

Recent Experiences with Regulating Capital Flows in India

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Capital Controls – A Very Brief History

- ❑ Introduced by the British in 1942
 - ❑ A complex framework of restrictions on current and capital account

- ❑ Began to ease after the Structural Adjustment Program with the IMF in 1991
 - ❑ Current Account began to liberalize
 - ❑ While some restrictions on Capital Account were eased, the framework for re-imposing restrictions remained intact

- ❑ In 2000
 - ❑ Current Account was made fully convertible
 - ❑ A modified framework for capital controls were put in place

- ❑ Upshot: The Indian capital control framework has been permanent, not transitory

Basic Principles Followed

In opening the capital account India has been very cautious

- ❑ Equity flows have been encouraged
- ❑ Debt flows – particularly short-term – have been discouraged
- ❑ Short-term debt has been restricted to only trade credit
- ❑ Banking sector has been permitted very little access to overseas markets for funding local operations
- ❑ Government borrowing from abroad has been negligible
 - ❑ India has not issued any sovereign bond since the “economic liberalization” of 1991

A Recent Point of View

“Under a permanent system of capital controls, costs are borne by the country at all times, whether there is a surge or capital flight or not. These costs may be justified if the capital controls are able to deliver on the goals of macroeconomic policy. The Indian experience does not suggest that these goals were met.”

Patnaik and Shah (2012)

<http://www.voxeu.org/article/did-indian-capital-controls-work-tool-macroeconomic-policy>

Framework for Capital Controls – I

Major Regulators

Inflows

Foreign Direct Investments

Government of India (GOI)

- Determines the sectors open to foreign direct investment
- Determines the caps on foreign equity holdings

Foreign Portfolio Investments

Securities and Exchange Board of India (SEBI)

- Regulator of the Indian Capital Markets
- Regulates the Foreign Institutional Investors (FII, 1992) and Qualified Foreign Investors (QFI, 2012)
- Determines the caps on individual and aggregate holdings of the FIIs and QFIs

Framework for Capital Controls – II

Major Regulators

Inflows and Outflows

- ❑ In addition to running the monetary policy, the [Reserve Bank of India \(RBI\)](#) regulates
 - ❑ The Credit Market (Banks and Nonbank Financial Corporations)
 - ❑ The Money Market
 - ❑ The Government Securities Market
 - ❑ The Foreign Exchange Market
 - ❑ The Over the Counter (OTC) Derivatives Market
- ❑ The RBI is the main regulator of the inflows and outflows by imposing restrictions on
 - ❑ Individuals
 - ❑ Firms
 - ❑ Foreign Banks

Nature of the Controls

- ❑ Most of the measures are quantitative
 - ❑ Either absolute restrictions
 - ❑ For example, aggregate foreign holdings of Government Bonds is capped at \$30 Billion US Dollars
 - ❑ Or relative restrictions
 - ❑ For example, Indian firms are permitted to invest overseas up to 400% of their net worth

- ❑ There are price based measures also
 - ❑ For example, ceilings on the interest rates at which Indian firms can borrow overseas

- ❑ At one point, other market based measures such as transaction taxes and reserve requirements were also considered but have never been implemented

Pre- and Post-Lehman Capital Surges

- ❑ Lehman collapsed on September 15, 2008
- ❑ Since Lehman, there have been two sharp capital outflow surges
 - ❑ After Lehman until mid-2009
 - ❑ Since May 2013-present
- ❑ Further, India has experienced two capital inflow surges
 - ❑ 2003-2008 (pre-Lehman)
 - ❑ 2009-2013 (post-Lehman)

Pre-Lehman – Y.V. Reddy (2003-2008)

Took bold capital control measures to discourage inflows and encourage outflows. Examples include the following

❑ Discouraging Inflows

- ❑ Jan, 2007: Caps on interest rates on non-resident bank deposits were reduced
- ❑ May, 2007: External Commercial Borrowings by real estate companies were banned

❑ Encouraging Outflows

- ❑ Dec, 2006: Prepayment limit on External Commercial Borrowings was raised to \$300 million US Dollars
- ❑ June, 2007: Portfolio Investment limits of Indian companies were raised

❑ In addition, several macro- and micro-prudential measures were taken to strengthen the Indian credit system

Post-Lehman – D. Subbarao (2008-2013)

No bold capital control measures until the May 2013 upsurge in capital outflows. After the upsurge, two measures to curb outflows

- ❑ Lowered the US Dollar remittances of the resident Indians from \$200,000 to \$75,000

- ❑ Lowered the cap on the Overseas Direct Investment of Indian firms for all fresh transactions from 400% of the net worth to 100%

- ❑ In addition, took monetary policy measures to lower Rupee liquidity to curb dollar purchases and increased the short-term interest rates as a transitory response

Current – R. Rajan (2013 - ?)

Too early to say much except that Rajan signaled that he is not interested in capital controls

- ❑ Reversed the monetary policy measures by narrowing the policy rates window 100 basis points: increased the lower bound by 25 basis points and decreased the upper bound by 75 basis point, effectively lowering the short rates
- ❑ Expressed interest in liberalizing the access of foreign investors to the domestic bond market
- ❑ Declared that inflation will be the main target of the RBI

Two Suggestions to Emerging and Developing Economies

- 1) Since domestic credit systems have no constraints on creating domestic credit, finance domestic production and consumption through the domestic credit system
- 1) Demand payments on the exports in the domestic currency