that CAC will allow more foreign investment, especially FDI, which would lead to an increase in real capital formation and economic growth does not really follow. The Asian crisis encouraged the belief that countries opening their economies to international financial transactions would benefit only if they first strengthen their markets and institutions. But if that is the case then John Major, the former prime minister of England, could not even defend the British pound sterling, where England supposedly has well developed financial markets and institutions.

Nevertheless Eichengreen (2004) argues that CAC is expected to have a positive impact on growth of the economy only if certain conditions are met, which are as follows:

- prudential supervision is first upgraded,
- the moral hazard created by an excessively generous financial safety net is limited,
- corporate governance and creditor rights are strengthened, and
- transparent auditing, accounting standards, equitable bankruptcy and insolvency procedures are adopted.

Although these institutional prerequisites are difficult to measure, there is a presumption that they are most advanced in high-income countries. Edwards (2001) supports this view: using Quinn's measure of the intensity of capital account restrictions, he finds that liberalization boosts growth in high-income countries and slows it in low-income countries. Kraay's (1998) attempt to test directly this hypothesis reveals that the effect of CAL depends on the strength of the financial system, the effectiveness of financial supervision and regulation, and the quality of other policies and institutions.

In the late 1970s, studies by Bhagwati (1978) and Krueger (1978) stressed the need for the removal of controls to encourage economic liberalization in developing countries. But the rationale for CAC is completely different from what was suggested by Bhagwati, who though being an ardent supporter of globalization has argued against CAC.

According to the mainstream view, a large body of empirical evidence suggests that liberalized economies have outperformed repressed, illiberal and closed economies (Edwards (1996). However, we should bear this in mind that this view holds only in an ideal world, where there are either no imperfections or externalities.

7.4: PITFALLS OF "CAC" FOR INDIA

In the previous section we have discussed some of benefits associated with CAC. However, it must also be borne in mind that unrestricted capital inflows are not without pitfalls. Not all orthodox economists favour such liberalization. Bhagwati (1998) for example, a leading theorist and advocate of free trade in goods and services regards CAL as inappropriate for developing countries. It is important to note that as in the case of the neoclassical argument for free trade, the maintenance of full employment and macroeconomic stability constitute an important prerequisite for reaping the benefits of a globalized capital market. Specifically, as Rakshit (2001) suggests, the theoretical model of the beneficial effects of free capital movements are associated with some unrealistic assumptions, firstly, resources are fully employed everywhere; secondly, capital flows themselves do not stand in the way of attaining full employment or macroeconomic stability; and finally, the transfer of capital from one country to another is governed by long-term returns on investment in different countries. The point to consider is whether these assumptions are likely to be valid under the current global economic regime, is doubtful.

The theoretical case against the view that unfettered capital movements are essential for maximizing the gains from trade and world economic welfare has been made by a number of economists from different schools of thought. First within the neoclassical tradition itself, Stiglitz (2000) argues that the concept of free movements of capital is fundamentally different from that of free trade in goods. Capital flows are subject to asymmetric information, agency problems, adverse selection and moral hazard.

Although such problems may occur also in trade in goods and services, they are intrinsic to financial flows and are far more significant. Importantly, there are also diverging views about the price formation process in asset markets such as the stock market and the currency markets. According to the Orthodox economists, who subscribe to the theory of efficient markets, prices are a collective outcome of actions of a multitude of individual economic agents whose behaviour is assumed to be based on utility maximization and rational expectations. This price formation process is thought to lead to efficient prices in these markets. A powerful counter-view is that put forward by John Maynard Keynes (1936) in chapter 12 of the General Theory and which is encapsulated in his well known "beauty contest" analogy which highlights the role of speculation in determining prices.

The post-Keynesian economists, particularly Davidson (2001), take a more radical stance. He puts forward analyses and evidence in favour of Keynes' thesis 'that flexible exchange rates and free international capital mobility are incompatible with global full employment and rapid economic growth in an era of multilateral free trade'. These economists also challenge the orthodox presumption that transparency and availability of more information would make the financial markets less prone to crisis. They point out that the crises are fundamentally due to the fact that the future is uncertain and people have different perceptions about it.

Williamson and Drabek (1998) provide evidence to suggest that countries which did or did not have economic crisis were differentiated only by whether or not they had liberalized their capital accounts. Most economists would now agree that even if premature financial liberalization without adequate prudential regulation was not the root cause of the crises in countries such as Thailand, Korea and Indonesia, it greatly contributed to the occurrence of the crisis and to its depth. In fact, the economic fundamentals prior to the crisis of the affected countries were better than those of India, but the latter was spared the crisis because of its control over the capital account. Similarly, China which, not having liberalized its capital account, not only managed to avoid the crisis, but even continued to have fast economic growth.

Moreover, another attribute of the capital flows, especially portfolio investment, which causes so much concern, is its volatility. Analysis and evidence suggests that both internal (e.g. weak domestic financial systems; frequent economic shocks) and external factors, particularly the herd behaviour of foreign investors, are involved in making these flows volatile. Kindleberger (1984) has observed that financial markets are subject to frequent crises, which he ascribes to periodic and alternating bouts of irrational exuberance and pessimism of investors largely unrelated to the fundamentals of the economy. It is quite interesting to note that Kindleberger's historical analysis is implicitly endorsed by Alan Greenspan, the Chairman of the U.S. Federal Reserve himself, whose comments on the 1987 U.S. stock market crash and the Asian financial meltdown of the 1990s are as follows:

> *"At one point the economic system appears stable, the next it behaves as though a dam has reached a breaking point, and water (read, confidence) evacuates its reservoir. The United States experienced such a sudden change with the decline in stock prices of more than 20 per cent on October 19, 1987. There is no credible scenario that can readily explain so abrupt a change in the fundamentals of long term valuation on that one day. ... But why do these events seem to erupt without some readily evident precursors? Certainly, the more extended the risk-taking, or more generally, the lower the discount factors applied to future outcomes, the more vulnerable are markets to a shock that abruptly triggers a revision in expectations and sets off a vicious cycle of contraction. ... Episodes of vicious cycles cannot easily be forecast, as our recent experience with Asia has demonstrated."* (Greenspan, 1998)

The proponents of the policy of CAC regime believes that in principle it is possible for the instability caused by CAL to be more than compensated for by faster long-term economic growth arising from the greater availability of capital inflows (Fisher, 1997 and Summers, 2000). However, this belief is far fetched. Singh (1997a) considers the case of advanced countries whose experience, he suggests, is relevant for developing economies. This is because the former have operated under a regime of relatively free trade and capital movements for nearly two decades, a period long enough to make at least a preliminary assessment of the effects of this economic regime on performance. Evidence provided by Singh (1997a) suggests that the record has been less than impressive despite the fact that the world economy during this period has not been subject to any abnormal negative shocks like the oil price increases of 1973 and 1979.

Indeed, the economic performance of industrial countries during this later period has been much worse than in the earlier period of the 1950s and 1960s when they functioned under a myriad capital controls. GDP growth in the 1980s and 1990s under a liberal regime of private capital flows was much lower than that achieved in the "illiberal" and regulated "golden age" of the 1950s and 1960s. Not only that, the productivity growth in the last fifteen years has been half of what it was in the "golden age". The critical failure is, however, with respect to employment; while 8 million people were unemployed in the OECD countries in 1970, but by the mid 1990s, 35 million were unemployed, which accounted for almost 10 per cent of the labour force.

The analysis of Singh (1997a) also shows that the poor performance of industrial countries during the 1980s and 1990s cannot alternatively be ascribed to exogenous factors such as the exhaustion of technological opportunities, or to labour market imperfections. Industrial economies have more flexible markets today than they did in the golden age. In addition they have the benefit of a new technological paradigm of information and communication technology which many economic historians regard as on a par with the most important technological revolutions of the last two centuries. In view of all these factors - a new technological paradigm, more flexible markets, absence of economic shocks such as the oil shocks of 1973 and 1975 - orthodox analyses would suggest that OECD economies should be growing today at a much faster rate than in the golden age. But as we see the opposite has been true.

The analyses of Eatwell (1996) and Singh (1997a) indicates that the poor performance of industrial countries in the recent period is closely linked to intrinsic features of the liberal financial regime. Co-ordination failures together with the absence of demand management by the state have led to sub-optimal levels of aggregate demand, output and employment in both the OECD countries and of the world as a whole. When capital flows were regulated in the 1950s and 1960s, and there was successful co-ordination under the hegemony of the United States, balance of payments between countries was achieved at much higher levels of output and employment than that has been achieved subsequently under financial liberalization.

7.5: WHAT SHOULD BE INDIA'S APPROACH TO CAC?

There are two basic approaches to CAC: the first is the *big bang approach*, in which the economy is opened on the capital account very rapidly; the other is the more *gradualistic approach* in which the liberalization is undertaken slowly and over a period of time. India has followed the latter approach towards CAC. The reason lies in the fact that the political opposition has played a major role. Moreover, the government realized that while a move towards complete CAC would bring in its wake several benefits, the attendant risks are also too many. The authorities have also realized that rapid and unplanned liberalization of the capital account can imply more harm than benefit to an economy that is not equipped with sound macroeconomic fundamentals as indicated by the fiscal deficit and inflation levels and a strong financial sector. The caution seems to have been validated by the experience of the East Asian countries which saw rapid growth rates and tremendous improvements in living standards comparable to those of the developed countries after opening up their economies to capital inflows.

Opening the capital account led to massive private capital inflows in the East Asian countries, which financed their current account deficits, and domestic investment booms reflected in the rate of growth of investment of 40-50 per cent. Implicit government guarantees to banks and fixed exchange rates encouraged excessive risk taking by banks and led to deterioration in the quality of loans. When export growth declined in 1996, investors' exuberance also faded simultaneously. Capital outflows put sharp downward pressure on the exchange rates and the contagion effects saw the collapse of stock markets and even greater pressure on exchange rates. In this situation debt servicing became increasingly difficult, adding to the liquidity constraints. There was a burgeoning of non-performing loans and increasing debt-equity ratios for corporates as the foreign debt component increased in local currency terms. The end result was a crippling destabilization of the financial and exchange rate markets.

It has been argued that the simultaneous presence of fixed exchange rates and free capital flows in an economy is the reason behind the financial crisis. However there was no fixed exchange rate in many countries faced with crisis, like the East Asian and Latin American countries. This fact has been reiterated by Akyuz (2002) who argues that if the capital account remains open, developing countries will be subjected to higher capital volatility regardless of the exchange rate system in place. This is due to the fact that if the capital account of an economy is open, then the residents of the country will have access to foreign currency markets and foreigners have access to the domestic currency markets and if transactions among residents can be conducted in foreign currency (what is termed as 'dollarisation'), there is no exchange rate regime that can provide stability; the economy will be vulnerable whether it has fixed or floating exchange rates.

Akyuz further pointed out that the advice emanating from the international financial establishment (specifically IMF and World Bank) with regard to exchange rate policy was 'inconsistent, confusing and confused'. It had prescribed different currency systems for different economies while never budging from its insistence on capital account openness, with the result that financial stability proved elusive. The fact that India emerged relatively unscathed from the contagion that gripped East Asia has been a testimony to the prudence of following a policy where there were substantial capital controls in place.

The interest rate policy followed by the RBI has also enhanced the country's ability to attract capital inflows. Patnaik and Shah (2004) suggests that the inflation rates have fallen sharply in the recent years, which together with the opening up of financial markets and falling international rates, have resulted in a significant decline in the real interest rates in the last six years. Although interest rates have been falling in India[56], they are at higher levels than in other countries[57], except for Turkey and Chile. This has helped to attract capital inflows, especially in terms of NRI deposits. Higher levels of capital flows have also meant that domestic liquidity management can be used

[56] According to Patnaik and Shah (2004) the interest rates in India have reached historical low levels in the recent years.
[57] These countries include both developed countries like US, UK, Japan, Germany and Canada, as well as the developing countries.

to lower interest rates and bolster domestic economic activity by reducing the cost of raising capital for investment (government securities).

While perceptible liberalization has taken place since the 1990s, full CAC would require further steps on all fronts. Liberalization so far has occurred in line with the broad reforms being undertaken elsewhere in the economy, such as in the external sector, banking sector and financial sector reforms. Further liberalization and its pace would depend on how quickly reforms are implemented in other areas, the health of the economy, especially the banking sector, and the level of foreign exchange reserves.

Since the currency crises of the 1990s economists have had a renewed interest in understanding the behavior of international capital flows. According to Bhagwati (1998) and Stiglitz (2002), high capital mobility results in increased macroeconomic instability and, in particular, in more volatile exchange rates and domestic interest rates. Dornbusch, Goldfajn and Valdés (1995) have also argued that in a world of high capital mobility "sudden stops" of capital inflows can be highly disruptive, especially in the emerging countries. According to them, sudden stops will result in major current account adjustment and in significant declines in economic growth. Even the IMF, a traditional supporter of free capital mobility, has recently supported the gradual opening of the capital account in emerging and transition economies (Prasad, Rogoff, Wei, and Kose, 2003)

A number of economists have argued that restricting short term capital mobility is the best way of dealing with the disruptive effects of sudden shifts in cross boarder capital movements. According to this view, long term capital flows, particularly FDI are generally beneficial. Short term flows, on the other hand, cause instability and increase vulnerability to financial contagion and crises. Supporters of restricting short term capital movements have argued that Chile's experience with controls on short term capital inflows during the 1990s was very successful, and it provides a useful blueprint for other emerging economies to follow.

Starting in 1991, all capital flows into Chile, independently of their maturity or length of stay, were subject to a one year unremunerated reserve requirement. About 30 per cent of the capital flowing into Chile had to be deposited at the Central Bank for one year. Since no interest was paid on these funds, shorter tem capital faced a higher cost than longer term capital. The fact that Chile grew very fast during the 1990s, at an average of 7 per cent per annum, and that it was not significantly affected by the successive currency crises in the emerging markets, has bolstered the view that emerging economies should restrict short term capital flows.

Indeed, Chile's controls on capital inflows have been praised from very different quarters[58] and have been seen as an example for the other emerging economies to follow. And former U.S. Secretary of the Treasury Robert Rubin, an ardent supporter of free capital mobility has now expressed support for controls on capital inflows, such as those adopted by Chile in the 1990's saying:

"...some kinds of restriction on inflows of capital will make sense for many developing countries." (The Economist, October, 2004)

[58] Joseph Stiglitz, a persistent critic of globalization, has been quoted by the New York Times (Sunday February 1, 1998) as saying: "You want to look for policies that discourage hot money but facilitate the flow of long-term loans, and there is evidence that the Chilean approach or some version of it, does this."

7.6: CURRENT SCENARIO OF THE CAPITAL ACCOUNT IN INDIA

The argument that is put forward for further liberalization of capital account transactions is that for most business and personal transactions the rupee is already partially convertible and in cases where specific permission is required for transactions above a monetary ceiling, it is generally received easily. The authorities have also declared that they will continue to pursue this deregulation policy further. However, it must be borne in mind that it is not immediately possible to give unrestricted freedom to domestic residents to convert their domestic bank deposits and idle assets in response to market developments or exchange rate expectations or even unlimited access to short-term external borrowings. Moreover, full CAC often provides wrong signals to the international investors as they are concerned about their profit maximization rather than productive investment. They mobilize their funds for higher returns which may result in moral hazard and adverse selection problems and thereby destabilize the financial system and cause great loss to the Indian economy.

India seems to be taking the approach that easing of capital controls would initially be marked by removal of capital outflow restrictions on NRIs, followed by corporates next, and then banks and finally freedom for residents in the last stage. Contrary to general belief, CAC can coexist with restrictions other than on external payments. For instance, it does not preclude the imposition of policy restrictions on foreign holding in any sector. For example, in the US there are restrictions on how much foreigners can own in the airlines industry even though the dollar is fully convertible on capital account.

At present the residents of the country cannot freely move money abroad. There are certain allowable limits beyond which permission from RBI is needed, which are shown in the Table 7.1, which lists the specific limits for purposes generally applicable. These limits are already quite liberal and even if the rules are relaxed in the future, most of the residents of the country would not be able to use any additional funds allowed, simply because of the fact that they cannot afford it. So, any further relaxation of the controls of the capital account would entail benefits only for a selected few. The point here is that for most people, CAC may not have any benefit as such.

Table 7.1: Specific Limits on the residents to move money abroad

(in US $)

Purpose	**Limit per annum**
Private visit abroad	10000
Business Travel	25000
Gifts / Donations[1]	5,000
For persons going abroad for employment	1,00,000
For persons emigrating abroad	1,00,000
For maintenance of close relatives	1,00,000
For studies abroad[2]	1,00,000
For general purpose including investments	25000

Source: Reserve Bank of India

Notes: **1** - The amount represents on each item of gift/donation

2 – It may also depend on fee requirement.

One of the preconditions set by the Tarapore Committee in 1997 was to have enough foreign exchange reserves before moving on to CAC, which should not be less than 6 months of import cover, or about $22 million. However, at present, the foreign exchange reserves are much more than that, and will be able to cover more than 13 months of import cover. Any more accumulation of reserves will adversely affect the profitability of the RBI, which we have already discussed in Part II of our study.

It is often reiterated that a move towards full CAC should always be preceded by financial sector reform, prudential norms and effective regulatory supervision. As evident from the foregoing discussion, India has been consistently attempting discernible improvement in each of the above areas before becoming fully convertible in the capital account. The sequencing of reforms was carefully thought out. Although the Asian crisis slowed down the move to CAC, the move is still very much on.

Till now, the stated stance of the authorities has been that the freedom of resident individuals has the least priority while sequencing reforms. Although even this stance is undergoing review at present, it is firmly believed that unless we are fully equipped, we should not rush into convertibility only to regret it at leisure. In order to prepare the country for CAC, the Government of India is taking steps to revamp the risk management systems and accounting standards for both banks and corporates so as to put them on a par with international standards. The NPAs of the Indian banking system continue to be above acceptable levels although the position is continuously improving. Legal changes have been effected to improve the recovery process. Moreover the Fiscal Responsibility Act is already implemented.

So far the Government of India has followed a path of gradual liberalization of its capital account, with considerable amount of controls in place. The rationale behind such endeavour was to insulate the Indian economy from the pitfalls of sudden reversals of short term capital flows, which has been evident in the various financial crises that has taken place in the developing countries in the 1990s.

Nonetheless, India still managed to attract huge amount of foreign institutional investment especially in the last 3-4 fiscal years. Moreover with the current account deficit of India under manageable terms and with substantial foreign reserves of over US$ 200 billion dollars, there is hardly any need for the Government of India to go for full CAC for more foreign investment. As our preceding analysis has shown, such foreign investment flows have been incapable of stimulating investment in India to any perceptible extent. So it would be prudent for the Government of India to put end to its endeavour of implementing full CAC in India, and continue with the gradual approach that we have observed so far.