# CAPITAL ACCOUNT LIBERALISATION: THE INDIAN EXPERIENCE

by

DR. NARENDRA JADHAV

**Paper Presented at**

***A Tale of Two Giants:***
***India's and China's Experience***
***with Reform and Growth***

New Delhi
(November, 2003)

# Capital Account Liberalisation: The Indian Experience*

## I. Introduction

When India and China successfully withstood the contagion from the East Asian crisis in 1997, the relatively restrictive capital account regime of these two countries was generally highlighted as the saviour. Unlike the pre-Crisis period when capital controls were generally viewed as a taboo, policy thinking in the post-crisis period has changed dramatically, with several emerging market economies slowing down the pace and content of liberalisation of capital controls with a view to limiting their vulnerability to crisis. The benefits and costs of an open capital account appear more ambiguous today than what many researchers and policy makers had believed in the pre-crisis period. In this context, the approach to capital account liberalisation as adopted by India and China has become an important subject of international policy discussions.

"When knowledge is limited, the rule for policy makers should be – first do no harm"[1]. Forms of liberalisation that may not solve any problem but can potentially become a source of instability must be avoided. Following this dictum, India has followed a gradual and calibrated approach towards capital account liberalisation. In particular, the Indian policy towards capital flows has laid emphasis on encouraging larger non-debt and longer-maturity debt flows, since the benefits associated with such flows may clearly outweigh the costs. On the other hand, the policy has retained controls on short-term debt inflows and also on capital outflows involving residents.

Today, the policy challenges for India arising from capital account liberalisation broadly fall under two categories:

(a) management of the surge in capital flows, and

---

* Dr. Narendra Jadhav is currently Principal Adviser, Department of Economic Analysis and Policy (DEAP), Reserve Bank of India. The paper contain author's personal views and not necessarily of the institution to which he belongs. The author is grateful to Shri Sitikantha Pattnaik and Shri Arindam Roy for assistance. However, the usual disclaimer applies.

[1] Rodrik, Dani (1998).

(b) achieving preconditions that could create room for further liberalisation of the capital account.

In the face of weak domestic absorption of foreign capital and a managed-float exchange rate regime, large reserve accretion in recent years has given rise to a challenge on the monetary management front. Even though effective sterilisation has helped in regaining control over the money supply process, costs associated with sterilisation have been an issue, which is being widely debated. Some have even argued that the high reserve policy has adverse growth implications and must be abandoned in favour of a regime characterised by flexible exchange rate and full market absorption of foreign capital. Some view that the recent surge in capital flows is in response to positive interest rate differentials in the face of a stable/appreciating exchange rate. The conditions that cause such surge in inflows must, therefore, change. There has also been a view that if the surge persist in the face of a current account surplus driven by large remittances and software exports, the "Dutch disease' may spread to India. There is a perception that India has attracted much less foreign capital, particularly FDI, despite a liberal policy environment. The overemphasis on preconditions, particularly fiscal consolidation and a strong financial system, has also been viewed as the factor that has slowed down the progress on liberalisation of capital account. All these views clearly indicate the trade-offs that may be involved in policy choices in the context of liberalisation of the capital account. This paper is aimed to clarifying some of these issues based on an assessment of the costs and benefits of liberalisation of capital account against the background of India's specific circumstances and needs.

This paper has been organised as follows:

1) Section II reviews the received wisdom on capital account liberalisation by drawing upon theoretical literature as well as country experiences. The pre-conditions that emerge are also briefly discussed before dealing with issues involved in the sequencing of capital account liberalisation.
2) A cross-country perspective on the policy preference for the broad framework of capital account liberalisation is provided in Section III by assessing the impact of capital account liberalisation on allocative efficiency for resources,

disciplining macroeconomic policy, and growth; effectiveness of capital controls; and the appropriateness of the international financial architecture to deal with challenges arising from capital mobility.

3) Section IV details the Indian approach, which has been diagnosed against the above benchmarks.

## II. Costs and Benefits, Preconditions and Sequencing of Capital Account Liberalisation

Capital controls have conventionally been used the world over to deal with situations of weak balance of payments. Over time, capital controls have also been increasingly viewed as an instrument of monetary and exchange rate autonomy. In a number of countries, application of capital controls allowed the authorities to manipulate interest rates and exchange rates so as to attain the objectives of internal and external balance. The Impossible Trinity (i.e., the incompatibility between monetary policy independence, open capital account and fixed/managed exchange rate regime) also validated a role for capital controls in countries operating with fixed/managed flexible regimes. Subsequent analyses based on asymmetric information and herd behaviour in financial markets suggested that capital controls may help in dealing with market failures more effectively, particularly those arising from volatility in short-term capital flows and exchange rates. As pointed out by Johnston and Tamirisa (1998), capital controls are more likely to exist in countries with fixed or managed exchange rate regimes, lower per-capita incomes, larger government consumption as a ratio to GDP, less independent central banks, larger current account deficits, low levels of economic development, high tariff barriers, and large black market premia.

Over the years, however, open capital account has been advocated quite strongly for developing economies, even when the perceived benefits of capital account liberalization were deemed to be limited. For example, Gilbert *et al* (2000) viewed that "if the benefits of capital market liberalization are smaller for the poorest countries than for the middle income countries, the same is probably also true of the costs". An assessment of the alternative sources of benefits and costs associated with an open may be summarized as follows:

**(a) The Case for an Open Capital Account**

- An open capital account could bring with it greater financial efficiency, specialisation and innovation by exposing the financial sector to global competition.
- Developing countries need external capital to sustain an excess of investment over domestic saving and an open capital account could attract larger foreign capital.
- Residents get the opportunity to base their investment and consumption decisions on world interest rates and world prices for tradeables, which could enhance their welfare.
- By setting prices right, an open capital account enables aggregate savings and investments to be optimised, leading to both allocative efficiency and competitive discipline.
- By offering the opportunity of using the world market to diversify portfolios, an open capital account permits both savers and investors to protect the real value of their assets through risk reduction.
- Capital controls could encourage (particularly during macro-economic instability) hidden capital flight and/or diversion of saving into real assets, gold, *etc*., leading to suboptimal use of internal resources.
- Capital controls are not very effective, particularly when current account is convertible, as current account transactions create channels for disguised capital flows.
- Capital controls intend to insulate domestic financial conditions from external financial developments. The influence of external financial conditions, however, has been increasing over the years even in countries with extensive capital controls and because the costs of evading the controls have declined and the attractiveness of holding assets in offshore markets have increased, capital controls are increasingly becoming ineffective.

- Going by the "squeezing on a balloon argument", capital being fungible, restrictions on one form of capital and not on others would quickly lead to displacement of flows to the uncontrolled segment[2].

**(b) The Case against Liberalization of Capital Account**

- An open capital account could lead to the export of domestic savings, which for capital scarce developing countries would cripple the financing of domestic investment.
- It would weaken the ability of the authorities to tax domestic financial activities, income and wealth.
- Capital convertibility could expose the economy to greater macroeconomic instability arising from the volatility of short-term capital movements, the risk of large capital outflows and associated negative externalities.
- Premature liberalisation (that is, if the speed and sequencing of reforms are not appropriate) could initially stimulate capital inflows that would cause real exchange rate to appreciate and thereby destabilise an economy undergoing the fragile process of transition and structural reform. Once stabilisation programme lacks credibility, currency substitution and capital flight could trigger a BoP crisis, depreciation and spiraling inflation.
- It is commodity convertibility rather than financial convertibility that is of the greatest welfare significance.
- Speculative short-term movements in the interest rates may make monetary policy ineffective.
- Due to higher capital inflows following capital convertibility, the appreciating real exchange rate would divert resources from tradable to non-tradable sectors (like construction, housing, hotels and tourism etc;) and this would happen in the face of rising external liabilities (i.e., the risk of the "Dutch disease effect").

[2] Quirk (1989).

- A convertible capital account could lead to financial bubbles, especially through irrational exuberance of investment in real estate and equity market financed by unbridled foreign borrowing.
- Capital convertibility would expose the distortions in the price of borrowing from abroad vis-à-vis the domestic market and under such circumstances private firms would borrow more than what is socially optimal. This generally increases the cost of foreign borrowings for all borrowers.

**(c) Preconditions**

The ever growing literature on the subject has thrown up the following pre-conditions:

a) Substantial narrowing of the differences between domestic and external financial market conditions.
b) Establishing a flexible interest rate structure.
c) Reducing fiscal deficit and financing the lower level of deficit in a non-inflationary way (i.e., complete avoidance of use of inflation tax).
d) Limiting/reducing taxes on income, wealth, and transactions to international levels.
e) An appropriate exchange rate policy, with greater flexibility as the degree of openness increases.
f) Restructuring and recapitalisation of domestic financial institutions.
g) Strengthening prudential supervision of financial institutions.
h) Enforcing domestic competition to foster allocative and operational efficiency within the financial sector.
i) Reducing restrictions inhibiting wage price flexibility.
j) Introducing Second Generation Reforms – promotion of domestic competition, increased transparency and accountability, good governance, labour reforms, and measures to ensure equitable distribution of growth benefits.

**(d) Sequencing of Capital Account Liberalisation**

In the neo-classical framework, capital inflows contribute to growth primarily by supplementing domestic saving, while in the endogenous growth framework the sources of growth attributed to capital flows comprise the spillovers associated with foreign capital in the form of technology, skills, and introduction of new products as well as the positive externalities in terms of higher efficiency of domestic financial markets and resultant improved resource allocation and efficient financial intermediation by domestic financial institutions. Since the spillovers and externalities associated with different forms of foreign capital could vary, a pecking order approach to the composition of capital flows is often advocated which could help in prioritizing capital inflows based on perceived growth enhancing role of each form of capital. Symmetrically, prioritization of outflows has also been emphasized in the literature.

McKinnon (1973) had underscored that restrictions on trade in goods and services should be liberalized prior to liberalization of capital transactions because, large capital flows that may result in response to opening up of the capital account could give rise to real exchange rate appreciation, which in turn could erode trade competitiveness and thereby constrain trade liberalization. McKinnon and Pill (1996) viewed that liberalistion of the capital account should wait till the reform process in the banking sector is completed and yields the desired result. Gilbert *et al* (2000) have sounded a serious precautionary note: "even with the best possible sequencing, mistakes will be made and crises will occur". It is widely contended that costs outweigh the benefits when the sequencing of liberalization becomes faulty and therefore, it is the attainment of preconditions that should determine the sequencing of liberalization.

## III. Cross Country Perspective

A country's policy approach to capital account essentially involves a search for answer to some broad questions:

- Can free mobility of capital ensure efficient allocation of global savings?
- Do capital account liberalization promote higher growth?
- Can financial openness discipline domestic macroeconomic policies?
- Can capital controls be effective?
- Is the design of the international financial architecture appropriate to deal with the challenges arising from free capital mobility?

The growing global macroeconomic imbalance – as evidenced by the large and sustained current account deficit of the US – suggests that markets may, at times, allocate global saving differently from what may be perceived by the policy makers as appropriate and sustainable in the long-run. The distribution of the private capital flows to emerging markets also reveals the high degree of concentration in a few countries. Despite the available empirical research on the determinants of capital flows, behaviour of capital flows at times cannot be explained by any fundamentals – as the market often gets dominated by herd behaviour driven by noise rather than news. For instance, the South East Asian countries received US $ 94 billion in 1996 and another US $ 70 billion in the first half of 1997. In the second half of 1997, however, there was an outflow of US $ 102 billion. Such order of reversal in a single year can hardly be explained by fundamentals alone.

The beneficial effects of capital account liberalization on growth are also ambiguous. An empirical assessment conducted by Rodrik (1998), found that " there is no evidence that countries without capital controls have grown faster, invested more, or experienced lower inflation". Indeed, highlighting the possible presence of reverse causality – i.e. countries with better overall economic performance favouring removal capital controls – the study concluded that empirical relationships between open capital account and economic performance are more likely to hide the negative relationship than explaining any positive relationship. "Capital controls are essentially uncorrelated with long-term economic performance once other determinants are controlled for". A caveat is

in order here. In empirical analyses, statistical measure of the degree of capital control has all along been a major irritant. As noted by Cooper (2001), "results (of empirical analyses) cannot be considered decisive until we have better measures of the intensity, as opposed to the mere existence, of capital controls".

There is, however, some unanimity on the point that open capital account exerts pressures to discipline domestic macro-economic and financial environment. Gruben and McLeod (2001) studied the potential link between two important developments in the 1990s – greater financial openness across a large number of countries and the significant decline in global inflation. The link between the two could arise from the penalties for excess money creation under an open capital account regime. They concluded that by giving rise to disinflation, open capital account could contribute to higher growth. Another study by Kim (1999) that analysed the disciplinary effects of an open capital account on fiscal deficit suggests that complete freedom for outward capital mobility could be associated with a reduction in budget deficit by 2.3 per cent of GDP. Gourinchas and Jeanne (2002) emphasized that many emerging countries may actually benefit from the discipline effect rather than the conventional resource allocation effect. They concluded, "capital account openness is not always and everywhere a necessary condition for an economic take-off".

On the effectiveness of controls, country experiences are varied, depending, at times, on the form of control used (Annex-1), the specific areas that are picked for liberalization (Annex-2), and the motive behind the use of controls (Annex-3). The broad lesson from country experiences suggest that, to be effective, controls may have to be comprehensive, strongly enforced and must be accompanied by fundamental reforms so that controls are not seen as a substitute for reforms. Most importantly, controls need not work in the face of persistent presence of incentive for circumvention, particularly in cases of attractive return differentials in the offshore market and growing expectations of currency depreciation.

Controls on outflows could be broadly classified into preventive controls and curative controls. While the former intend to prevent the emergence of a balance of payments crisis, the latter could be applied as a means to manage a crisis (as in the case of Malaysia). Yoshitomi and Shirai (2000) present a review of the empirical studies on the effectiveness of both variants of control which suggests that "in almost 70 per cent of the cases where the controls on outflows were used as a preventive measure, a large increase in capital flight was observed after their imposition". The support for using curative control came from Krugman (1998) who suggested temporary use of controls amidst a crisis to avoid the adverse effects of the alternative –*i.e.* a high interest rate defence of the exchange rate[3].

The Malaysian case offers several interesting lessons. The Malaysian Ringgit fell sharply from $1=RM 2.5 in the second quarter of 1997 to $1=RM 4.2 in the second quarter of 1998 and initially the authorities tried to defend the depreciation through tight monetary policy[4]. In the face of large difference in the onshore and off shore interest rates, controls were implemented in September 1998 for avoiding speculative activities. The controls banned transfers between domestic and foreign accounts and between foreign accounts, prohibited ringgit credit extended to non-resident banks and stock broking firms, prevented repatriation of investment for one year (amounting to a compulsory one year holding period requirement), and fixed the exchange rate at $1=RM 3.8. In February 1999, price based controls replaced prudential/quantitative controls with levies on repayment of debt and repatriation of profits[5]. These measures allowed non-residents to withdraw funds but penalized them for early withdrawals. After an year, i.e., September 1999 onwards the measures were further simplified and lifted. The major advantage of these controls, besides stemming speculation, was in terms of giving policy

[3] In his open letter to Prime Minister Mahathir on the Malaysian controls, however, Krugman emphasized that: (a) controls should disrupt ordinary business as little as possible, (b) distortions associated with controls are serious and tend to grow over time, suggesting that controls must be used as a temporary measure, (c) controls may do most damage when the intention is to defend an overvalued exchange rate, and (d) controls must aid reforms and they should not be viewed as the alternative to reform.

[4] Growth in base money fell from 25 per cent in 1997 to minus 15 per cent in 1998, and the domestic lending rate hardened by close to 3 percentage points.

[5] The one year holding period requirement was replaced by 0-30 per cent graded exit levies on outflow of principal, and 10-30 per cent levy on profit repatriation, depending on the period over which profits were realized.

discretion to the authorities for restoration of confidence[6]. On the other hand, as noted by Yoshitomi and Shirai (2000), the success of controls in Malaysia may not be overemphasized because controls were imposed almost 14 months after the crisis started by which time large part of the speculative outflows had already occurred. The controls were also introduced against the backdrop of an undervalued exchange rate, which enhanced the probability of success.

Unlike the controls on outflows, in discussions relating to the effectiveness of controls on inflows, one generally refers to the Chilean experience. During 1978-82, when Chile experienced surge in capital flows, external loans up to 24 months maturity were forbidden, and those with maturities from 24 to 36 months were subjected to non-interest-yielding reserve requirement ranging from 10 to 25 per cent. Prudential regulations also helped in limiting the foreign liabilities of commercial banks, which were linked directly to the banks' equity. Chile, however, could not avoid a crisis despite such restrictions in 1982. Chilean capital controls, thus, may have given a false sense of security. It could control short-term inflows on original maturity basis, but not on residual maturity basis (Edwards, 1999).

In the early 1990s, Chile again used similar instruments. In June 1991, all external loans were subjected to 20 per cent non-interest-yielding reserve requirement[7]. In May 1992, the reserve requirement was raised to 30 per cent and also extended to most other forms of foreign capital ( including trade credits, foreign deposits with domestic banks, financial FDI and ADR/GDR proceeds). In June 1998, when Chile experienced capital outflows, it reduced the reserve requirement to 10 per cent, and subsequently to zero per cent in September 1998. (Alternative forms of such taxes/tax equivalents and the motive behind their use are set out in Annex-4)[8]. For assessing the effectiveness of these

[6] After the introduction of the controls, short-term interest rates fell by close to 5 percentage points and as a matter of policy the fiscal deficit was widened from 3.7 per cent of GDP in 1998 to 6.1 per cent in 1999.
[7] The reserves were to be maintained with the central bank for a minimum period of 3 months.
[8] While some suggest the imposition of a tax on a permanent basis on all inflows, Tobin suggested "throwing sand in the wheels" approach under which countries must appropriately raise the "threshold limit on capital inflows". As per a modified two-tier Tobin tax, a country could impose a transaction tax to increase the cost of forex trading and an exchange surcharge with the rate progressively increasing with the deviation from the equilibrium exchange rate.

controls, as emphasized by Edwards (1999), one has to consider three basic objectives behind the introduction of controls on inflows:

(a) to slowdown the volume of capital inflows and to tilt the composition in favour of longer maturities,

(b) to avoid real exchange rate appreciation that stemmed from surges in capital flows, and

(c) to maintain a domestic interest rate different from international rates so that domestic rates could be used as part of independent monetary policy to attain monetary policy goals.

The experience of Chile suggests that none of these objectives could be eventually met, which validate the argument that controls on inflows may not be effective[9].

Finally, the inappropriateness of the international financial architecture to deal with the crises arising from open capital account has been recognised in the post East Asian crisis period. As underscored by Gilbert, Irwin and Vines (2000), "within a cost-benefit framework, the benefits are seen as more modest than had previously been supposed, while the Asian crisis has increased our estimates of the potential costs of liberalization". The change in international thinking on the issue appears quite stark in the context of the decision of the Interim Committee in April 1997 favouring an amendment of the Articles of Agreement to make liberalisation of the capital account as one of the purposes of the IMF (Eichengreen, 1999). Despite the recent international initiatives on crisis prevention and resolution, the international architecture falls short of the requirement that could enhance the confidence of the emerging economies while designing country specific strategies for liberalization of capital transactions. Unlike in the pre-crises period, the need for entrenching preconditions has come to the forefront of policy thinking while deciding on the pace, timing, content and sequencing of liberalization.

[9] Neither the volume of capital inflows nor the composition of capital flows (in terms of residual maturity rather than original maturity) altered drastically in response to controls. The real exchange rate appreciated by 28 per cent during April 1991 and September 1998. The interest rate differential adjusted for expected change in the exchange rate was small and disappeared quickly over time.

## IV. The Indian Approach

In India, liberalization of the capital account transactions received policy attention in the aftermath of the 1991 external payments crisis. As part of the overall restructuring package of the external sector, it aimed at reducing reliance on debt creating flows – particularly short-term, while encouraging foreign investment - especially foreign direct investment (FDI). While the focus was primarily on attracting adequate private capital of the desired composition, during surges in capital flows the policy measures were also directed at regulating the inflows. With gradual liberalisation of foreign investment, both FDI and portfolio investment (FPI), the Rupee for all purposes has been made convertible for foreign investors. However, restrictions on capital outflows involving residents continue. Such controls have indeed served the needs of the external sector and the overall economy well, and many of them can be removed depending on the progress on entrenching the preconditions on a durable basis.

### (a) Linkage between Current and Capital Account

The Indian experience of capital account liberalisation, like many other developing countries was preceded by trade liberalisation. India's trade liberalisation included a virtual elimination of licensing and a progressive shift of restricted items of imports to Open General Licences (OGL). At the same time, reduction of tariff rates were initiated in the early 1990s. The average tariff rate has been more than halved between early and late 1990s. The long-term objective of India's tariff reduction is to bring such rates in line with those prevailing in the members of Asia Pacific Economic Cooperation. Tariff reduction was also followed by removal of non-tariff barriers. Between 1999 and 2001, India has eliminated all quantitative restrictions on imports, which were earlier imposed for balance of payments consideration.

Initial reform measures were directed at current account convertibility leading to acceptance of Article-VIII by August 1994. Foreign exchange regulations, however, built in certain safeguards related to current account transactions. The precautionary safeguards stemmed from the recognition of possible linkages between capital account

and current account transactions like capital outflows in the guise of current account transactions. Such safeguard measures, which strengthened the effectiveness of the management of the capital account included:

- requirement of repatriation and surrender of export proceeds while allowing a portion of it to be retained in foreign currency accounts in India which could be used for approved purposes,
- allowing Authorised Dealers to sell foreign exchange for underlying transactions based on documentary evidence, and
- placing indicative limits for purchase of foreign exchange to meet different kind of current account transactions, which were reasonable in relation to the purpose.

**(b) Preconditions for Capital Account Liberalisation**

Even before the onset of the South East Asian Crises of 1997, India had worked on an appropriate road map for liberalizing the restrictions on capital transactions through a Committee on Capital Account Convertibility (CAC)[10]. The Report recommended detailed measures for achieving CAC, including specification of the preconditions, sequence and time frame for undertaking such measures; and suggested necessary domestic policy measures and changes in institutional framework. The findings and recommendations of the Report appear particularly path-breaking, when assessed in the context of similar recommendations that started flowing from almost every quarter, *albeit*, only after the East Asian crises. The unique aspect of the Report was that despite the strong wave in favour of CAC that was prevailing prior to the East Asian crisis, it emphasized the importance of preconditions and sequencing. Its particular emphasis was on fiscal consolidation, low inflation, comfortable foreign exchange reserves, and strong and resilient financial system as important preconditions, which has received wider support now from international policy makers. Only on the appropriate exchange rate regime that could be consistent with CAC, its recommendation seemed somewhat inconsistent with the now popular "impossible trinity". CAC may require a more flexible

[10] The Committee was chaired by the then Deputy Governor of the Reserve Bank of India, Mr. S. S. Tarapore.

exchange rate, and any fixed/managed regime may turn vulnerable to attack once the capital account is opened up. Real exchange rate targeting – and the associated loss of nominal anchor – also has implications for monetary policy independence. Recognising these limitations, the Indian authorities rightly did not accept the recommendation of +/- 5 per cent REER band and still persist with a managed-float regime. The exchange rate that evolved during this regime (since March 1993) has successfully avoided both large volatility and major misalignment in terms of REER appreciation.

Subsequent to the Report, substantial liberalisation of the capital account has been made, particularly with respect to inward foreign investment. This has been possible due to significant progress towards achieving the following preconditions (Annex-5 presents the current position in respect of specific precondition recommended in the Report):

- mandatory annual average inflation rate of 3-5 per cent (as against the realised rate of 3.4 per cent in 2002-03, though not mandatory),
- deregulated interest rates (except rates on savings bank account),
- reduction of CRR to the statutory minimum of 3 per cent (as against the current requirement of 4.5 per cent),
- external debt service ratio of 20-25 per cent (as against 14.6 per cent in 2002-03),
- foreign exchange reserves providing import cover of more than 6 months (as against 17 months at end-October 2003),
- and adoption of best practices of risk management, accounting and disclosure norms.

However, India is yet to make considerable progress on the other set of preconditions like:

- fiscal consolidation with a stipulation of reduction of gross fiscal deficit to 3.5 per cent of GDP by 1999-00 (as against GFD of 5.9 per cent in 2002-03 and budgeted estimate of 5.6 per cent in 2003-04)[11], and

[11] The recent legislation on Fiscal Responsibility and Budget Management with a stipulation of eliminating revenue deficit of the Central Government by end-March 2008 is expected to create conducive environment for fiscal consolidation.

- further strengthening of the financial system with the indicative gross non-performing assets of total advances to be brought down to 5 per cent by 1999-00 (as against reduction in gross NPA of public sector banks from 16 per cent to 11 per cent in 2001-02)[12].

**(c) Operationalising CAC**

It needs no emphasis that mere attainment of preconditions may not be enough to go for full liberalization. The approach towards CAC must be consistent with the overall policy framework that is assigned to the objective of growth and stability. Incremental higher growth that comes at the expense of high instability should be avoided. Indeed, avoiding instability itself has emerged as a major precondition to higher growth. Needless to say that liberalisation measures that are clearly beneficial need priority attention, and such areas have already been liberalized in India. As underscored by Panagariya (1998), "most of the benefits of capital mobility can be reaped via partial mobility, principally equity and direct foreign investment". Within India, however, some have preferred more extreme forms of CAC. Virmani (1999) for example, had advocated that every resident individual should be allowed to use up to $50,000 per annum to purchase goods and services abroad, and to open a bank account abroad. It was also recommended that corporations and businesses be allowed to make financial capital transfers abroad (including opening bank accounts with check facility) up to a limit of $50,000 per annum. Indeed, most of these suggestions for liberal overseas investment have been recently implemented with robust external sector and burgeoning forex reserves.

India considers liberalization of capital account as a process and not a single event. As highlighted by Reddy (2000), in its gradual and cautious approach for operationalising CAC in India, a clear distinction is made between inflows and outflows, with asymmetrical treatment from control angle for inflows (less restricted), outflows

[12] The on going efforts of banking sector reforms, which focuses on better credit risk management and recovery measures, including the recent Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002 is expected to provide banks with additional avenues for disposition of their non-performing assets.

associated with inflows (free) and other outflows (more restricted). Differential restrictions are also applied to residents *vis-a-vis* non-residents and to individuals (highly restrictive) *vis-a-vis* corporates (restrictive) and financial intermediaries like banks (more restrictive) and institutional investors (less restrictive). A combination of direct administrative controls (i.e., interest rate ceilings) and market-based instruments of control (i.e., tax or reserve requirement) is used for ensuring the requirements of a prudent approach to management of the capital account. The policy of ensuring a well diversified capital account with rising share of non-debt liabilities and low percentage of short-term debt in total debt liabilities is amply reflected in India's policies of foreign direct investment, portfolio investment and external commercial borrowings. Quantitative annual ceilings on ECB along with maturity and end-use restrictions broadly shape the ECB policy. NRI deposits have been liberalised while policy framework imparted stability to such flows. FDI is encouraged through a liberal but dual route: a progressively expanding automatic route and a case-by-case route. Portfolio investments, which have been progressively liberalised, are restricted to select players, particularly approved institutional investors and the NRIs. Indian companies are also permitted to access international markets through GDRs/ADRs, subject to approval. Foreign investment in the form of Indian joint ventures abroad is also permitted through both automatic and case-by-case routes. Restrictions on outflows involving Indian corporates, banks and those who earn foreign exchange (e.g. exporters) have also been liberalised over time, subject to certain prudential guidelines.

In what follows, a detailed review of various aspects of CAC is presented, first in respect of "debt-creating" inflows, and "non-debt creating" inflows. This has been followed by reviewing various measures related to liberalisation of capital outflows with respect to overseas investment, while clarifying the policy stance on convertibility of domestic assets, dollarisation, reserves management, exchange rate management and sterilisation.

## (d) Management of Debt-Creating Inflows

### (i) External Commercial Borrowings

External Commercial Borrowings (ECBs) have been guided by the overall consideration of prudent external debt management. Access to ECBs has been generally restricted to corporates and development financial institutions thereby keeping out banks from such borrowings. At the same time, ECBs have been subjected to overall annual ceilings, maturity norms and end-use restrictions. Over time, with liberalization of ECBs, corporates have been allowed to borrow up to US$ 50 million under the 'automatic route' and up to US$ 100 million with prior approval from RBI. For borrowing above US$ 100 million, prior approval from the Government needs to be obtained. Greater priority has been accorded for projects in the infrastructure and core sectors such as power, oil exploration, telecom, railways, road & bridges, ports, industrial parks, urban infrastructures and for 100 per cent Export Oriented Units. End-use and maturity prescriptions have also been substantially liberalized in the recent years, besides permitting ECB for rupee expenditures. Indian corporates can now access ECB from any recognised lender with a minimum maturity of three years subject to a ceiling on spreads over LIBOR rates. The spreads have been brought down gradually in tune with the soft interest rate conditions in the international market. However, in additional to the annual ceiling on ECBs, end use restrictions for financing real estate and equity market investment are still in force (except for developing integrated townships and financing disinvestment of PSUs). Very recently, the policy on access of ECB by corporates has been reviewed. ECBs beyond the "automatic" route can now be accessed only for forex needs of infrastructure projects and machinery imports. Corporates are also required to park the funds abroad pending actual utilization.

A distinguishing feature of the liberalised regime is to provide greater flexibility to corporates in order to manage their exposure on ECB by allowing prepayment under the automatic route without any ceiling and also allow hedging. In addition to facilities of undertaking cross-currency hedging and Rupee forward cover (up to one year as is

currently available). Rupee options have been introduced in June 2003. Furthermore, in order to enable corporates to hedge exchange rate risks and raise Rupee resources domestically, Rupee denominated structural obligations are permitted to be credit enhanced. While the above measures will encourage corporates to hedge their exposure and thereby limit risks on their balance sheets, given their long-term exposure to currency risks, there is an urgent need to develop the nascent Rupee derivatives market expeditiously.

Apart from the overall policy towards ECB, as part of pre-emptive confidence building measure towards bolstering forex reserves, appropriate size of foreign capital has been raised periodically through issuance of special bonds by the largest nationalised bank[13]. Even though, at times, the rationale behind raising such high cost debt capital has been questioned, when viewed in the context of their role in enhancing market confidence amidst major shocks to the country's external sector, one could say that the overall benefit seems to have outweighed the additional costs. While nearly half of the proceeds of redemption of US$ 1.6 billion of IDBs were reinvested into the country, more recently, redemption of US$ 4.3 billion of RIBs were effected smoothly without any adverse impact on the foreign exchange market. It is expected that bulk of the proceeds could have been reinvested into the country.

Following the policy imperatives, gross disbursement of ECBs (excluding IDB, RIB and IMD) declined from a peak of US $ 7.4 billion in 1997-98 to US $ 1.9 billion in 2002-03, reflecting reduced reliance on debt financing. Net flows (excluding IDB, RIB and IMD) turned negative since 1998-99 reflecting reduced recourse to ECBs as well as prepayment undertaken by corporates in recent years to take advantage of soft interest rates prevailing in the overseas market[14].

[13] The State Bank of India raised US$ 1.6 billion of India Development Bond in 1990-91, US$ 4.2 billion of Resurgent India Bonds in 1998-99 and US $ 5.5 billion of India Millennium Deposit in 2000-01.
[14] Total prepayment by corporates, which amounted to US $ 1.1 billion during April 2001 to December 2002 is estimated to save interest cost of US $ 90 million for the corporates.

**(ii) Non-Resident Deposits**

There have been significant changes in the policy framework for non-resident (NRI) deposits held by the Indian banking system, which constitute a major portion of external debt for India. The BoP crisis of 1990-91 demonstrated the volatility of NRI deposits due to large interest differentials and explicit exchange rate guarantee provided by the Government. Since then, the policy aimed at attracting stable deposits. This has been achieved through:

(i) withdrawal of exchange rate guarantees on various deposits.

(ii) a policy induced shift in favour of local currency denominated deposits;

(iii) rationalization of interest rates on rupee denominated NRI deposits[15];

(iv) linking of the interest rates to LIBOR for foreign currency denominated deposits;

(v) de-emphasising short-term deposits (up to 12 months) in case of foreign currency denominated deposits; and

(vi) making NRI deposits fully repatriable[16].

Reserve requirement on these deposits has been varied as an instrument to influence monetary and exchange rate management and to regulate the size of the inflows depending on the country's requirements.

Outstanding NRI deposits grew steadily from US $ 14.0 billion at end-March 1991 (constituting 16.7 per cent of total external debt) to US $ 28.5 billion at end-March 2003 (25.3 per cent of total external debt). However, there has been a significant policy induced compositional shift ensuring stability of such deposits with the proportion of local currency denominated deposits increasing from around one-fourth in end-March

[15] During the recent period, while short-term rupee denominated NRI deposits have been discontinued, interest rate on such deposits are now subject to a lower reduced ceiling of 25 basis points over Libor.

[16] As part of the rationalisation of NRI deposits, non-repatriable rupee denominated (NRNRD) deposits, which amounted to US$ 7.1 billion in end-March 2002, on which only interest payments were freely repatriable, was discontinued effective from April 1, 2002. At the same time, as part of the gradual move towards capital account convertibility, the maturity proceeds of outstanding NRNRD deposits could be reinvested in fully repatriable NRI deposits. Accordingly, the outstanding NRNRD deposits declined steadily to US $ 2.8 billion at the end of July 2003, with the bulk of such deposits being reinvested in NRE account of NRI deposits.

1991 to over two-third by end-March 2003. The short-term component of NRI Deposits also declined sharply during the corresponding period. More recently, to prevent arbitrage driven inflows on rupee denominated NRI deposit, short-term flows (less than one year) have been discontinued and interest rate on such deposits is now subject to lower ceiling rate of 25 basis points over Libor in alignment with one-year forward premium on the dollar in the Indian market. While banks were allowed to take forward cover on their exposure, the recent Monetary and Credit Policy of November 2003 has emphasised hedging on lending by banks to corporates based on well-laid down guidelines by their Boards.

**(iii) Short-term Debt**

Apart from annual ceilings on long-term ECBs, short-term borrowings are under severe quantitative restrictions, excepting those strictly related to trade. These ceilings are applied in consonance with the outlook for the balance of payments. The differential treatment in favour of trade related flows is accorded due to its stable source of financing and also due to the leads and lags in trade related payments that affect the level of short-term debt. The tight control on short-term debt resulted in an absolute decline from US$ 8.5 billion in end-March 1991 (10.2 per cent of total debt) to US$ 5.8 billion in end-June 2003 (5.3 per cent of total debt). This resulted in significant improvement of liquidity measure, with short-term debt as a proportion of foreign currency assets declining sharply from 382.1 per cent in end-March 1991 to 7.4 per cent in end-June 2003.

**(iv) Government Account Debt**

External borrowing by the Central Government, till now has been limited to borrowing from official sources, i.e., credit from bilateral and multilateral sources. Such debt flows are characterised by their long maturity and high concessional element. As part of prudent debt management, the Government has not contracted any short-term debt. At the same time, State Governments are not allowed to directly access any form of external borrowings. In recent years, as part of active management of the external debt portfolio on Government Account, the Government has resorted to several prepayment options of its high cost debt. In 2002-03, the Government prepaid US $ 3.1 billion of high cost debt. The recent policy measure also included limiting such debt to major bilateral donors (Japan, Germany, USA and France), with the remaining balance of debt owed to other donors, which amounted to US $ 1.6 billion to be prepaid[17].

The major plank of external debt management has been maintaining a strict control on short-term debt, encouraging long-term debt, avoid bunching of repayments, gradual liberalisation of debt inflows by prioritising them with regard to its utilisation for productive investment purpose, and providing necessary flexibility to borrowers for risk management of their debt portfolio. As a result of this prudent external debt management, there has been a significant turn around as reflected by debt indicators. While debt-GDP ratio declined from a peak of 38.7 per cent in 1991-92 to 20.0 per cent in 2002-03, debt service ratio was more than halved to 14.7 per cent in 2002-03 from a high of 35.3 per cent in 1990-91. Reflecting the consolidation in external debt, India has now been classified as a "less" indebted country by the World Bank in sharp contrast to being nearly classified as a "severe" indebted country in early 1990s. Another crucial feature in India's external debt management is a history of strong commitment towards making no compromise on honouring debt service obligations. India has never defaulted on any external obligations.

[17] With reduced reliance on external borrowing, external debt of the Government declined steadily from US $ 50.0 billion in end-March 1991 to US $ 45.8 billion at end-December 2002. Along with rising private debt, the share of Government debt in the total external debt accordingly declined from 59.6 per cent in end-March 1991 to 43.7 per cent in end-December 2002.

## (e) Management of Non-debt Creating Inflows

### (i) Foreign Direct Investment

Since the 1980s, there has been a gradual liberalisation of norms governing the operation of companies under foreign collaboration. This process gathered momentum and took a definite shape during the 1990s. The Industrial Policy Statement, 1991 effected significant policy liberalisation in the context of foreign collaborations – both financial and technical. Two specific routes for foreign collaborations were specified – an automatic route and a route for case-by-case approval. Initially certain specific sectors were identified where foreign collaborators could approach the Reserve Bank of India for setting up new units under the automatic route. By and large, the maximum permissible foreign equity participation under the automatic route was at 51 per cent.

In the course of the 1990s, sectoral coverage of FDI under the ambit of automatic route approval has been significantly enhanced. The automatic route is not limited to the manufacturing sector alone. There are major thrusts in allowing foreign collaborations in infrastructure related and technology-intensive sectors through the automatic route. Since 2000, all industries, except a small list, have been brought under the purview of the automatic route[18]. In addition, there is a negative list of only six industries where the Government prohibits FDI[19]. All other cases of FDI, including collaborations/takeover of existing Indian companies required case-by-case approvals from the Government. The Foreign Investment Promotion Board (FIPB), set up by the Government of India, acts as the nodal agency for case-by-case foreign collaboration approvals.

[18] The small list of industries, which require case-by-case approval from the FIPB include domestic airlines, petroleum sector (except for private sector oil refining), print media and broadcasting, postal and courier services, development of integrated township, tea plantation, defence and strategic industries, atomic minerals, establishment and operation of satellite, and investing companies in infrastructure and services sector.

[19] The negative list includes retail trading; atomic energy; lottery business; gambling and betting; housing and real estate business; and agriculture (excluding floriculture, horticulture, development of seeds, animal husbandry, pisiculture, cultivation of vegetables, mushrooms, etc. under controlled conditions and services related to agro and allied sectors) and plantation (other than tea).

The automatic route is currently divided into four different categories. Key sectors where 100 per cent foreign ownership is allowed under the automatic route include power; roads and highways; ports and harbours; mass rapid transport system; drugs and pharmaceuticals; hotel and tourism sector; advertising; and mining. Another major thrust area where up to 100 per cent FDI has been permitted under the automatic route is Special Economic Zones for most manufacturing activities. The major sectors where less than 100 per cent FDI is permitted under the automatic route are telecommunications (49 per cent), airports (74 per cent), and defence industry sector (26 per cent). The financial sector has also been gradually opened for FDI in tune with the gradual liberalisation initiated since the early 1990s. Currently, FDI is allowed in private sector banks (49 per cent), non-banking financial companies (100 per cent), and insurance sector (26 per cent).

In addition to sectoral policy reforms, other measures have been initiated to facilitate FDI flows. The disinvestment process, which has been initiated for the public sector enterprises is open to FDI finance. Measures have also been introduced to allow foreign companies to set up wholly owned subsidiaries in India. This has enabled foreign companies to convert their joint ventures into wholly owned subsidiaries. The percentage of FDI through merger and acquisition route has also been increased to around 30 per cent from around 10 per cent in 1999. Apart from equity participation, various terms and conditions relating to technical collaborations have also been brought under the automatic route. Under this approach payment to foreign collaborators on account of trademark, brand name, lump sum fees etc. up to certain threshold limits are allowed under the automatic route.

Along with increasing the scope of foreign collaborations and permitting repatriation of technical fees under the automatic route, rules governing repatriation of profits and even the initial investments have been fully liberalised and made free subject to certain prudential considerations. Along with other foreign investors, investments by Non-Resident Indians (NRI) in foreign exchange have also been made fully repatriable. The divergence between corporate income tax payable by Indian and foreign companies has been wedged substantially. Currently, the corporate tax rate applicable for foreign

companies is higher by only five percentage points as compared to Indian companies. This differential in corporate taxation rate is maintained to counterbalance the favourable treatment extended to foreign companies *vis-à-vis* Indian companies in respect of taxation of dividend at source.

As part of adopting international best practices in compilation of FDI statistics, data on FDI for both inward and outward flows has been revised in June 2003. FDI data based on the new methodology now include reinvested earning s and other direct capital (inter-corporate debt transactions between related entities). Gross FDI flows, which was barely US $ 0.6 billion in 1992-93 increased sharply over the years to US $ 6.2 billion in 2001-02. However, FDI inflows remain low in comparison to other emerging market economies. In 2002-03, gross flows were lower at US $ 4.8 billion.

**(ii) Portfolio Investment**

Investment by Foreign Institutional Investors (FII) was permitted in the early 1990s. Portfolio investments are restricted to selected players mainly for approved institutional investors. A single FII can invest up to 10 per cent in any company, while FIIs together can invest up to sectoral caps in both the primary as well as the secondary market. There are currently two classes of FIIs, the first one is subject to equity:debt investment in the ratio of 70:30 and the other class pertains to 100 per cent debt funds. While the former class of FIIs can invest in debt securities, including Government securities and units of domestic mutual funds in the ratio of 70:30, investments by 100 per cent debt funds are subject to an overall cap of US$ 1 billion. The cap on investment by debt funds is based on the consideration of controlling short-term debt flows as part of the overall external debt management. Moreover, premature opening up of FII investment in debt securities, particularly in short-term Government securities can increase vulnerability to liquidity crisis and speculative attack as evidenced from the Russian crisis in 1998[20].

[20] By late 1997, the year when non-residents were allowed to invest in government securities, roughly 30 percent of the GKO (a short-term government bill) market was accounted for by nonresidents.

There are no restrictions on repatriation of portfolio investment unlike stipulation of a minimum lock-in period imposed in some countries. However, taxes on short-term gains are higher than long-term gains. In tune with the priority accorded to liberalise inflows, corporates were allowed to raise funds through ADRs/GDRs. While foreign portfolio investment has substantially increased over the years, it has also shown much greater year-to-year variations, moving in the range of net inflow of US $ 3.3 billion in 1996-97 to an outflow of US $ 61 million in 1998-99. In 2002-03, net portfolio investment amounted to US $ 1.0 billion.

**(f) Liberalisation of Capital Outflows**

The major issues with respect to liberalisation of capital outflows include lifting of controls on convertibility of domestic assets by residents, dollarisation of domestic assets, and internationalisation of local currency. While some measures are being taken to liberalise overseas investment, particularly during the recent years, the stance on dollarisation and internationalisation of the Rupee has been quite conservative, based on appropriate prudential consideration for ensuring financial stability.

**(i) Overseas Investment**

Overseas investment in Joint Ventures (JVs) or Wholly Owned Subsidiaries (WOS) have been recognized as important instruments for promoting global business by Indian entrepreneurs. At present, the complete use of ADR/GDR proceeds and the EEFC account balances for this purpose is also permitted. As a result of liberalization of the policy framework for Indian investment abroad, Indian FDI flows increased from negligible levels in early 1990s to US $ 1.4 billion in 2001-02, before declining marginally to US 1.1 billion in 2002-03. Facilitated by the burgeoning reserves, overseas investment has been liberalised in 2003. Indian companies can now invest abroad in joint ventures or 100 per cent subsidiaries up to US $ 100 million without any prior approval. Similarly, individuals as well as listed Indian companies can invest abroad in listed shares and debt securities in companies that hold at least 10 per cent equity in a listed Indian company. Further, registered mutual funds, subject to an overall cap of US$ 1 billion, can

invest in debt securities and listed shares of companies with 10 per cent equity in a listed Indian company. All these measures are expected to make Indian companies globally competitive.

The hierarchy followed with regard to liberalisation of outflows has been in the order of corporates, financial intermediaries and individuals. This is, however, in contrast to the Tarapore Committee recommendation of preferring liberalisation of flows on individual account earlier in the hierarchy. It would be reasonable to expect some further liberalisation on outflows with regard to corporates in the near term, and for o banks and other financial intermediaries with further progress in financial sector reforms.

**(ii) Convertibility of Domestic Assets**

A crucial element in capital account liberalisation is allowing free convertibility of domestic assets by residents. In the event of any external shock, there could be expectations of imminent depreciation of the local currency. An anticipated depreciation of the local currency could lead to a large number of residents simultaneously deciding to convert their domestic assets, which could be self-fulfilling, thereby making a severe external crisis inevitable. For India, the possible impact on the exchange rate could be gauged from the fact that domestic stock of the bank deposits in rupees was close to US $ 290 billion at the end of March 2003, more than four times the forex reserves. However, industrial countries with international currencies like the US dollar or the euro, this kind of eventuality is less likely to occur since these currencies are held internationally by banks, corporates and other entities as part of their long-term global asset portfolio. In contrast, for emerging market currencies, banks and other intermediaries normally take a daily long or short position for purposes of currency trade. Thus, for India, convertibility of domestic assets is expected to be lower down in the agenda towards CAC.

**(iii) Dollarisation and Internationalisation of Rupee**

A related issue, which arises with capital account liberalisation is allowing domestic residents to open foreign currency denominated accounts. A highly conservative approach is adopted with reference to both dollarisation of domestic

economy and internationalisation of domestic currency. On dollarisation, it has been generally recognised that large scale dollar denominated assets within a country can disrupt the economy by creating potential destabilising flows. As a result, no dollar denominated transactions has been generally allowed between residents[21].

The counterpart of dollarisation is internationalisation of domestic currency when the currency of a developing country could be officially traded outside the country without any underlying trade or investment transactions. When such currencies are held increasingly outside the country, any expectation of a depreciating currency due to fundamentals or contagion could lead to widespread sell off which results in very sharp fall in the currency, especially when the local markets are not well developed. Keeping this concern, India does not permit rupee to be transacted offshore, i.e., Rupee is not allowed to be officially used as international means of payment or store of value[22].

**(g) Opening of the Financial Sector**

The opening of the financial sector is a crucial element of capital account liberalisation due to its implications of systemic risks on financial and macroeconomic stability. Thus, opening of the financial sector needs to be carefully sequenced and timed. The Indian financial sector has been steadily opened up to direct foreign investment in the 1990s. The issue of foreign investment in the Indian financial sector could be viewed from the twin angles of the signalling impact and market discipline. In case of emerging market economies, such as India, the liberalisation of foreign investment in the financial sector is often taken to be a benchmark of the process of reforms itself. Secondly, the introduction of foreign players typically imparts a degree of market discipline to the domestic industry. Foreign banks in India, for example, have typically enjoyed higher profitability with higher spread as well as better asset quality. In order to provide a level playing field, the maximum limit of shareholding of Indian promoters in the private

[21] However, to provide greater flexibility to foreign exchange earners, their foreign currency accounts could be used only for external payments. If such balances are to be used for local payments, they have to be converted into rupees. Further, since November 2002, resident individuals have been allowed to open domestic foreign currency account only when they acquire foreign exchange through normal banking channels.

[22] Moreover, Indian banks are not permitted to offer two-way quotes to NRIs or non-resident banks.

sector banks has been raised to 49 per cent of their paid-up capital. In case of public sector banks, FDI and foreign portfolio investment has been allowed up to 20 per cent. However, direct foreign investment in Indian banks following relaxation of guidelines has not picked up especially because most leading international banks already have a presence in India through their subsidiaries.

Banks are now permitted to invest in overseas money market investments and debt instruments up to 50 per cent of their unimpaired Tier 1 capital or US $ 25 million whichever is higher. However, banks are not allowed to invest by availing of loans/ overdrafts from their Head Office/overseas branches/correspondents. Banks are also free to invest the undeployed FCNR (B) funds in overseas markets in long-term fixed income securities while ensuring that the maturity of such investments shall not exceed the maximum maturity of the underlying FCNR (B) deposits and the instruments invested shall have quality ratings[23].

NRI deposits primarily constitute the bulk of the external liabilities of the Indian banking system, since banks are not allowed to access ECBs. However, in recent times, in order to enable banks to have greater operational flexibility and also to align the domestic interest rate with international rate, banks have been allowed to borrow from the overseas market up to 25 per cent of their unimpaired Tier I capital. Such borrowing should be within the bank's open position limit and maturity mismatch limits (GAP limits).

Opening up the financial sector and the economy also meant that balance sheets of the financial intermediaries are exposed to the risks of financial fragility. In order to enhance financial stability, the Reserve Bank has initiated several measures to strengthen balance sheets. There are now prudential norms relating to income recognition, asset classification and provisioning requirements and incentive-based regulation through the prescription of capital to risk-weighted assets. This has been supplemented by the institution of asset-liability management and risk management systems, encompassing

[23] AA(-) by Standard and Poor/FITCH IBCA .

credit, market and country risks in tune with the Core Principles for banking supervision of the BIS. In order to monitor asset quality, the loan portfolio is required to be classified into standard assets, sub-standard, doubtful and loss assets depending on the period for which interest and/or repayment of principal has remained overdue, with strict provisioning norms. Over the period, the guidelines have also been tightened to bring them in line with best international practices: sub-standard assets would be initially defined in terms of 90 days from end-March 2004. For investment valuation, banks are now required to classify their entire portfolio into three categories 'Held to Maturity', 'Available for Sale' and 'Held for Trading'. While in the first category, the investment should not exceed 25 per cent, in the other two categories the banks have a freedom to decide the proportion as they will be marked to market. Besides, a host of transparency and disclosure standards recommended in the International Accounting Standards have been implemented in a phased manner for the banking system.

In addition to banks, other financial intermediaries have also been opened for foreign investment. FDI in non-banking finance companies (NBFCs) are permitted up to 100 per cent subject to minimum capital norms linked to the extent of shareholding. In the insurance sector, even though foreign companies are not allowed to operate directly, they are permitted to enter into a joint venture arrangement with an Indian company with a share holding of up to 26 per cent in the paid up equity capital of the company. As per the latest information available, foreign capital of Rs.625 crore were invested in new private insurance companies by March 2002. With the announcement of the new pension scheme by the Central Government, pension funds are being opened up to the private sector with access to foreign fund. The opening up of these sectors to foreign investors are being facilitated by appropriate institutional development, with the Insurance Regulatory Development Authority (IRDA) already being set up and the Pension Regulatory Authority in the process of being set up.

**(h) Reserves Management**

Reflecting the liberalization measures for inflows, India has attracted considerable private flows, primarily in the form of foreign direct investment, portfolio

investment, external commercial borrowing and NRI deposits. Capital flows have also undergone a major compositional change in favour of non-debt flows as well as longer maturity debt flows (Table-1). The surplus in India's capital account increased from US $ 3.9 billion during 1980s to US $ 8.8 billion during 1990s (1992-2002) and further to US $ 12.8 billion in 2002-03, with a higher share of foreign investment than debt flows. As a proportion of GDP, capital flows increased from 1.6 per cent during 1980s to 2.3 per cent during 1992-2002 and further to 2.4 per cent in 2002-03, indicating that capital flows have been largely in tune with the absorptive capacity of the growth process during the 1990s.

With the modest current account deficit experienced in the 1990s at about 1 per cent of GDP, private capital flows have generally appeared adequate, leading to comfortable reserve build up. However, with the turnaround to a surplus current account balance in the last two years, there has been a sharp build up in reserves. As the current account deficit remained modest at about 1 per cent of GDP during this period, on an average, reserves increased by about 1.7 per cent of GDP every year since 1991-92. In absolute terms, forex reserves increased from US $ 5.8 billion at end-March 1991 to US $ 71.9 billion at end-March 2003 and further to US $ 92.6 billion on end-October, 2003. The accretion to reserves has been the sharpest since April 2002, increasing by US $ 39 billion during the last 19 months. The high reserve policy has been viewed by some as a costly measure for the economy. It is, therefore, appropriate to examine in some detail the relevance of such concerns in the context of the overall approach pursued by India for its capital account in particular and the external sector in general.

While India's foreign exchange reserves increased sharply during the last two years, it needs to be noted that bulk of the accretion to reserves has been on account of non-debt creating flows. For instance, out of the total reserves accretion of US 20.8 billion during the year 2002-03, the major non-debt creating sources like current account surplus (19.7 per cent), foreign investment (22.1 per cent) and valuation changes (18.3 per cent) together accounted for 60.1 per cent of the increase. Further, net drawdown in foreign assets of banks, which are also non-debt creating flows contributed to an increase

in net banking capital by US $ 4.9 billion, thereby accounting for another 23.6 per cent of reserves accretion[24]. So far as non-debt creating flows are concerned (i.e., FDI or FPI), such inflows bear the same risk-return profile as any domestic investment or remittance by residents and therefore the cost to the country of such flows is the same irrespective of whether they accrue to reserves or are matched by equivalent foreign currency outflow due to higher imports or investment abroad by residents. Further more, interest rates on NRI Deposits (which accounted for 14.4 per cent of the reserves accretion) are in line with prevailing overseas interest rates, while external assistance, which are concessional flows are contracted at much lower interest rates. Overall, it seems that the cost of additional reserves is not an area of concern given its present structure.

**(i) Exchange Rate Management**

A recent IMF study of 20 select developing and industrial countries has described India's exchange rate policy as being "ideal" for Asia. While few countries with global or reserve currencies (like US Dollar and Euro) have in place a free float, most of the countries, including India and even some industrial countries adopted intermediate regimes of various types, such as, managed floats with no pre-announced path and independent floats with foreign exchange intervention moderating the rate of change and preventing undue fluctuations. On the other hand, with periodic episodes of currency crises in East Asia and most recently in Argentina, a fixed exchange rate system is clearly out of favour. Since the external value of the currency continues to be a matter of concern to most countries, with a liberalised capital account regime, intervention by most central banks has become necessary due to the growing importance of capital flows in influencing the exchange rate movements on a day-to-day basis. Moreover, unlike trade flows, capital flows in "gross" terms can be several times higher than "net" flows during any particular period and is much more sensitive due to expectations, which makes herding behaviour unavoidable. Thus countries should be able to intervene or manage

[24] Out of US $ 8.4 billion increase in net banking capital flows, net draw down in foreign assets of banks contributed to an increase in banking capital by US $ 4.9 billion. The remaining portion of the increase in banking capital was due to net increase in foreign liabilities of banks, comprising mainly of NRI Deposits (US $ 3.0 billion).

exchange rates, at least to some degree, if movements are believed to be destabilising in the short-run.

Reflecting the policy imperatives, as highlighted by Jalan (2003), the main pillars of exchange rate management is characterised by the following strategies:

- RBI does not have a fixed "target" for the exchange rate which it tries to defend or pursue over time;
- RBI is prepared to intervene in the market to dampen excessive volatility as and when necessary;
- RBI's purchase or sales of foreign currency are undertaken through a number of banks and are generally discreet and smooth; and
- market operations and exchange rate movement should, in principle, be transaction oriented rather than being purely speculative in nature.

**(j) Capital Account Liberalisation and Conduct of Monetary Policy**

The art of monetary management essentially boils down to the challenge of balancing the domestic and external sources of monetisation. In the Indian context till the 1990s, barring the few years of large remittances in the 1970s, the problem was of containing the monetary pressures emanating from the fisc. A distinctive feature of the 1990s was the growing influence of capital flows on the conduct of monetary policy. The Reserve Bank had to contain the monetary (and hence inflationary) effect of capital flows on the one hand and maintain the export competitiveness of the economy on the other. In order to strike the desired balance, throughout the 1990s, the Reserve Bank, in effect, traded the surplus bank liquidity emanating from capital flows with the deficit of the Government. This could be effected through a strategy of timely auctions of government securities and open market (including repo) operations.

Periodic switches in capital flows, such as during the South-Asian crisis of 1997-98, the sanctions following the Pokhran blast and episodic border tensions, necessitated the Reserve Bank to suitably change the composition of its domestic and foreign currency assets to modulate monetary conditions. The sustained capital inflows since the latter half

of 2000-01 has been hemorrhaging the stock of Government paper with the Reserve Bank. The parallel reduction in reserve requirements since the later half of the 1990s has also drained out the Reserve Bank's domestic assets. The scale effect of CRR cuts and the substitution effect of capital flows, therefore has seriously depleted the stock of Government securities with the Reserve Bank, limiting the scope for sterilisation. In addition, the combination of strong capital flows on the supply side and weak credit offtake on the demand side, generated market interest in Government paper.

The challenge is, therefore, to find a way out to enlarge the stock of Government securities with the Reserve Bank. The most standard solutions attempted in other countries include ways and means to either create domestic assets (by issuing central bank bills) or do away with the need to possess domestic assets for the purpose of sterilisation (by conducting uncollateralised repo operations such as a deposit facility). For sterilization purpose, some countries also resort to foreign exchange swaps, shifting of Government/Public Sector deposits from commercial banks to the central bank, use of higher CRR, unremunerated reserve requirement, and use of interest equalisation tax.

In the Indian context, the ambit of feasible solutions, in this regard, is also circumscribed by the statutory limitations of the Reserve Bank of India Act, 1934. First, the Reserve Bank, for example, cannot issue its own paper, thereby ruling out the possibility of issuing central bank bills at this juncture. Second, the Reserve Bank cannot borrow on a clean basis more than its paid-up capital of Rs.5 crore - ruling out the possibility of conducting uncollataralised repo operations. It is against this background that the Reserve Bank has been replenishing the stock of Government securities available for sterilisation in a variety of ways. First, the Reserve Bank has put in place a strategy of combining private placements when liquidity conditions are tight and open market operations when market conditions improve. Second, the Reserve Bank has been funding prepayment of external debt of the Government in foreign currency in exchange for private placement of government securities. Finally, the Reserve Bank has converted the non-marketable special securities issued in the past to fund rollover of *ad hoc* Treasury Bills into marketable government paper to conduct open market operations.

**(k) Growth, Capital Flows and Exchange Rate Management**

A recent paper entitled "The Growth Slowdown: Real Exchange Rate Misalignment, Fiscal Deficits and Capital Inflows" by Deepak Lal, Suman Bery and D K Pant (2003) suggests that India could have attained a higher growth trajectory in the absence of its high foreign exchange reserves and fiscal deficits. The policy of preventing complete market absorption of entire capital flows through high reserves and the crowding-out effects associated with fiscal deficits might have involved considerable sacrifice of growth – in the range of 1 to 6 per cent in different years in the 1990s. On the basis of their findings they make the following policy recommendations: (a) instead of reserves management policy one should concentrate on appropriate monetary and exchange rate policies that could boost growth, (b) have a tighter fiscal policy (to contain the crowding out effect) and a looser monetary policy (by non-sterilisation of reserves that could increase prices and lower interest rates – both of which can raise absorption of foreign capital), (c) high reserves and low domestic inflation provide the right environment against which the rupee can be made fully convertible on the capital account, and (d) abandon the managed exchange rate regime by full float.

An informed and rational assessment of these issues would suggest the following:

- With full absorption, given the incremental capital output ratio close to 4, additional investment of about 2 per cent of GDP made possible by capital flows could have, at best, yielded additional growth of about 0.5 per cent (and not 1 to 6 per cent as suggested by the paper). The extra 0.5 per cent growth, however, would have been attained against lower reserves and a flexible exchange rate leading to large real appreciation, thereby increasing the vulnerability to crisis. The experience of the emerging market crises in the last one decade shows that on an average, the crisis years witnessed a growth reversal of more than 6 to 7 per cent in all the crisis affected countries. In other words, the extra 0.5 per cent growth attained by India over several years by pursuing the policy as recommended by the authors could have been more than reversed in just one year, in the event of a crisis.

- Even if REER appreciation is allowed to ensure full absorption of foreign capital, given the asymmetric response of exports and imports to price changes, it is possible that a higher CAD would be attained more by fall in exports than the increase in imports.
- Lessons from past crises in emerging markets like Mexico, Thailand and Korea suggest that foreign capital should not be allowed to either give rise to excessive consumption or excessive investment just to ensure full absorption. In India, reserves have not been accumulated with an intention to compress absorption, rather in the absence of adequate demand, reserve accumulation has been adopted as the preferred policy.
- Decision on further opening of the capital account needs to be based on entrenchment of preconditions, particularly fiscal consolidation and stronger financial system, and liberalization of capital account should not be viewed as a means to deal with the problem of temporary surplus.

## V. Conclusion

In terms of the standard indicators of effectiveness of capital controls, one could view that controls have been effective in India because: (a) despite strong inflows there have been no major real appreciation of the exchange rate, (b) monetary independence has not been lost, and a wedge between domestic and foreign interest rates has been successfully created and maintained, and (c) black market premia on exchange rate has declined drastically to negligible levels with concomitant decline in capital flight. The emphasis on preconditions and a policy of gradual liberalization have enabled the country to reap the benefits while avoiding the sources of vulnerability. Inadequate absorption of foreign capital has weakened the contribution of foreign capital to growth; however, the policy of high reserves and the associated prevention of exchange rate appreciation, both of which provide a cushion to financial stability cannot be abandoned in favour of a more flexible exchange rate and more open capital account just to deal with the problem of surplus. If the latter measures fail to increase absorption, such policies can also represent a recipe for disaster. Given the trade-off between growth/efficiency and stability associated with capital flows, India's preference has strongly been in favour of avoidance of instability. Such an approach has imparted stability not only to the financial system but also to the overall growth process. The relative weights to efficiency and stability needs to be constantly reviewed with reference to both domestic and international developments. While realizing that the impulses of growth could be supplemented with foreign capital, it is imperative to ensure that liberalisation of the capital account responds to the requirement of the economy in an appropriate, gradual and cautious manner. While inflows have been substantially liberalised with a preference for corporates, which is expected to be continued, and if the momentum of capital flows is maintained, it may be possible that with limits to sterilization, more capital account liberalisation on outflows could be forthcoming, particularly for corporates and financial intermediaries. The pace of liberalization, particularly for financial intermediaries would, however, depend on domestic factors, especially the progress in the financial sector reform, fiscal consolidation and the evolving international financial architecture.

**References:**


Bank for International Settlements (2002), 72nd Annual Report.

Bhagwati, Jagdish (1998), " The Capital Myth: The Difference Between Trade in Widgets and Trade in Dollars", Foreign Affairs, Vol.77.

Cooper, Richard N. (2001), " Should Capital Controls be Banished?", in Global Financial Crises and Reforms, Edited by B.N. Ghosh, Routledge.

Dornbusch, Rudiger (1998), " Capital Controls: An Idea Whose Time is Past", ", in Should the IMF pursue Capital –Account Convertibility?, Essays in International Finance 207, Princeton.

" (1998), " Should Capital Account Convertibility a World objective?", ", in Should the IMF pursue Capital –Account Convertibility?, Essays in International Finance 207, Princeton.

Dooley, Michael P (1996), " A Survey of Literature on Controls of International Capital Transactions", IMF Staff Papers, December.

Edison, Hali J. and Carmen M. Reinhart (2000), " Capital Controls During Financial Crises: The case of Malaysia and Thailand", International Finance Discussion Papers, Board of Governors of the Federal Reserve System, Number 662, March.

Edwards, Sebastian (1999), " International Capital Flows and Emerging Markets: Amending the Rules of the Game", at the Conference on Rethinking the International Monetary System, Federal reserve bank of Boston, June.

Eichengreen, Barry and Michael Mussa (1998), " Capital Account Liberalisation and the IMF", Finance and Development, December.

Fieleke, Norman S. (1994), " International Capital Transactions: Should they be Restricted?", New England Economic Review, March/April.

Fischer, Stanley (1998), " Capital Account Liberalisation and the Role of the IMF", in Should the IMF pursue Capital –Account Convertibility?, Essays in International Finance 207, Princeton.

Gilbert, Christopher L., Gregor Irwin and David Vines (2000), " International Financial Architecture, Capital Account Convertibility and Poor Developing Countries", presented at the Overseas Development Institute Seminar, June.

Goldstein, Morris (1995), " Coping with Too Much of a Good Thing: Policy Response for Large Capital Inflows to Developing Countries", Institute for International Economics.

Gruben, William C. and Darryl McLeod ( 2001), " capital account liberalisation and Disinflation in the 1990s", Federal Reserve Bank of Dallas, February.

Jalan, Bimal (1999), " International Financial Architecture: Developing Countries' Perspective", Reserve Bank of India Bulletin, October.

---------- (2003), "Exchange Rate Management : An Emerging Consensus", Reserve Bank of India.

Johnston, R. Barry and Natalia T. Tamirisa ( 1998), " Why Do countries Use Capital Controls", IMF Working Paper, WP/98/181, December.

Khor, Martin (1998), " The Dangers of Financial Liberalisation", Third World Network, Jul. 10.

Klein, Michael W and Giovanni Olivei (1999), " Capital Account Liberalisation, Financial Depth, and Economic Growth", NBER Working Paper, No. 7384.

Krugman, Paul (1998), " An Open Letter to Prime Minister Mahathir", September 1.

Lal, D.; S. Bery and D.K. Pant (2003), " The Growth Slowdown: Real exchange Rate Misalignment, Fiscal Deficits and capital Flows", Mimeo, NCAER, New Delhi.

Mathieson, D. and L. Rojas-Suarez (1993), " Liberalisation of the Capital Account: Experiences and Issues", IMF Occasional Paper No. 103.

Miller, Marcus and lei Zhang( 1999), " Sequencing of Capital Account Liberalisation: A Challenge to the Washington Consensus", University of Warwick, July.

Nadal-De Simone and Piritta Sorsa (1999), " A Review of Capital Account Restrictions in Chile in the 1990s", IMF Working Paper, WP/99/52.

Neely, Christopher J. (1999), " An Introduction to Capital Controls", Federal Reserve Bank of St. Louis, Nov./Dec.

Panagariya, Arvind (1998), " Full Convertibility: Must we have it?", The Economic Times, Oct. 26.

Pattanaik, Sitikantha (1997), " Targets and Instruments for the External Sector with an Open Capital Account", Economic and Political Weekly, Vol. 32, No.40.

Quirk, P and O. Evans (1995), " Capital Account Convertibility: Review of Experience and Implications for IMF Policies", IMF Occasional Papers No. 131.

Reddy, Y.V. (2000), " Capital Account Liberalisation: The Developing Country Perspective", Overseas Development Institute, London.

" (2000), " Operationalising Capital Account Liberalisation: Indian Experience", Reserve Bank of India Bulletin, October.

Reserve Bank of India (1993), " Report of the Committee on Capital Account Liberalisation (Chairman: S.S. Tarapore)".

" (2001, 2002), " Report on Currency and Finance".

Rodrik, Dani (1998), " Who Needs Capital Account Convertibility?", ", in Should the IMF pursue Capital –Account Convertibility?, Essays in International Finance 207, Princeton.

Virmani, Arvind (1999), " Capital Account Convertibility: Timing and Phasing", December.

Yeyati, Eduardo Levy (1999), " Global Moral Hazard, Capital Account Liberalisation and the Overlending Syndrome", IMF Working Paper, WP/99/100.

Yoshitomi, Masaru and Sayuri Sihari (2000), " Policy Recommendations for Preventing Another Capital Account Crisis", Asian Development Bank, July 07.

## Annexure-1 Types of Capital Controls

Capital controls have in general taken tow main forms: (a) **direct or administrative** controls and (b) **indirect or market-based** controls.

**(a) Direct or administrative capital controls** restrict capital transactions and/or the associated payments and transfer of funds through outright prohibitions, explicit quantitative limits, or an approval procedure (which may be rule-based or discretionary). Administrative controls typically seek to directly affect the volume of the relevant cross-border financial transactions. A common characteristic of such controls is that they impose administrative obligations on the banking system to control flows.

**(b) Indirect or market-based controls** discourage capital movements and the associated transactions by making them more costly to undertake. Such controls may take various forms, including: dual or multiple exchange rate systems; explicit or implicit taxation of cross-border financial flows (e.g. a Tobin tax); and other predominantly price-based measures. Depending on their specific type, market-based controls may affect either the price or both the price and volume of a given transaction.

- In ***dual (two-tier) or multiple exchange rate systems,*** different exchange rates apply to different types of transactions. Two-tier foreign exchange markets have typically been established in situations in which the authorities have regarded high short-term interest rates as imposing an unacceptable burden on domestic residents, and have attempted to split the market for domes currency by either requesting or instructing domestic financial institutions not to lend to those borrowers engaged in speculative activity. Foreign exchange transactions associated with trade flows, FDI, and usually equity investment are excluded from the restrictions. In essence, the two tier-market attempts to raise the cost to speculators of the domestic credit needed to establish a net short domestic currency position, while allowing nonspeculative domestic credit demand to be satisfied at normal market rates. Two-tier systems can also accommodate excessive inflows and thus prevent an overshooting exchange rate for current account transactions. Such systems attempt to influence both the quantity and the price of capital transactions. Like administrative controls, they need to be enforced by compliance rules and thus imply administration of foreign exchange transactions of residents and domestic currency transactions of nonresidents to separate current and capital transactions.

- ***Explicit taxation of cross-border flows*** involves imposition of taxes or levies on external financial transactions, thus limiting their attractiveness, or on income resulting from the holding by residents of foreign financial assets or the holding by nonresidents of domestic financial assets, thereby discouraging such investments by reducing their rate of return or raising their cost. Tax rates can be differentiated to discourage certain transaction types or maturities. Such taxation could be considered a restriction on cross-border activities if it discriminates between domestic and external assets or between nonresidents and residents.

- ***Indirect taxation of cross-border flows, in the form of non-interest bearing compulsory reserve/deposit requirements*** (URR hereafter) has been one of the most frequently used market-based controls. Under such schemes, banks and nonbanks dealing on their own account are required to deposit at zero interest with the central bank an amount of domestic or foreign currency equivalent to a proportion of the inflows or net positions in foreign currency. URRs may seek to limit capital outflows by making them more sensitive to domestic rates. For example, when there is downward pressure on the domestic currency, a 100 percent URR imposed on banks would double the interest income forgone by switching from domestic to foreign currency. URRs may also be used to limit capital inflows by reducing their effective return; and they maybe differentiated to discourage particular types of transactions.

- ***Other indirect regulatory controls*** have the characteristics of both price- and quantity-based measures and involve discrimination between different types of transactions or investors. Though they may influence the volume and nature of capital flows, such regulations may at times be motivated by domestic monetary control considerations or prudential concerns. Such controls include: provisions for the net external position of commercial banks, *asymmetric open position limits* that discriminate between long and short currency positions or between residents and nonresidents; and certain credit rating requirements to borrow abroad. While not a regulatory control in the strict sense, reporting requirements for specific transactions have also been used to monitor and control capital movements (e.g., derivative transactions, non-trade related transactions with nonresidents).

**Source: IMF documents**

## Annexure-2

## Types of capital transactions that could be subjected to controls

| **INFLOWS** | OUTFLOWS |
|---|---|
| **Capital and Money Markets** | |
| ***Shares or other securities of a participating nature*** | |
| Purchase locally by nonresidents | Sale or issue locally by nonresidents |
| Sale or issue abroad by residents | Purchase abroad by residents |
| ***Bonds or other debt securities*** | |
| Purchase locally by nonresidents | Sale or issue locally by nonresidents |
| Sale or issue abroad by residents | Purchase abroad by residents |
| ***Money market instruments*** | |
| Purchase locally by nonresidents | Sale or issue locally by nonresidents |
| Sale or issue abroad by residents | Purchase abroad by residents |
| ***Collective investment securities*** | |
| Purchase locally by nonresidents | Sale or issue locally by nonresidents |
| Sale or issue abroad by residents | Purchase abroad by residents |
| **Derivatives and other instruments** | |
| Purchase locally by nonresidents | Sale or issue locally by nonresidents |
| Sale or issue abroad by residents | Purchase abroad by residents |
| **Credit operations** | |
| ***Commercial credits*** | |
| To residents from nonresidents | By residents to nonresidents |
| ***Financial credits*** | |
| To residents from nonresidents | By residents to nonresidents |
| **Guarantees, sureties, and financial backup facilities** | |
| To residents from nonresidents | By residents to nonresidents |
| **Direct investment** | |
| Inward direct investment | Outward direct investment |
| | Controls on liquidation of direct investment |
| Real estate transactions | |
| Purchase locally by nonresdidents | Purchase abroad by residents |
| | Sale locally by nonresidents |
| Provisions specific to commercial banks | |
| Nonresident deposits | Deposits overseas |
| Borrowing abroad | Foreign loans |
| **Personal capital movements: deposits, loans, fits, endowments, inheritances, and legacies** | |
| To residents from nonresidents | By residents to nonresidents |
| **Settlements of debts abroad by immigrants** | |
| Transfer into the country by immigrants | Transfer abroad by emigrants |
| Provisions specific to institutional investors | |
| | Limits (max.) on securities issued by nonresidents and on portfolio invested abroad |
| | Limits (max.) on portfolio invested locally |

**Source: IMF Documents**

## Annexure-3

## Purposes of Capital Controls

| Purpose of Control | Method | Direction of Control | Example |
|---|---|---|---|
| Generate Revenue/ Finance War Effort | Control on capital outflows permit a country to run higher inflation with a given fixed-exchange rate and also hold down domestic interest rates. | Outflows | Most belligerent use during WW-I and WW-II |
| Financial Repression/ Credit Allocation | Governments that use the financial system to reward favoured industries or to raise revenue, may use capital controls to prevent capital from going abroad to seek higher returns. | Outflows | Common in developing countries |
| Correct a Balance of Payments Deficit | Controls on outflows reduce demand for foreign assets without contractionary monetary policy or devaluation. This allows a higher rate of inflation than otherwise would be possible. | Outflows | U.S. interest equalisation tax, 1963-74 |
| Correct a Balance of Payments Surplus | Controls on inflows reduce foreign demand for domestic assets without expansionary monetary policy or revaluation. This allows a lower rate of inflation than would otherwise be possible. | Inflows | German Bardepot scheme, 1972-74 |
| Prevent Potentially Volatile Inflows | Restricting inflows enhances macroeconomic stability by reducing the pool of capital that can leave a country during a crisis. | Inflows | Chilean *encaje*, 1991-98 |
| Prevent Financial Destabilisation | Capital controls can restrict or change the composition of international capital flows that can exacerbate distorted incentives in the domestic financial system. | Inflows | Chilean *encaje*, 1991-98 |
| Prevent Real Appreciation | Restricting inflows prevents the necessity of monetary expansion and greater domestic inflation that would cause a real appreciation of the currency. | Inflows | Chilean *encaje*, 1991-98 |
| Restrict Foreign Ownership of Domestic Assets | Foreign ownership of certain domestic assets – especially natural resources – can generate resentment. | Inflows | Article 27 of the Mexican constitution |
| Preserve Savings for Domestic Use | The benefits of investing in the domestic economy may not fully accrue to savers to that economy, as a whole, can be made better off by restricting the outflow of capital. | Outflows | |
| Protect Domestic Financial Firms | Controls that temporarily segregate domes5tic financial sectors from the rest of the world may permit domestic firms to attain economies of scale to compete in world markets. | Inflows and Outflows | |

**Source: Neely (1999)**

**Annexure-4**

*Three proposals for "sand in the wheels" capital controls, and how they differ.*

| | Chile's deposit requirement on inflows | Eichengreen-Wyplosz deposit requirement proposal | Tobin tax proposal |
|---|---|---|---|
| 1. Motive | Prevent over-indebtedness | Protect balance of payments | Reduce volatility in exchange rate (and raise revenue) |
| 2. Tax applied to: | Capital inflows | Capital outflows (and inflows) | All foreign exchange transactions, including trade |
| 3. Paid immediately by: | Foreign investors | Banks | All traders (mostly banks) |
| 4. Paid immediately to: | Central bank (foreign currency earnings) | Central bank (seignorage only) | Tax authority (domestic revenue) |
| 5. Relationship of tax amount to interest rate | Rises with foreign interest rate | Rises with domestic interest rate | Invariant to interest rate |
| 6. Relationship to maturity | Fixed amount (falling with maturity in % p.a. terms) when maturity < 1 year | Falls with maturity? But does not apply to I ntra-day trading | Fixed amount. In %p.a. terms, falls continuously with maturity |
| 7. Where imposed | One country (facing inflows0 | One country (facing outflows) | Must be world-wide |
| 8. Probable level of tax rate | Moderate (30% times interest rate) | High )to discourage speculative attacks) | Low (to avoid distortions and substitution) |

Source: The African Financial Journal, Volume 1, Part 1, 1999.
Proposals Regarding Restrictions on Capital Flows - by: Jeffrey Frankel.

## Annexure -5

### India's current position in respect of the preconditions suggested in the Report on Capital Account Convertibility.

| Preconditions | Current Status |
|---|---|
| Fiscal Consolidation:<br>**1.** Reduction in Gross Fiscal Deficit as percentage of GDP from 4.5 in 1997-98 to 4.0 in 1998-99 and further to 3.5 in 1999-2000. | **1.** Gross fiscal deficit as a percentage of gross domestic product stood at 5.9 per cent during 2002-03 and is budgeted at 5.6 per cent for 2003-04. |
| Mandated Inflation Rate<br>**1.** The mandated rate of inflation for the 3 year should be an average of 3 to 5 per cent.<br>**2.** RBI should be given freedom to attain tarred mandate of inflation approved by the parliament. | **1.** The realized (not mandated) inflation rate in 2002-03 was 3.4 per cent.<br>**2.** Although inflation is an important objective of monetary policy, there is no target/mandated inflation approved by the Parliament. |
| Strengthening of Financial System:<br>**1.** Interest rates to be fully deregulated in 1997-98 and any formal or informal interest rate controls must be abolished.<br>**2.** CRR be reduced in phases to 8% in 1997-98, 6% in 1998-99 and to 3 % in 1999-2000.<br>**3.** Non-Performing Assets as percentage of total advances to be brought down in phases to 12% in 1997-98, 9% in 1998-99 and to 5% in 1999-2000.<br>**4.** 100% marked to market valuation of investments for banks.<br>**5.** Best practices on risk management and accounting /disclosure norms be implemented. | **1.** All interest rates (except savings bank interest rate) have been deregulated.<br>**2.** CRR reduced to 4.5 per cent in 2003-04.<br>**3.** NPA of the public sector banks as a percentage to total advances has come down from 16% in March 1998 to 11.1% in end-March 2002.<br>**4.** This concept of 100% marked to market valuation has been done way with. The modern concept works on Banks classifying their entire portfolio into three categories 'Held to Maturity', 'Available for Sale' and 'Held for Trading'. While in the first category, the investment should not exceed 25%, in the other two categories the banks have a freedom to decide the proportion as they will be marked to market.<br>**5.** Risk management guidelines have been issued (broadly covering credit risk and market risk) and the regulatory and supervisory system has been strengthened to ensure effective monitoring, transparency and compliance with prudential standards. |
| Important Macroeconomic Indicators<br>**1.** A monitoring band of +/-5% around the neutral Real Effective Exchange Rate (REER) to be introduced and attained through intervention whenever the REER goes outside the band.<br>**2.** Debt service ratio to be reduced to 20 % from 25%.<br>**3.** The foreign exchange reserves should not be less than 6 months of imports. | **1.** The exchange rate policy has no explicit/implicit target (whether point or band). The market has generally ensured an exchange rate path that avoids major misalignment in terms of REER.<br>**2.** Debt Service ratio has steadily declined from 19.5 % in 1997-98 to 14.6 % in 2002-03.<br>**3.** As at end-March 2003, foreign exchange reserve cover was for more than a year's import. |

## Table 1 : Pattern of Capital Flows and their Use

($ million)

| | Current Account Balance | Capital Flows (Net) | | | | | Total Capital Inflows | Reserves (end March) | Increase(+)/ Decrease(-) in Reserves* | Current Account Balance/ GDP(%) | Short Term Debt/ Total Debt (%) | Debt Stock/ GDP (%) | Debt Service Ratio (%) |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | Foreign Inve-stment | External Coml. Borr | NRI Deposits | External Aid | Other Capital | | | | | | | |
| | | | | | | | | 3962 | | | | | |
| **1990-91** | -9680 | 103 | 2248 | 1536 | 2210 | 1091 | 7188 | 5834 | -1278 | -3.1 | 10.2 | 28.7 | 35.3 |
| **1991-92** | -1178 | 133 | 1456 | 290 | 3037 | -1139 | 3777 | 9220 | 3385 | -0.3 | 8.3 | 38.7 | 30.2 |
| **1992-93** | -3526 | 557 | -358 | 2001 | 1859 | -1123 | 2936 | 9832 | 698 | -1.7 | 7.0 | 37.5 | 27.5 |
| **1993-94** | -1158 | 4235 | 607 | 1205 | 1901 | 1747 | 9695 | 19254 | 8724 | -0.4 | 3.9 | 33.8 | 25.4 |
| **1994-95** | -3369 | 4922 | 1030 | 172 | 1526 | 1506 | 9156 | 25186 | 4644 | -1.0 | 4.3 | 30.8 | 25.9 |
| **1995-96** | -5910 | 4902 | 1275 | 1103 | 883 | -3474 | 4689 | 21687 | -2936 | -1.7 | 5.4 | 27.0 | 24.3 |
| **1996-97** | -4619 | 6153 | 2848 | 3350 | 1109 | -2048 | 11412 | 26423 | 5818 | -1.2 | 7.2 | 24.5 | 21.2 |
| **1997-98** | -5500 | 5390 | 3999 | 1125 | 907 | -1410 | 10011 | 29367 | 3893 | -1.4 | 5.4 | 24.3 | 19.0 |
| **1998-99** | -4038 | 2412 | 4362 | 960 | 820 | -294 | 8260 | 32490 | 3829 | -1.0 | 4.4 | 23.6 | 17.8 |
| **1999-2000** | -4698 | 5191 | 313 | 1540 | 901 | 3155 | 11100 | 38036 | 6142 | -1.0 | 4.0 | 22.1 | 16.2 |
| **2000-01** | -3590 | 6789 | 3732 | 2317 | 427 | -3819 | 9446 | 42281 | 5830 | -0.8 | 3.6 | 22.4 | 17.2 |
| **2001-02** | 782 | 8151 | -1579 | 2754 | 1204 | 445 | 10975 | 54106 | 11757 | 0.2 | 2.8 | 21.0 | 13.9 |
| **2002-03** | 4137 | 5639 | -2353 | 2976 | -2428 | 9009 | 12843 | 75428 | 16980 | 0.8 | 4.4 | 20.1 | 14.7 |

* : Not adjusted for the valuation effects

** : Includes Errors and Omission.

**Note :** Net Inflows in the Capital Account (excluding IMF) are used for financing Current Account Deficits and the accretion to the Foreign Exchange Reserves.

Since 2000-01, data on FDI have been revised with expanded coverage to approach best international practices.