CHAPTER VI
Summary and Conclusion

In India, the role of capital account was minimal and restricted to the financing of the current account deficit in the pre liberalization period till 1991. All private transactions were heavily regulated. The official flows dominated capital account together with External Commercial Borrowings (ECB) and Non Resident Indian (NRI) deposits in this period. By 1991, however, India became one of the heavily indebted countries in the World. In addition to the external debt problem, as a result of several adverse domestic and international developments as well as the macroeconomic imbalances created by the inward looking regime that spilled over to the Balance of Payments (BOP), liquidity crisis in BOP occurred in 1991. Capital account collapsed with the drying up of external finances as a result of loss in investor confidence. In response to the crisis, the government of India adopted the economic reform program involving both domestic and external sector reforms.

The broad approach to the capital account reforms was based on the recommendations of the Rangarajan Committee Report on the BOP (1993). The major elements identified in the report (1993) were a policy preference for foreign equity over foreign debt, reduction in recourse to commercial sources of borrowing and NRI deposits to prevent the recurrence of a crisis in the future. This was mainly intended to achieve the traditional benefits of capital account openness identified in the literature like increased availability of capital, portfolio diversification and consequent reductions in macroeconomic volatility and the disciplining effect on macroeconomic policies.

With these reforms already implemented in the first round, Reserve Bank of India (1997) appointed a committee under S.S.Tarapore to lay out a road map towards full capital account convertibility. The Tarapore Report (1997) recommended moving towards full capital account convertibility by 2000 provided conditions like fiscal consolidation, mandated inflation target; more flexible exchange rate policy, adequate foreign exchange reserves and a strong domestic financial sector were satisfied. However, the south East Asian financial crisis in 1997 brought about a shift in the policy with importance to stability than growth. A cautious approach has since been adopted towards capital account liberalization process by India. Ever since Prime
Minister Dr. Manmohan Singh (2006) put forward the idea of full capital account convertibility in India in the changed international scenario; the choice of an attitude towards it is again in question. The second committee appointed by RBI under Tarapore (2007) showed in their report that there is already an ongoing process of capital account liberalization and there is a need to build up on it. It recommended a phase by phase opening up of the remaining transactions. However, debate is still going on in this regard.

Given this background, this study is an attempt to empirically verify how far we have succeeded in achieving the major aims of implementing the capital account reforms. Such an attempt is particularly relevant for its policy implications since there is no detailed study on the capital account for the post liberalization era in the Indian context. The major objectives of this study are

1. Measure the degree of capital account openness in India and analyze the impact of specific policies on component wise capital flows
2. Analyze the impact of capital account openness on output, consumption and real exchange rate volatility
3. Examine the disciplining effect of capital account openness on inflation and fiscal deficit

The study begins with a review of the existing literature and country experiences regarding the implications of capital account openness. It clearly points out the importance of the degree of capital account openness and other country specific factors in this regard. The implications of capital account openness therefore need to be examined against the framework of the institutional and macroeconomic policy changes associated with it in a country.

Chapter 2 therefore discusses in detail the features of the capital account policy in the pre (1973-74 to 1992-93) and post liberalization (1993-94 to 2006-07) period in India. The control regime was formalized by 1973 legislation the Foreign Exchange Regulation Act (FERA). Hence 1973 is taken to mark the beginning of the control (pre liberalization) period and 1993, when several measures to decontrol the capital account were introduced the beginning of the post liberalization period. Two phases can be identified in the pre liberalization period. The period from 1973-74 to 1980-
was one with selective discrimination and controls and the period from 1981-83 to 1991-92 was a period of gradual and partial liberalization of the capital account in India. Multilateral and bilateral external assistance with high concessionality dominated the capital account in the first phase. In addition to them, ECBs together with NRI Deposits dominated capital account in the second phase in pre liberalization era. Regarding the exchange rate policy in India in this period, the rupee was pegged to the pound sterling after which there was a shift to a multicurrency basket linked arrangement.

The BOP crisis in 1991 provided the motivation for opening up of the Indian economy. In response to the crisis, capital account policy also changed as a part of the widespread economic reforms adopted by the government of India in 1991. Based on the Ranagaraj Committee Report on the Balance of Payments (1993), external sector reforms were implemented. The first round of capital account liberalization was aimed at changing the composition of the capital account with a shift from debt to non-debt creating flows like Foreign Direct Investment (FDI) and Foreign Portfolio Investment (FPI), a reduction in external commercial borrowings complemented with the removal of ceilings on many capital account transactions. The report of the Committee on Capital Account Convertibility (1997) under Tarapore formed the blueprint for the liberalization that followed thereafter. The deregulation of each control has ranged from complete restriction to prior approval on an individual or automatic basis to total freeing of the transaction.

The Foreign Exchange Management Act (FEMA) of 1999 is replaced by FERA (1973). This is consistent with full current account convertibility and contains provisions for progressive liberalization of capital account transactions. The second committee headed by Tarapore (2006) emphasized the need for deepening the ongoing process of capital account liberalization. Restrictions still exist on many capital account transactions. While the inflows and the outflows associated with inflows are made fully convertible, the other outflows are restricted. Further differential restrictions are applied to residents vis-à-vis non residents and to individuals vis-à-vis corporates and financial institutions. On a review of existing controls, a broad time frame of a five year period in three phases, 2006-07 (Phase I),
2007-08 and 2008-09 (Phase II) and 2009-10 and 2010-11 (Phase III) has been considered appropriate by the second Committee for further liberalization measures.

Against this background, Chapter 3 evaluates the impact of specific polices on components of capital flows. As a prelude to this, the degree of capital account openness in India is measured using two indicators i.e. policy indices following Quinn (1997) and the ratio of capital flows to GDP. Comparing these two indicators with that of other countries, it can be seen that the capital account in India is neither completely restricted nor very open. However, the degree of capital account openness in terms of policy indices (1.3 on an average) and gross capital flows to GDP ratio (19 percent) has increased significantly in the post liberalization period. The magnitude of the net capital inflows to GDP (2.7 percent) however is comparable to that of other developing countries (3.5 percent).

The composition of capital flows has changed significantly with a shift from debt creating flows like ECBs and NRI Deposits in the pre reform period to non debt creating flows like FDI and FPI in the post reform period. It is found that a diversified portfolio of financial assets with FDI (30 percent) and FPI (31 percent) dominating the capital account along with NRI Deposits (16.6 percent) and ECBs (17.1 percent) has been achieved since 1993-94. Canonical correlation is used to identify which policies affect which flows. The most significant policy measures affecting net capital inflows are found to be the opening up of more industries to FDI under the automatic route, opening up of Indian stock markets to FIIs and the introduction of India Millennium Deposit (IMD) Schemes to NRIs. The measures, which were not significant in influencing component wise net capital inflow to GDP ratio, are obtained to be OCB investment in India under the portfolio investment scheme and differential treatment to corporates based on end uses of ECB. The analysis shows a pattern of substitution between debt creating flows (ECB and NRI Deposits) and non-debt creating flows like FDI and FPI in the post reform period. Further, the policy measures aimed at discouraging volatile NRI Deposits and favoring non-debt creating flows like FDI and FPI are found to be effective to create a shift from debt to equity as recommended by RBI (1993) Report.
Theoretically, increased degree of capital account openness may provide an internationally diversified portfolio of financial assets and thereby help in reducing macroeconomic volatility. As per this, a small rise in diversification opportunities may raise welfare even in the absence of net capital flows. Hence how far the various reform measures related to capital account have succeeded in achieving its aim of reducing macroeconomic volatility through the diversified portfolio of assets is discussed.

In chapter 4, the implications of capital account openness as captured by the two indicators, on the volatility of macroeconomic aggregates like output, consumption and real exchange rate and volatility of consumption to volatility of output ratio is analysed using the model developed by Buch et al (2003). This model is used in the study since it allows controlling for the monetary, fiscal and terms of trade shocks existing in a country, which influences the impact of capital account openness on macroeconomic volatility. In the model the effects of interactions between capital account openness and (1) monetary policy volatility and (2) fiscal policy volatility on macroeconomic volatility are also captured. The results show that capital account openness in India has contributed significantly in reducing output volatility and real effective exchange rate volatility whereas no significant impact was seen on consumption volatility and ratio of consumption volatility to output volatility. Component wise disaggregated analysis shows that among the component wise capital flows, only FDI inflows were found to contribute significantly in reducing output and real effective exchange rate volatility. Thus, shift in the policy from debt to non-debt creating flows since 1993-94 may be justified given its positive outcomes. It is found that increased degree of capital account openness has reduced the impact of fiscal policy shocks on output. Also, it is shown that the increased degree of capital account openness may have reduced the impact of monetary policy shocks on real effective exchange rate volatility. Among the other variables, monetary policy shocks and fiscal policy shocks are obtained to be the significant positive determinants of output volatility. Further, monetary policy shocks contribute significantly to rise in REER volatility.

In Chapter 5, the policy disciplining effect on inflation and fiscal deficit, which is another major aim of capital account reforms in India is examined empirically. This
is examined in a multivariate framework which includes other variables also that may affect inflation and fiscal deficit mentioned in the literature. Lagged inflation, trade openness, growth rate of money supply and Prime Lending rate (PLR) are the other major variables available in the literature that can affect inflation. Trade openness, inflation and number of government changes are the other major variables available in the literature that can affect fiscal deficit. The theory does not give a clear cut picture regarding the direction of causality between the dependent and explanatory variables used in the analysis. Hence Granger causality tests are used to examine the direction of causality. Only those variables which are obtained to have causality to inflation and fiscal deficit are used in the estimation. The estimation results using OLS method show significant negative effect capital account openness on inflation and no statistically significant impact on fiscal deficit. In other words, the disciplinary effect of capital flows might be weaker on fiscal deficit than on inflation. This might be probably due to the fact that government policies like reducing fiscal deficit may be less affected by capital account openness since it may be politically more painful for the host government to reduce government deficit than to reduce inflation rate (Dräzen, 2001). At the disaggregated level among the capital flows, only FDI inflows are found to contribute significantly in reducing inflation. Growth rate of money supply and inflation expectations are obtained empirically to be the other two significant determinants of inflation particularly in the post liberalization period.

To sum up the study shows that the capital account reforms in India have succeeded to a great extent (1) in increasing the availability of capital (2) in changing the composition of the flows with a shift from debt to equity and (3) achieving a diversified portfolio of financial assets. Further it is the policies like opening up of more industries to FDI under the automatic route, opening up of Indian stock markets to FIIIs and the introduction of IMD Schemes to NRIs were found to be the most effective. It is also seen that opening up capital account has succeeded to a certain extent in achieving its two aims of (1) reducing macroeconomic volatility through the diversified portfolio of assets and (2) policy disciplining effect.

85 The political business cycle literature reports a robust positive association between fiscal deficit and re-election probability whereas the association between inflation and re-election probability is weaker or even negative (Dräzen, 2001). This means that politically it is more painful to reduce fiscal deficit than to reduce inflation.
6.1. Policy Implications
Our analysis shows that the capital account reforms have not contributed significantly in reducing consumption volatility. Empirical studies (Kose et al., 2003, 2005) have shown that the benefits of capital account openness in terms of consumption smoothing possibilities accrue only beyond a threshold value of the level of gross capital flows (approximately around 49 percent of GDP) while for India it is only 19 percent. Stringent restrictions still exist on many capital account transactions particularly on outflows in India. Thus our study shows that a phase by phase liberalization as recommended by RBI (2006) Report in the rules governing resident corporates/business entities, banks, non banks and individuals to invest abroad may be justified for the sake of increased capital flows so as to reduce consumption volatility also. However, given our focus on stability rather than growth our monetary and fiscal framework needs to be stabilized before further opening up capital account. This is particularly so since our findings that monetary and fiscal shocks play a major role in aggravating volatility emphasizes the need for stabilizing monetary and fiscal framework before further opening up of capital account. It is pertinent to remember in this context that the countries that avoided serious financial crises in the context of an open capital account had sustainable monetary and fiscal policies and systematic approach to safeguard domestic financial sector stability (Sweden, Australia, U.K etc).

6.2. Scope for further research
In this study, the two major channels through which the degree of capital account openness can affect Indian economy are discussed. Another indirect channel through which capital account openness can affect an economy is through its implications on financial sector stability. Capital account openness can have both positive and negative effects on the stability of financial system. On the one hand, capital account openness can improve economic growth and support an efficient allocation of resources and have favourable effects on the domestic financial system. It may fuel macroeconomic disturbances and also may increase specific types of risks that financial institutions typically face in their domestic activities like credit risk, market risk, interest rate risk and liquidity risk. How to coordinate the increased degree of capital account openness with different financial sector policies, taking into account the initial condition of financial and non financial entities and their capacity to manage the risks associated with international capital flows etc can be a major area for research in the Indian context. This can be undertaken for various segments of financial sector (eg: banking and non banking sectors). It is a very promising area for future research.