Abstract of Dissertation
Capital Account Openness and its Implications for Indian Economy-
An Empirical Study

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In the ongoing debates on the required degree of capital account openness in India, a critical assessment of its success so far needs to be empirically verified within the country specificities. Such a study is missing in the Indian context. This study tries to fill this gap. More specifically, the implications of capital account openness are examined in the framework of the institutional and policy changes in India. Given the above background, the objectives of the present study are,

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

The degree of capital account openness in India is measured using two indicators available in the literature (1) rule based indices and (2) capital flows as a percentage of GDP. The impact of specific policies on specific components of capital flows is examined using canonical correlation analysis. The results show that the capital account in India is neither completely open nor completely closed in a cross-country perspective though the degree of capital account openness has increased significantly in the post liberalization period (1993-94 to 2006-07). The magnitude of the net capital inflows to GDP ratio is however comparable to other developing countries. The composition of capital flows has changed significantly with a shift from debt creating flows like External Commercial Borrowings and Non Resident Indian Deposits in the pre reform period (1973-74 to 1993-94) 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 and FPI dominating the capital account has been achieved since 1993-94. The most significant policy measures affecting component wise 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 FIIIs and the introduction of IMD Schemes to NRIs. Further, the policy
measures aimed at reducing as well as discouraging volatile NRI Deposits and favoring non-debt creating flows like FDI and FPI are obtained to be effective to create a shift from debt to equity as recommended by RBI (1993) Report.

The implications of capital account openness on the volatility of output, consumption, real exchange rate and volatility of consumption to output volatility ratio are examined in our study by controlling for the effects of monetary, fiscal and terms of trade shocks using the model developed by Butch et al(2002). The results show that the capital account openness in India may have significantly contributed in reducing output volatility and real effective exchange rate volatility whereas no significant impact on consumption volatility and volatility of consumption relative to that of output volatility is found. Among the component wise capital flows, only FDI inflows are obtained to contribute significantly in reducing output and 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. However the results show that the effect of fiscal policy shocks on output is smoothened by the increased degree of capital account openness. At the same time the effects of monetary policy shocks on real exchange rate is smoothened by the increased degree of capital account openness.

The impact of capital account openness on inflation and fiscal deficit is examined by multivariate modeling, which includes other relevant variables identified in the literature. Our results show capital account openness has a strong disciplining effect on inflation whereas it has no significant effect on fiscal deficit.

In the Indian context, further phase-by-phase liberalization of transactions seems to be justified for better positive outcomes on macro volatility and for the disciplining effect. In this context, our study shows that the monetary and fiscal frameworks need to be stabilized before further opening up capital account.