The Indian Experience with Managing Capital Flows

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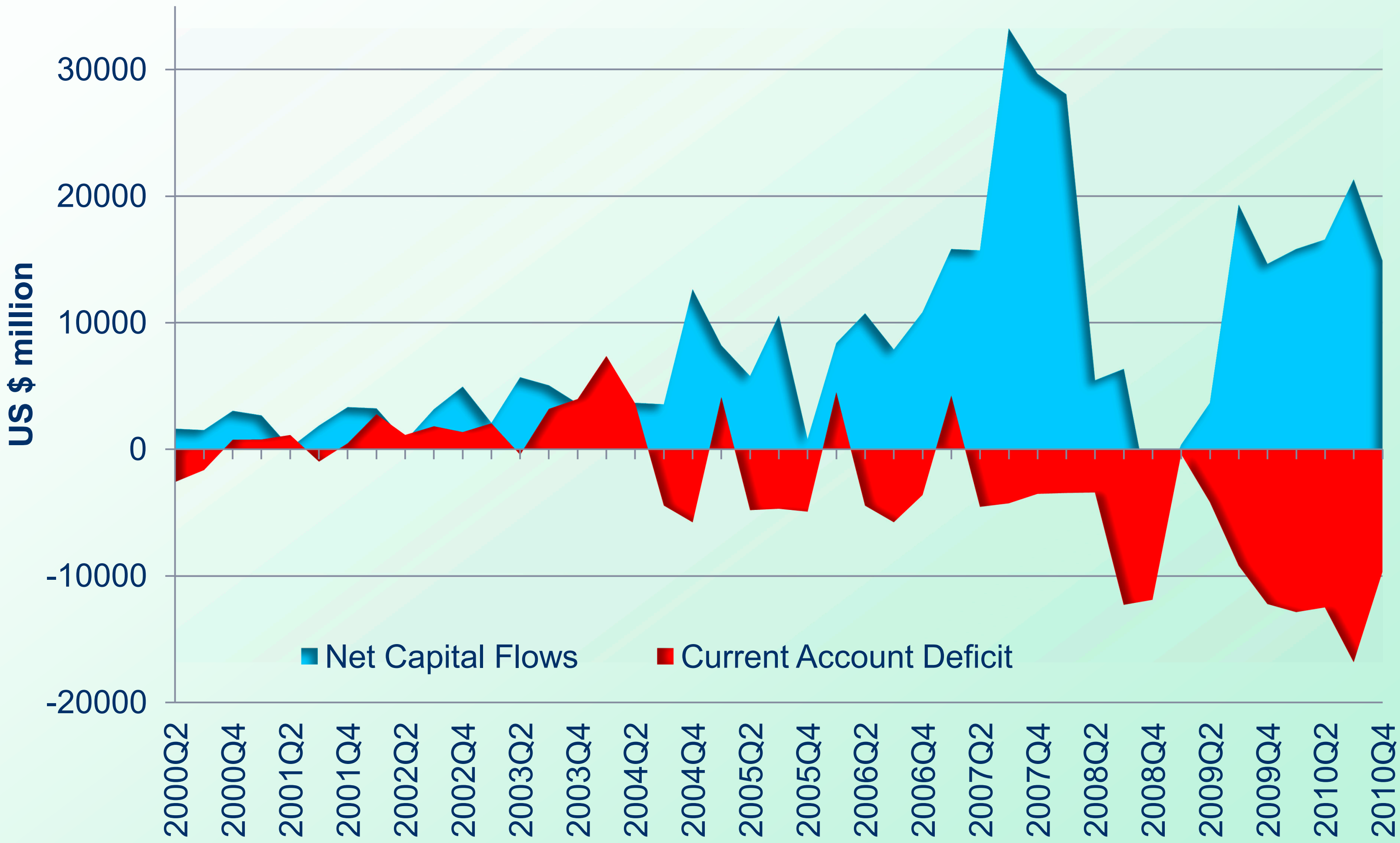
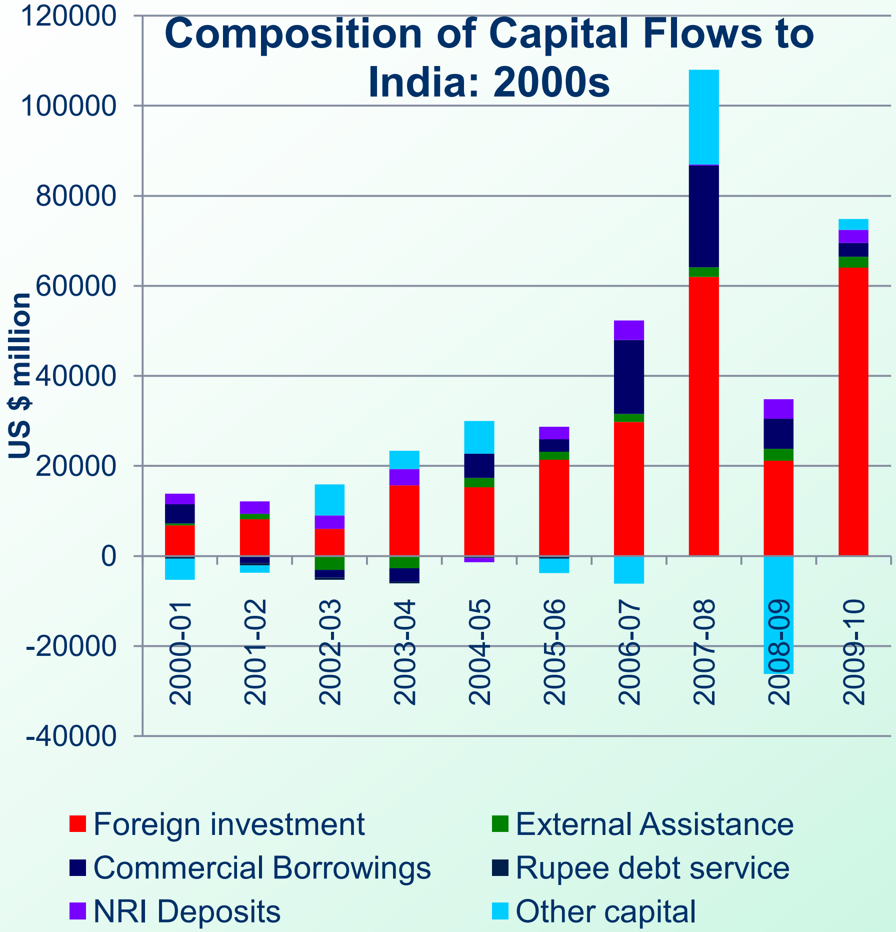
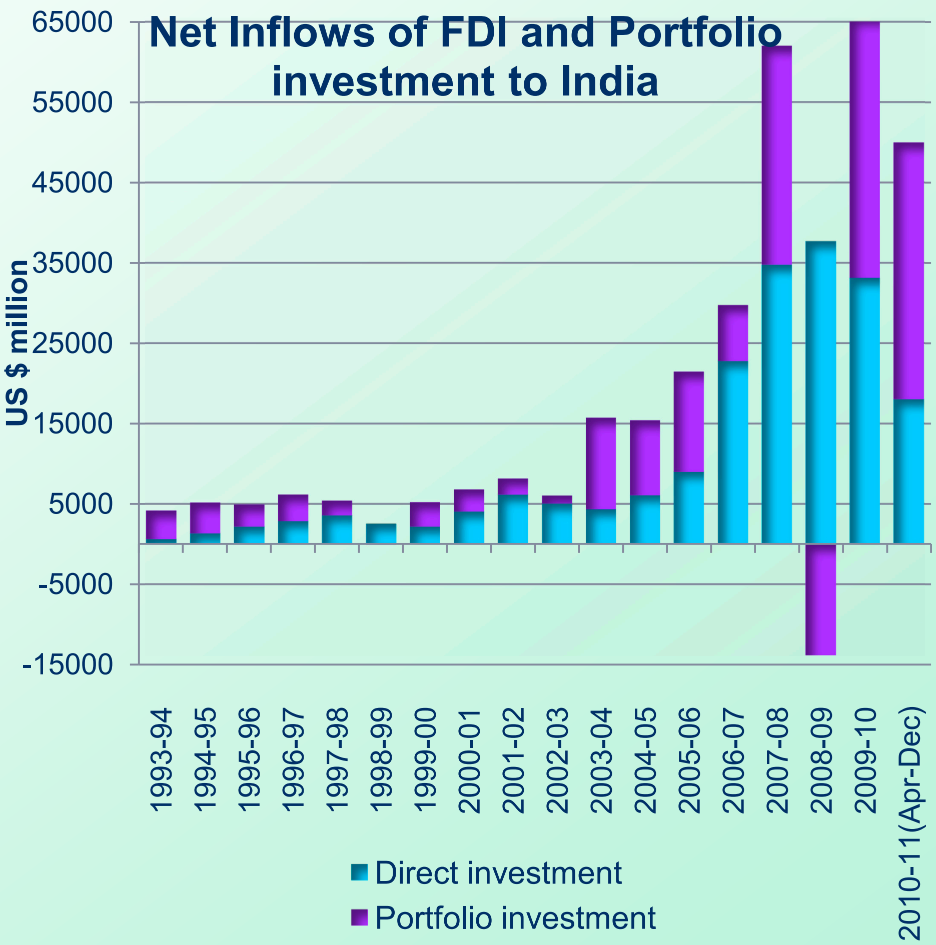
Slide 1: Balance of Payments

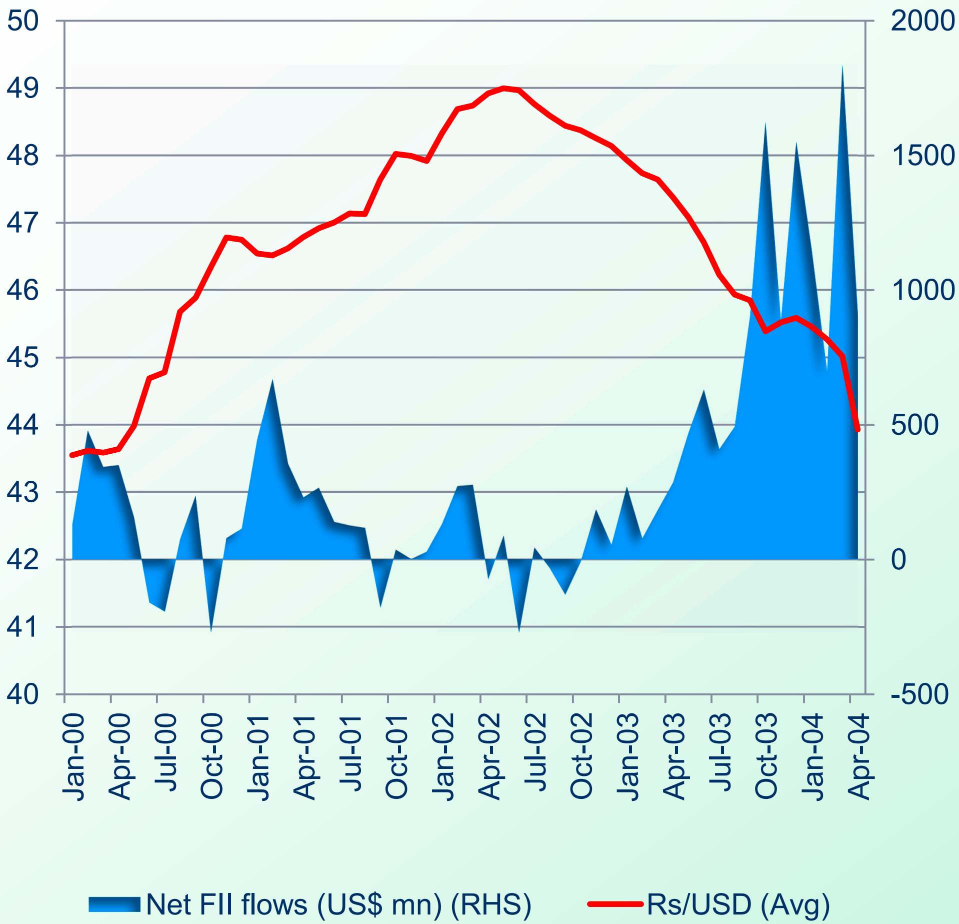


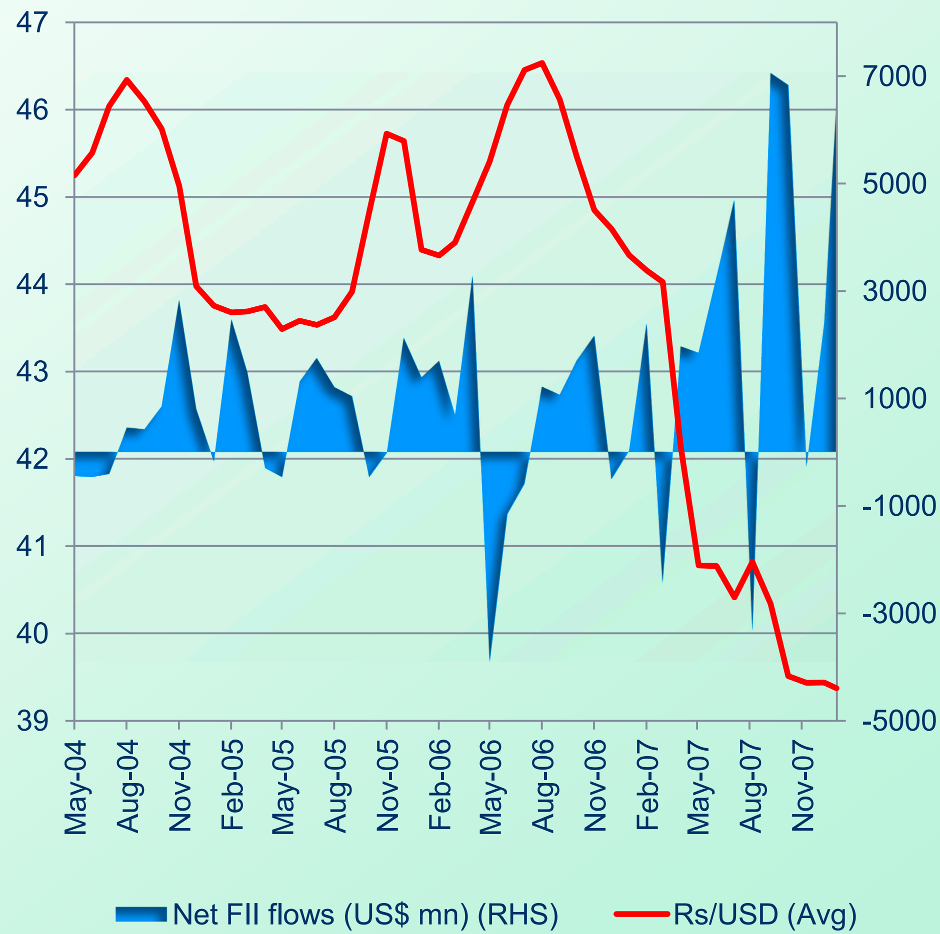
Slide 2: Composition of Capital Flows



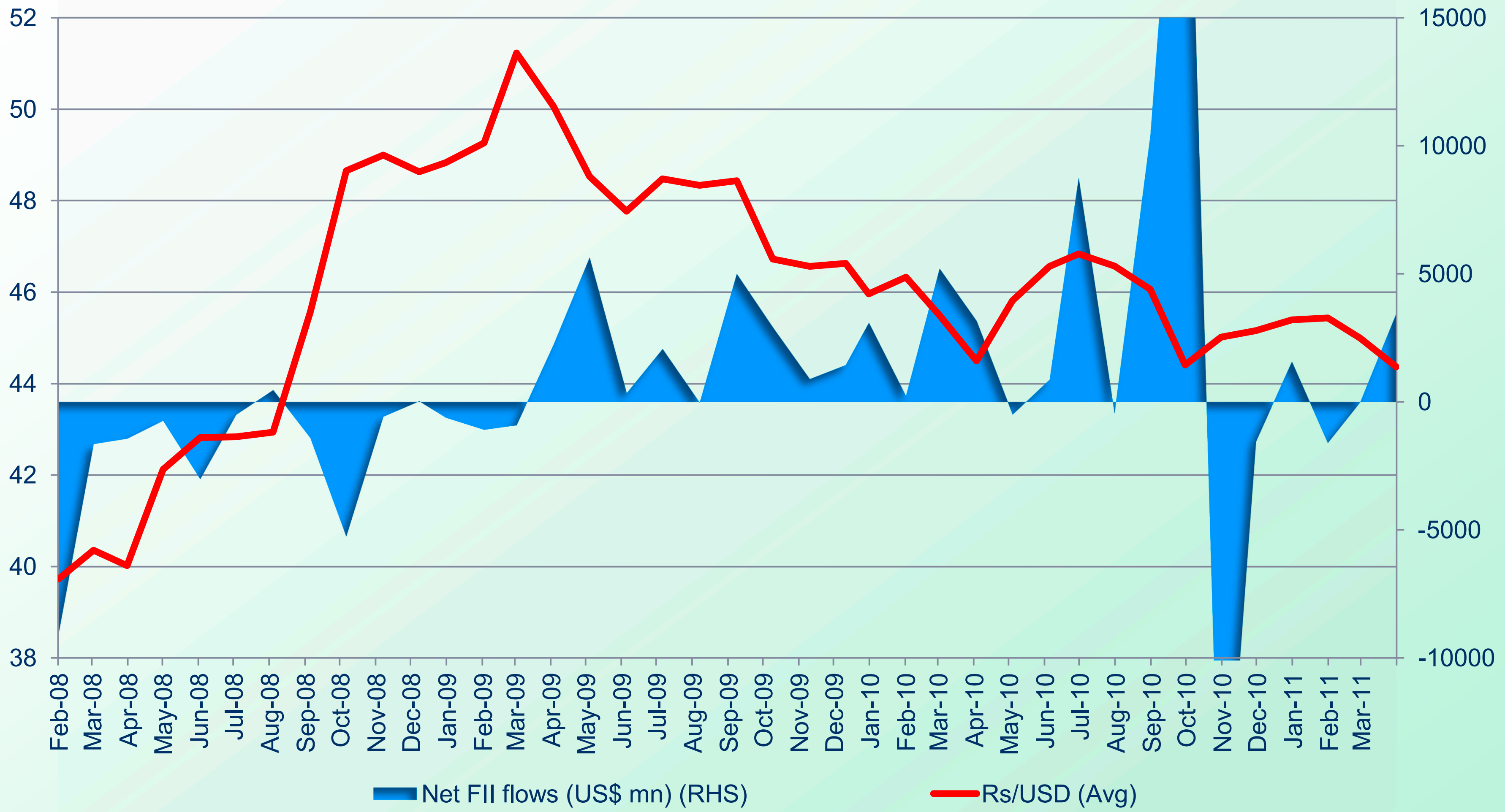


Slide 3: Exchange Rate Dynamics..1





Slide 4: Exchange Rate Dynamics..2



Slide 5: An Evolving Approach: The Exchange Rate

- Transition from balance to net surplus in the early 2000s

- Phase 1 Response (until Jan 2007): **Intervention with sterilization**
  - *Design and use of Market Stabilization Bonds*
- Phase 2 Response (Feb 2007 onwards): **Essentially no intervention**

Slide 6: An Evolving Approach: Capital Controls

- **Preference Ordering**
  - Foreign Direct Investment
  - Foreign Portfolio Investment in Equities
  - Long-term Debt
  - Short-term Debt
- Barring some sector-specific constraints, FDI flows are unconstrained
- Equity investments are unconstrained for institutions; new channels have been created for individuals
- Debt flows are subject to approval relating to end-use
- Some quantitative and pricing controls are in effect on debt flows

Slide 7: A Conceptual View…1

- Co-existence between capital controls and effectively floating exchange rate since 2007

Strategic vs. **Tactical** Controls

- Preference Ordering reflects a **strategic** view of macroeconomic benefits and risks of different channels
- Once controls are in place, they stay for some time, making rules of the game stable and predictable
- **“Reform”** then implies a change in the risk-benefit assessment of specific channels

- Intervention and controls such as URR are **tactical** in nature
- Issues of predictability and monetary management

Slide 8: A Conceptual View…2

- Intervention and controls such as URR are **tactical** in nature
- Issues of predictability and monetary management

Assessment

- Non-intervention has facilitated monetary policy operations
- It has made stakeholders sensitive to exchange rate risk, resulting in more effective hedging
- **"Reform"** implies development of market-based hedging instruments and better regulation of OTC instruments

Slide 9: Concluding Thoughts

- The Indian capital flow management framework has evolved in response to challenges in maintaining macroeconomic stability

- Even as intervention has been stopped, controls on some forms of inflows are still considered necessary

- A balance has been sought through the conceptual distinction between **strategic** and **tactical** controls

- Country circumstances differ and should determine the approach
- However, this distinction might provide a useful input into the thought process