Capital Account Management

Duvvuri Subbarao
Governor of Reserve Bank of India

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Like everyone else before me, I want to thank the IMF, Professor Olivier Blanchard, and Managing Director Christine Lagarde for inviting me to this conference and for the privilege of chairing this session. This penultimate session of this conference is on capital account management.

Intellectual Shift on Capital Controls

The change in our worldview on capital account management is by far one of the most remarkable intellectual shifts brought on by the crisis. In her opening remarks yesterday, the Managing Director said that the crisis shattered the consensus on many macroeconomic issues and shibboleths. Nowhere is this more true than in the broad policy area of capital account management. In my view, the three big issues on which the precrisis consensus has dissolved are the following.

First, movement toward a fully open capital account; second, the use of capital controls as short-run stabilization tools; and third, the desirability of foreign exchange intervention. I will comment briefly on each of these.

Movement Toward a Fully Open Capital Account

The first issue on which consensus is broken is a fully open capital account. Before the crisis, the consensus was that every country should eventually move toward a fully open capital account. The debate was only about the appropriate strategy—

sequencing and timing, in particular—for transitioning to full capital account convertibility.

China and India

Let me invoke the example of India. Moving toward full capital account convertibility has always been our policy goal. The only variable was the road map for getting there, which, it was agreed, should be redefined from time to time, consistent with the evolving situation. There was also general agreement that we should start with floating the exchange rate and decontrolling interest rates, and finish with the capital account, on the rationale that this strategy will best preserve macro stability.

There has been a long and vigorous debate in China, too, on opening up the capital account, with a roughly similar consensus as in India about sequencing. Over the past few years, though, China has apparently changed its strategy, as is evident from their policy direction. If you accept that measures to internationalize the renminbi are a big step toward capital account convertibility, then this initiative by China has been much bolder than its actions on freeing up exchange and interest rates.

Controls and Financial Stability

The crisis has, however, changed all this. It shifted the debate from the strategy and timing for capital account convertibility, to questioning the very imperative for capital account convertibility. In other words, the consensus that every country should eventually move toward a fully free capital account is now broken.

The main argument in support of the new view—that full capital account convertibility need not be an eventual goal—is that controls prevented emerging markets from adopting some of the financial products that proved toxic in advanced countries. So, there is merit, it is argued, in retaining capital controls. Against this is the old argument, which is still quite persuasive, that as countries become more integrated economically, they will need to become more integrated financially.

With that backdrop, the questions on this subtopic of movement toward a fully open capital account are the following:

1. Although there is virtual consensus that free trade in goods is welfare enhancing, opinion is divided on the virtues of financial openness. What explains this difference? In what ways is financial liberalization different from trade liberalization?

2. Is full capital account convertibility still an appropriate objective for every country?

3. If so, what is the best strategy for achieving it? Should it be *festina lente*, which, I believe, is Latin for *making haste slowly*?

Capital Controls as a Stabilization Tool

The second issue on which the precrisis consensus is broken is the use of capital controls as a stabilization tool. Before the crisis, the consensus was that capital controls are bad, always and everywhere. That consensus no longer holds. The received wisdom today is that capital controls are not only appropriate, but even desirable, in certain circumstances. Even so, there are many unsettled debates.

Effectiveness of Capital Controls

The first big debate is about the effectiveness of capital controls. People have questioned effectiveness on the basis of mainly two arguments. First, that capital controls do not alter the volume of flows, but alter only their tenor. Second, that capital controls can easily be circumvented by disguising short-term flows as long-term flows.

Price vs. Quantity Controls

Then, there is a debate about what type of controls are effective. Countries have used both price-based controls such as taxes, as well as quantity-based controls. However, evidence on which of them has been effective, and under what circumstances, is not conclusive. And you will hear about that firsthand from two of our panelists, who are from Latin America.

India's Experience

In India, for example, we deploy both price-based and quantity-based controls. Our experience has been that although quantity controls are more effective in the short term, they can also be distorting, inefficient, and inequitable.

Capital Controls vs. Prudential Measures

There is also an argument about whether capital controls can be substituted by prudential measures. It is not clear that they are always exact substitutes. If capital inflows are intermediated through the banking system, then prudential measures can be applied directly on domestic banks, circumventing the need for controls. But what if the inflows are direct? That is to say, loans are channeled directly from foreign entities to domestic companies. In that case, the only mechanism to prevent excessive leverage, and foreign exchange exposure, may be by imposing controls.

Against that backdrop, the questions regarding capital controls as a short-run stabilization tool are the following:

1. Can we define the distortion that capital controls are meant to correct? For example, how do we determine if capital flows are excessive or dangerous?

2. What have we learned about the effectiveness of capital controls as a stabilization tool?

3. When can prudential measures be substituted for capital controls?

4. What criteria should we adopt to choose between price-based and quantity-based controls?

5. Are capital controls symmetric as between inflows and outflows? In other words, should we use one type of controls to control inflows and another type to limit outflows?

Foreign Exchange Intervention

The third important issue on which the precrisis consensus has dissolved is foreign exchange intervention. The precrisis consensus, at least among advanced economies, was that intervention in the foreign exchange market is suboptimal. That consensus no longer holds, with even some advanced economies defending their currencies from the safe haven impact. Emerging markets, for their part, have had long and varied experience of struggling with foreign exchange intervention. The policy dilemma in the event of receiving capital flows, beyond the country's absorptive capacity, can be quite complex.

If you didn't intervene in the foreign exchange market, then you would have currency appreciation quite unrelated to fundamentals. If you intervened, but did not sterilize the resultant liquidity, you become vulnerable to inflation pressures and asset price bubbles. If you intervened in the foreign exchange market and sterilized the resultant liquidity, you may find interest rates firming up—which attracts even more flows—a classic case of Dutch disease. What all this says is that there is really no benign option for dealing with volatile capital flows.

There is one other important issue relating to foreign exchange intervention. Both currency appreciation and currency depreciation, quite unrelated to fundamentals, are complex problems. But there is a significant asymmetry between intervention for fighting appreciation and intervention for fighting depreciation.

When you are fighting currency appreciation, you are intervening in your own currency. Your capacity to do so is, at least in theory, unlimited, quite simply because you can print your own currency. But when you are fighting currency depreciation, you are intervening in a hard currency. Your capacity to intervene is, therefore, limited by the size of your foreign exchange reserves. What complicates the dilemma is that the market is aware of this.

So, there is the real danger that by intervening in the foreign exchange market, you could end up losing foreign exchange reserves, and not gaining on the currency. The lower your reserves dip, the more vulnerable you become. And the vulnerability can become quite serious if your reserves go below the level that markets perceive as necessary to regain market access. It should also be clear that a failed defense of the exchange rate is worse than no defense at all. So, when you are intervening in the foreign exchange market, it is important to make sure that your intervention is successful.

In that context, the questions on this topic of foreign exchange intervention are the following:

1. Under what conditions is it appropriate for countries to intervene in the foreign exchange market?

2. Under what conditions is foreign exchange intervention preferable to capital controls?

3. In most cases, countries claim that they are intervening in the foreign exchange market, not to target any particular rate, but only to manage the volatility in the exchange rate. Is it necessary, then, to

define up front your measure of volatility that will trigger intervention?

I have raised very difficult questions for which I have no answers. But to answer those difficult questions we have an expert panel.