VIII APPROACH TO CAPITAL ACCOUNT CONVERTIBILITY

Introduction

8.1 The decade of the 1990s witnessed a spate of financial crises in several countries across the world with risks emanating mainly from the capital account of balance of payments. Consequently, the capital account has come to receive increasing attention in policymaking. The crises of the 1990s underscored the inadequacy of erstwhile theories in explaining the sharp volatility in capital flows. The benefits and costs of an open capital account appear more ambiguous now than what many researchers and policy makers had perceived earlier. Moreover, the international financial community is hard put to provide a conclusive set of prescriptions for containing the ill-effects of such capital movements, particularly during episodes of sudden reversal in flows. The debate assumes a critical dimension in respect of developing countries and emerging market economies (EMEs). While these economies can potentially benefit enormously from larger volumes of capital inflows, their relatively shallow and underdeveloped institutions render them more vulnerable to crises as compared with the developed economies.

8.2 The lessons from the East Asian and other financial crises of 1990s have brought about a marked shift in the approach towards capital account liberalisation, particularly among developing countries. Countries are less confident today of the conventional wisdom which maintained that trade flows were the key determinants of exchange rate movements. The long-standing assumption that the case for liberalising capital account transactions is analogous to that for liberalising trade is being increasingly called into question (Bhagwati, 1998). In more recent times, with the tail of mobile capital accounts wagging the dog of the balance of payments, the importance of capital flows in determining the exchange rate movements has increased considerably, rendering some of the earlier guideposts of monetary policy formulation possibly anachronistic (Mohan, 2003). On a day-to-day basis, it is capital flows rather than trade flows which influence the exchange rate and interest rate arithmetic of the financial markets. Thus, instead of the real factors underlying trade competitiveness, it is expectations and reactions to news which drive capital flows and exchange rates, often out of alignment with fundamentals. Unregulated capital flows in some instances have been subject to destabilising speculation, thereby imposing a burden on the real economy. It is well recognised now that although global capital flows have a potential for improving efficiency and growth prospects, they also can trigger instability, due to a variety of reasons (Reddy, 2000a).

8.3 The East Asian crisis of 1997 amply demonstrated the need to proceed with caution in opening the capital account. Not surprisingly, the pace and content of opening up of the capital account has slowed down in many EMEs with a view to limiting their vulnerability to crises. It has been recognised that capital account liberalisation needs to be undertaken as an integral part of macroeconomic and structural reforms and be synchronised with appropriate macroeconomic, exchange rate and financial sector policies. The issue relates as much to the sequence of reforms as to their speed. It is argued that a combination of sound macroeconomic policies, a well-regulated financial system and restrictions on short-term speculative flows is likely to create a system wherein the benefits of external capital could be reaped without its adverse effects (Jadhav, 1999; Rangarajan and Prasad, 1999).

8.4 In India, capital account liberalisation is treated as a process rather than an event (Reddy, 2000a). India adopted a cautious approach while initiating a process of gradual capital account liberalisation in the early 1990s. The Report of the Committee on Capital Account Convertibility (Chairman: S.S. Tarapore) provided the framework for liberalisation of capital account and served as the basis for undertaking further liberalisation during the late 1990s. Initial reform measures on the heels of the balance of payments crisis in 1991 were predominantly directed at current account convertibility leading to acceptance of obligations under Article VIII of the International Monetary Fund's (IMF) Articles of Agreement by August 1994. Subsequently, policies in regard to foreign direct investment (FDI), portfolio investment and long-term commercial borrowings were progressively liberalised. With growing consolidation of the external sector, restrictions on outflows have also been liberalised over time. There are, however, two areas, where extreme caution is advocated, *viz.,* (i) unlimited access to short-term external commercial

borrowing for meeting working capital and other domestic requirements; and (ii) unrestricted freedom to domestic residents to convert their domestic bank deposits and idle assets (such as, real estate) in response to market developments or exchange rate expectations (Jalan, 2003). The policy challenges for India arising from the opening of the capital account broadly fall under two categories: (i) management of the surges in capital flows; and (ii) entrenchment of preconditions that could create room for further liberalisation of the capital account (Jadhav, 2003).

8.5 Against this backdrop, the Chapter is organised in six Sections. Section I delineates, in brief, movements in international capital flows and discusses the associated problems of volatility and contagion, which define the negative aspect of capital flows. Section II presents a theoretical perspective on the costs and benefits of capital account liberalisation. Country experiences with the imposition and withdrawal of capital controls are discussed in Section III with focus on four broad groups of countries which applied/withdrew capital controls under various circumstances. The general motives and design for imposition of capital controls are also analysed. Section IV discusses the approaches of the multilateral institutions like the IMF, the World Bank, the OECD and the European Union to capital account liberalisation. In Section V, the Indian experience with capital account liberalisation is covered with special reference to the recommendations of the Committee on Capital Account Convertibility. The final Section presents some concluding observations.

I. VOLATILITY OF CAPITAL FLOWS AND CONTAGION

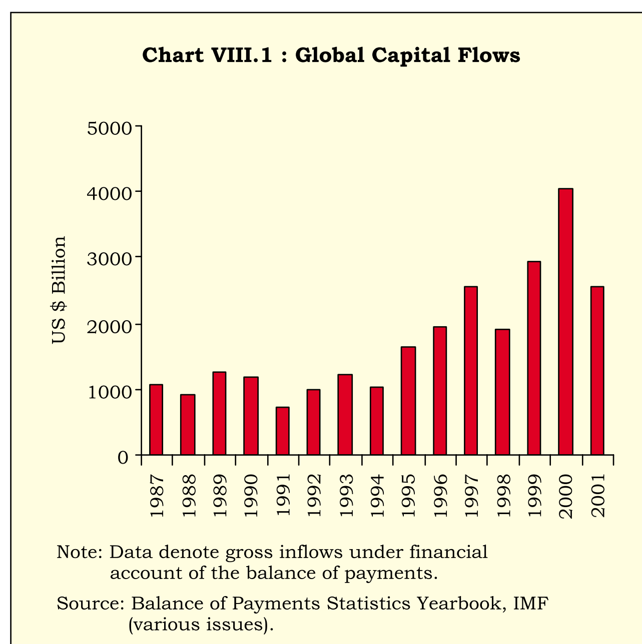
8.6 The history of capital flows in the last four decades reveals well-defined periods of booms and reversals. EMEs experienced a dramatic surge in capital inflows in the 1970s. The oil shock of 1973-74, growth of the Eurodollar market and a sharp increase in bank lending during 1979-81 all contributed to this spurt. Latin America was the primary recipient of these inflows. The composition of capital flows during this period was dominated by syndicated bank loans. The flow of international lending, however, came to an abrupt end in 1982 with a sharp increase in world interest rates and a severe debt crisis in several Latin American countries. The late 1980s saw a revival in capital flows to EMEs led again by Latin America. This time round, an increasing volume of inflows also found their way to Asia. The composition of capital flows also underwent a change with FDI and portfolio investment replacing bank lending. Bank lending to both Asia and Latin America declined from 70 per cent of net private capital flows in the 1970s to about 20 per cent in the 1990s (Kaminsky, 2003).

8.7 During the 1980s and the 1990s, several developing countries in Asia undertook capital account liberalisation as part of unilateral financial deregulation, often in the face of large external surpluses. In general, the period from the mid-1980s to mid-1990s was characterised by removal of official restrictions on financial markets and wider market-oriented reforms in both mature and EMEs (Mohan, 2003). These developments have had the effect of further strengthening the capital flows which increased substantially at the global level (Chart VIII.1).

8.8 The early 1990s experienced capital flow boom again, followed by the reversal of such flows especially in the second half of the 1990s. The first reversal occurred in the aftermath of Mexico's currency crisis in December 1994. It was, however, limited to some Latin American economies and capital flows resumed soon after. The second reversal, which was more severe and enduring, came in 1997 and resulted in the East Asian crisis. This was aggravated by the Russian default in August 1998 and the Brazilian crisis in 1998-99, followed more recently by the collapse of the Argentine currency board peg in 2001 and the spate of corporate failures and accounting irregularities in the USA in 2002.

8.9 The reversal of short-term flows was especially "brutal" with such flows to Asia declining from net inflows

Chart VIII.1 : Global Capital Flows



Note: Data denote gross inflows under financial account of the balance of payments.

Source: Balance of Payments Statistics Yearbook, IMF (various issues).

of US $ 69 billion in 1996 to net outflow of US $ 104 billion in 1997. Net flows to developing countries declined almost continuously after 1997. The fall was particularly sharp in the form of bank lending and bonds, reflecting uncertainty and risk aversion. In 2002, net capital flows fell again, remaining far below the 1997 peak. Flows to Latin America reached their lowest level in a decade. Flows to Asia began a hesitant recovery with new bank lending exceeding repayments for the first time in five years. Global FDI inflows, down by 41 per cent in 2001, fell by another 21 per cent in 2002, attributable to weak economic growth, large sell-offs in equity markets, and a plunge in cross-border mergers and acquisitions. Flows to Asia were less badly affected primarily on account of large FDI flows into China. The overall capital flows to all emerging market economies are yet to assume their pre-reversal volumes (Kaminsky, 2003).

8.10 In the final analysis, the heightened exchange rate volatility of the era of capital flows has had adverse implications for all countries except the reserve currency economies. The latter have been experiencing exchange rate movements which are not in alignment with their macro imbalances and the danger of persisting currency misalignments looms large over all non-reserve currency economies (Mohan, 2003).

8.11 Against this background, it would be useful to take a closer look at the recent upheavals in the East Asia. Large and volatile capital flows combined with sharp increases in current account deficits of the crisis economies (from 2 per cent of GDP in 1993 to over 5 per cent of GDP in 1996), played a significant role in the East Asian crisis. In some cases, notably in Malaysia and Thailand, current account imbalances became extremely severe, rising to 8-10 per cent of GDP. This increase in current account deficit was partly triggered by significant appreciation of real exchange rates of several East Asian economies by 10-20 per cent during 1994-97. The real appreciation in the exchange rates was mainly because of stable nominal exchange rates, higher domestic inflation as compared with world averages, rise in the US dollar against other major currencies and to some extent, devaluation of the Chinese yuan by around 32 per cent in 1994. Obviously, the increased current account deficit was financed by huge capital inflows from abroad, which also went on to increase the reserves of these countries. Once the surge of capital inflows into these economies began to build up, there followed a rampant increase in domestic asset prices (in typical "bubble" fashion), which induced further capital inflows. This led to further real appreciation of their currencies. Eventually, current account deficits deteriorated sharply, leading to a hard landing (IMF, 1998).

8.12 The fragile banking sector had the effect of building up of huge net foreign liabilities. The vulnerabilities of banking sector were twofold, both of which were linked to the behaviour of capital inflows. A withdrawal of capital inflows led to currency devaluation, which inflated the value of foreign currency liabilities of the banks. At the same time, reversal of capital inflows led to collapse of the real estate and equity prices, thus undermining the collateral which was the backing of the banks' assets. This vicious double squeeze was the main problem leading to the crisis in the banking sector (Reddy, 1998).

8.13 To add to the problems of external sector, the process of financial sector vulnerability began to unfold during the crisis period. The freeing up of financial system along with the capital controls coupled with high domestic interest rates gave the incentive to take cheap foreign currency loans. The tendency was exacerbated by low to non-existent perceived foreign currency risk, as the exchange rate of most of the currencies remained largely stable between 1993 and 1996. Relying on a stable currency over the years, the market participants had not hedged their currency exposures. With significant depreciation, these loans had suddenly become expensive to repay, which had hit corporate balance sheets and added to the risk of defaults in payments. This was aggravated further by the hardening of interest rates. The exposure of the banking system and the non-banking financial sector to these external liabilities with a concentration towards short-term maturities particularly when the financial health of such economies was in bad shape led to further deterioration in the situation (Reddy, 1998).

8.14 The experience of the Asian crisis, thus, reveals that large and volatile capital flows may lead to overshooting of exchange rates, often out of alignment with the fundamentals. Such volatility imposes substantial risks on market agents, who may not be able to sustain or manage such risks. Furthermore, financial markets, driven by the massive cross-border capital flows and the information technology revolution, immediately transfer the valuation of risks associated with uncertainty across the globe and this can lead to contagion. Indeed, global interdependence is marked by common shocks and a "confidence channel" rapidly transmits these shocks to various parts of the world (Mohan, 2003). In such circumstances, the key issue under consideration of the monetary authority is to determine whether the capital inflows are of a

permanent and sustainable nature or whether such inflows are temporary and subject to reversal. In practice, this determination is difficult to achieve. Since external capital flows cannot be easily predicted and can reverse even in the presence of sound fundamentals, management of capital account involves control, regulation and gradual liberalisation. Gradualism in liberalisation implies that the mix between regulated and liberalised capital transactions keeps changing gradually in favour of the latter (Reddy, 2000a).

8.15 While controls may be potentially inefficient, there is considerable merit in using a regulatory mechanism for moderating the ebb and flow in capital movements. In regard to the dynamics of control or regulation *vis-à-vis* liberalisation, it is clear that a workable framework appropriate to each country is necessary. The more important aspect of management of capital account is the flexibility available in the framework to progressively liberalise the capital account transactions, depending on the domestic and international developments. At the same time, such flexibility could permit quick responses to changes in magnitudes, direction and composition of flows that may appear to be inappropriate to the circumstances. This flexibility in operations may, for success, warrant complementarity with other policies. Finally, there may be a case for retaining the freedom to re-impose controls or tighten regulations as long as the vulnerability to highly speculative or motivated attack on the currency exists, since market corrections may be more destabilising to the economy. Thus, it may be wise, even with a liberalised capital account to retain an option to impose controls or tighten regulations (Reddy, 2000a).

8.16 There is certainly an implicit recognition that the net benefits from liberalisation of capital account in respect of any developing country would be enhanced if certain complementary policies are followed. Strengthening the banking system, diversifying financial intermediation through both banks and non-banks, and developing as well as regulating financial markets in a sound manner are some of the primary prerequisites of capital accounts liberalisation. Second, the regulatory practices and the co-ordination between regulators at the national level and among the national level regulators at the international level are also attracting attention. Third, monitoring the balance sheets of large banks, large corporates and even governments in terms of their growth, quality and vulnerability to shocks is considered important. This monitoring may have to cover stocks and flows, as also foreign currency exposures, hedged or unhedged, and direct or indirect. Fourth, there is a fiscal burden in case there are systemic problems, especially in banking sector, irrespective of whether banking is in public or private sector. The health of banking sector is critical for many reasons, one of them being stability in external sector (Reddy, 2000a).

8.17 In India, it is recognised that the pace of liberalisation of the capital account would depend on both domestic factors (especially progress in the financial sector reform), and the evolving international financial architecture. The regulatory framework is being used in several combinations to address problems of excessive inflows and pressures towards outflows. In this regard, an integrated view of the state of development of activities in financial markets needs to be taken. The activity in foreign exchange markets and its linkages with other markets, including money market, debt market (especially government securities market), and equity markets have to be identified and monitored while managing capital flows. Recognition of such linkages, monitoring the developments, and willingness to intervene credibly in any or all of these markets, as appropriate, may be essential. As each of the financial markets develops and gets integrated with others, measures to increasingly liberalise the capital account could be considered. Indeed, it is possible to argue that liberalisation of the capital account would aid the process of development of financial markets, but this is valid only when some informed judgements are made in respect of each country on the interactions between the management of capital account and the financial markets. In any case, capital control or regulatory framework of liberalisation would be ineffective or unstable in the absence of proper appreciation of such linkages among financial markets.

II. THEORETICAL PERSPECTIVES ON COSTS AND BENEFITS OF CAPITAL ACCOUNT LIBERALISATION

8.18 Capital account liberalisation essentially provides freedom from prohibitions on transactions in the capital and financial accounts of the balance of payments. The role of capital flows was integrated into traditional macroeconomics by Fleming and Mundell spelling out the requirement of balance in the external sector of an economy for equilibrium to be attained. This was formalised with the inclusion of a BP (balance of payments) curve in the erstwhile IS-LM framework. A corollary of the Fleming and Mundell model was what has come to be known as the “impossible trinity”- the idea that free capital

mobility, fixed exchange rates and independence in monetary policy cannot coexist (Mundell, 1963). Sterilisation in various degrees and a managed float, however, are two instruments which allow policy makers a certain degree of manoeuvrability in this respect. The third way out of the trilemma is offered by regulating the extent of capital mobility through the use of capital controls. The debate on capital account liberalisation, however, extends much beyond the impossible trinity as free capital flows have numerous direct and indirect effects not captured within any single model.

Costs and Benefits of Capital Account Liberalisation

8.19 There are some differences of opinion as to whether liberalisation of capital account would necessarily add to growth prospects of the developing countries. There are nevertheless, several developments in regard to international trade in goods and services, international business, technology and cross border flows of capital that would necessitate a more active management of capital account, with a view to continuously assess the costs and benefits of liberalisation *vis-à-vis* control or regulation (Reddy, 2000a).

8.20 The origins of the theoretical controversy over the benefits of capital account liberalisation can be traced to the basic question – are financial markets predominantly efficient or do information asymmetries and real sector rigidities render them irredeemably, or at least in large measure, inefficient? Proponents of the efficient markets hypothesis argue that an open capital account could bring with it greater financial efficiency, specialisation and innovation by exposing the financial sector to global competition.

8.21 Gruben and McLeod (2001) found that greater financial openness across a large number of countries and the significant decline in global inflation could contribute to higher growth. Capital account liberalisation could, in combination with other policies, play a significant role in the take-off of less developed countries, and to the extent that it does, it would have large benefits (Gourinchas and Jeanne, 2002). Developing countries need external capital to sustain an excess of investment over domestic saving and an open capital account could attract foreign capital. Residents get the opportunity to base their investment and consumption decisions on world interest rates and world prices for tradables 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. Capital flows permit nations to trade consumption today for consumption in the future to engage in inter-temporal trade (Eichengreen *et al.*, 1999). Again, 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. On the other hand, capital controls could encourage hidden capital flight and/or diversion of savings into real assets and gold, leading to sub-optimal use of internal resources.

8.22 In the neo-classical framework capital flows contribute to growth primarily by supplementing domestic savings. In the endogenous growth framework, the contributions to 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 positive externalities in terms of higher efficiency of domestic financial markets resulting in 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 pursued by prioritising the capital flows based on the growth-enhancing role of each form of capital.

8.23 Several arguments, on the other hand, are put forward against the liberalisation of the capital account, *viz.,* potential macroeconomic instability arising from the volatility of short-term capital movements; the risk of large capital outflows and associated negative externalities; export of domestic savings from capital scarce developing countries; and weakening the ability of authorities to tax domestic financial activities, income and wealth. There is also the potential risk of the "Dutch disease effect" due to large capital inflows and appreciating real exchange rate diverting resources from tradable to non-tradable sectors in the face of rising external liabilities. Inefficient financial markets with asymmetric information could also lead to risk of financial bubbles. Besides, premature liberalisation could lead to currency substitution and capital flight, balance of payments crises, depreciation and inflation. It is argued that monetary contraction not only slows economic activity through the normal interest channels, but also can threaten the health of the economy through the banking system (Kaminsky and Reinhart, 1999). Although financial globalisation can, in theory, help to promote economic growth through various channels, there is as yet no robust empirical evidence that financial integration helps developing countries to improve growth rates and reduce macroeconomic volatility (Prasad *et al.*, 2003).

8.24 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 is perceived by the policy makers as appropriate and sustainable in the long-run. Like the effect on resource allocation, the beneficial effects of capital account liberalisation on growth are ambiguous. There is no evidence that countries without capital controls have grown faster, invested more, or experienced lower inflation (Rodrik, 1998).

8.25 Unlike the ambiguity surrounding the resource allocation argument, there is greater unanimity on the point that open capital account exerts pressures to discipline domestic macro-economic and financial environment. Disciplinary effects of an open capital account on the fiscal deficit suggest that complete freedom for outward capital mobility could be associated with a reduction in the budget deficit (Kim, 1999). Gourinchas and Jeanne (2002) emphasised that many EMEs may benefit from the discipline effect rather than the conventional resource allocation effect. If the benefits of capital market liberalisation are smaller for the poorest countries than for the middle income countries, the same is probably also true of the costs (Gilbert *et al.,* 2000).

8.26 Furthermore, controls on outflows are viewed by markets as an additional risk factor, and their prolonged use has often been associated with capital flight. Fischer (1998) insisted that currency controls, no matter how well executed, impose distortions on the economy and the longer they are in place, the more serious they tend to get. Another fact that weighs against capital controls relates to their efficacy. Capital controls are not very effective, particularly when the 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. As 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. As per 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 (Quirk and Evans, 1995).

8.27 In the aftermath of the Asian crisis, there has, however, been an increasing clamour for reimposing capital controls. Controls on outflows could be broadly classified into preventive controls and curative controls. While the former intend to prevent balance of payments crises, the latter could be applied as a means to manage a crisis (as in the case of Malaysia). A review of the empirical studies on the effectiveness of both variants of control 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 (Yoshitomi and Shirai, 2000). 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 a high interest rate defence of the exchange rate. Krugman justified temporary capital controls on the ground that the costs of any resulting distortions were likely to be lower than the alternative costs to the economy on account of higher interest rates and economic slump. The qualifications to this argument were fourfold, *viz.,* (i) controls should disrupt ordinary business as little as possible; (ii) controls must be used as a temporary measure as distortions associated with controls tend to grow over time; (iii) controls may cause the greatest damage when the intention is to defend an overvalued exchange rate; and (iv) controls must aid reforms and they should not be viewed as an alternative to reform. Bhagwati (1998) asserted that full capital mobility was not a necessary condition for free trade. He advocated capital controls as a stop gap measure as part of the solution for Asia on grounds that it allowed these countries to adopt more expansionary monetary and fiscal policies and hence promoted a faster recovery of the real economy. Such a recovery could be expected to reduce the problems of insolvency and closure in the corporate sector and non-performing loans in the banking system. Stiglitz (1998) contended that the cost of disruption due to swings in expectations is invariably high for developing countries. Thus, there exists a case for more direct intervention in less sophisticated economies. Given the nature of international financial transactions, developing countries ought to give themselves as much freedom as they can to place prudential controls on the more volatile forms of capital movements, in particular, portfolio capital and short-term flows (Agosin, 1998). Gilbert, Irwin and Vines (2000) felt that, "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 liberalisation".

8.28 While no conclusive end to the debate appears to be in sight, there is a general consensus that the case for capital account convertibility would rest on the circumstances and economic conditions specific to a

country as also the extent of development of its markets and institutions. In the absence of an all-or-nothing case for or against capital account convertibility, several countries have experimented with various types of capital controls in different situations. The experiences of these countries provide useful lessons for theorists and policymakers alike.

III. COUNTRY EXPERIENCE ON CAPITAL CONTROLS

8.29 Despite substantial disparities in the initial conditions of countries which have made use of capital controls, certain broad commonalities emerge when experiences of countries with regard to capital controls are studied in aggregation. 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 (Johnston and Tamirisa, 1998). Historically, experiences of countries with capital account liberalisation throw up three general observations. First, capital account liberalisation usually went hand in hand with domestic economic and financial liberalisation. Second, the policy on portfolio capital flows has differed from the policy on foreign direct investment. Third, circumstances and policy goals varied for controls on inward and outward capital flows.

8.30 The country experience with respect to imposition of capital control in recent times has been varied. In this context, it is useful to review the experiences of EMEs separately from those of developed economies. Experiences of emerging market economies, may be categorised into four broad groups: (i) Brazil (1993-97), Chile (1991-98), Colombia (1993-98), Malaysia (1994) and Thailand (1995-97) used capital controls to limit short-term capital inflows in response to concerns about the macroeconomic implications of the increasing size and volatility of such flows; (ii) Romania (1996-97), Russia (1998) and Venezuela (1994-96) resorted to extensive system of controls in both current and capital transactions in connection with crises; (iii) Malaysia (1998), Spain (1992) and Thailand (1997-98) imposed controls on capital outflows; and (iv) Argentina (1991), Kenya (1991-95), and Peru (1990-91) implemented relatively rapid liberalisation of the capital accounts by removing controls (Ariyoshi *et al.*, 2000).

8.31 Many different measures were available for controlling capital inflows in the first group of five countries (see Chapter VI). These countries used controls on inflows mainly to preserve or enhance monetary policy autonomy. Obviously, sterilisation operations were usually the first policy response to inflows. However, such operations typically entailed costs to the central bank and attracted further inflows as they tended to keep interest rates high. Controls on capital inflows were imposed to reduce reliance on sterilisation and in some cases to postpone other adjustments. The controls were seen as a means to resolve the classic policy dilemma that resulted from having more objectives than independent policy instruments. Various episodes suggest that capital controls had only temporary effect on stemming capital inflows. Capital controls on inflows in Colombia (1993-98) and Brazil (1993-97) did not prevent the continued appreciation of their currencies. Likewise, between 1991 and 1998, Chile applied a reserve requirement that placed a wedge between domestic and foreign interest rates, and provided a disincentive to short-term capital. These controls also lost effectiveness as loopholes were found to avoid the regulations. Capital controls in Thailand and Malaysia may have altered the maturity structure of capital inflows, but did not insulate the Thai baht from speculative attacks in 1997.

8.32 In the second category (crisis-driven current and capital account controls), extensive exchange controls were undertaken to stabilise the respective foreign exchange markets. Experiences of Romania, Russia and Venezuela indicate that such controls may temporarily relieve pressures on the balance of payments but they do not provide lasting protection when the fundamental causes of the imbalances remain unaddressed. As with more targeted controls, in these countries the controls reduced access to foreign capital.

8.33 The desire of authorities to limit downward pressures on their currencies was one of the most frequent motives for imposing capital controls in the third category (controls on capital outflows). Such restrictions were mainly applied to short-term capital transactions to counter volatile speculative flows. In some cases, these restrictions served as an alternative to prompt adjustment of economic policies and, thus, helped the authorities to “buy time”. They have also been used to insulate the real economy from volatility in international financial markets. The experiences of Malaysia, Spain and Thailand with controls on capital outflows indicates that: (i) controls do not provide lasting protection in the face of sufficient incentives for circumvention; (ii) ability to control off-shore market activity may have been instrumental in containing outflows and stemming speculative pressures; and (iii) effective measures risk discouraging even legitimate transactions.

8.34 In all three economies in the fourth category (rapid liberalisation of capital account), the liberalisation of the capital account was preceded by a period of severe macroeconomic imbalances in the external account or other sectors of domestic economy. Capital account liberalisation was intended to signal a strong pre-commitment to reform and was motivated by a desire to create conditions that would attract foreign financing and sustained growth. In these countries the liberalisation of the capital account was just one part of a wide-ranging liberalisation programme. Experiences of Argentina, Kenya, and Peru with rapid liberalisation of the capital account highlighted the importance of sound macroeconomic policies combined with ongoing efforts to strengthen the financial system and implement associated reforms.

8.35 The experiences of countries undertaking capital controls suggests that the designs of controls varied widely. The single common factor was their targeting of the activities of non-residents by restricting the access of the latter to domestic currency funds that could be used to take speculative positions against the domestic currency. The controls explicitly exempted current account transactions, foreign direct investment flows, and certain portfolio investments. Sale of short-term instruments to non-residents and outright forward and swap transactions with foreigners were prohibited in some of these countries. Tax on foreign investment in the debt and stock markets is another common form of discouraging capital outflows. Limits on, and approval procedures for short-term external commercial borrowings were also imposed by some countries.

8.36 Thus, the experiences with capital controls by a spectrum of EMEs suggest the following: First, to be effective, the controls must be comprehensive, strongly enforced and accompanied by necessary reforms and policy adjustments. Controls may lose effectiveness over time as markets exploit the loopholes in the system to channel the ‘undesired’ flows through the exempted ones. Second, although capital controls appeared to be effective in some countries, their role remains doubtful given the problems involved in disentangling the impact of the controls from that of the accompanying policies, which included strengthening of prudential regulations, greater exchange rate flexibility and adjustments in monetary policies. Third, inflow controls may not be ideally suited as instruments of prudential policy, as they are often imposed and modified for macroeconomic rather than microeconomic reasons. The experience of a number of countries *e.g.,* Brazil and Thailand, also suggests that the use of controls on inflows may not provide lasting protection against reversals in capital flows if they are not accompanied by necessary adjustments in macroeconomic policies and strengthening of the financial system.

8.37 In respect of developed countries, experiences with capital controls highlight a somewhat different set of issues. The time taken by developed countries to liberalise their capital account varied considerably, ranging from a number of years for France and Japan to a few months in the case of United Kingdom. Australia and New Zealand are also examples of speedy transition from rather restrictive to open financial regimes. Experiences of these countries reveal that accompanying macroeconomic policies and domestic reforms were critical for successful liberalisation under either approach. It was felt that proper sequencing in relation to reforms in other areas is important to ensure stabilisation. In particular, the need for developing adequate prudential supervision standards before liberalisation has been underscored. In most cases, direct investment flows were formally liberalised ahead of portfolio flows. On the other hand, restrictions on cross-border bank lending and foreign investment opportunities by the residents were among the last to be lifted (Griffith-Jones *et al.*, 2000).

Motives of Capital Controls

8.38 A number of motives have been suggested for maintaining controls on capital movements. While there is some overlap between the motives, they can generally be classified into those relating to (i) balance of payments and macroeconomic management; (ii) underdeveloped financial markets and regulatory systems (markets and institutional evolution); (iii) prudential; and (iv) other reasons (Johnston and Tamirisa, 1998). In practice capital controls are used for a number of purposes – both short-term and long-term, some of which may not correspond exactly to the four-fold classification mentioned above (Box VIII.1).

Types of Capital Controls

8.39 Broadly, there are three categories of measures that fall under the definition of capital controls, *viz.*, quantity-based, price-based and regulatory capital controls. Quantity-based measures involve the explicit limits or prohibitions on capital account transactions such as ban on investment in money market instruments and limits on short-term borrowings. On outflows, these can take the form of explicit moratorium. Price-based controls, such as tax on stock market purchases and

Box VIII.1

Purposes of Capital Controls

Purpose of Control	Method	Direction of Control	Example
1	2	3	4
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 World War I and World War 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 E*ncaje*, 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 E*ncaje*, 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 E*ncaje*, 1991-98
Restrict Foreign Ownership of Domestic Assets	Foreign ownership of certain domestic assets – especially natural resources – can generate resentment.	Inflows	Article 27 of 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 domestic 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).

tax on foreign exchange transactions, seek to alter the cost of capital account transactions (Neely, 1999). Regulatory capital controls could be both price- and quantity-based and generally treat transactions with non-residents less favourably than those with the residents. The coverage of regulations could apply to inflows as well as outflows on actions initiated by non-residents and residents. The transactions which may be subject to capital controls are with reference to maturity *i.e.,* short and long-term transactions or with reference to the nature of investments involved *i.e.,* foreign direct investment, portfolio investment, cross border holdings of real estate, domestically and internationally issued equity and debt, deposits with banks and other financial institutions, guarantees and financial back up facilities, life insurance contracts and derivative instruments (Box VIII.2).

Box VIII.2

Mechanism of Capital Controls

Capital controls have in general taken two main forms: direct or administrative controls and indirect or market-based controls. 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.

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. 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 of foreign financial assets by residents or the holding of domestic financial assets by nonresidents, 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. Indirect taxation of cross-border flows, in the form of compulsory unremunerated reserve/deposit requirements (URR) has been one of the most frequently used market-based controls. Under such schemes, banks and non-banks 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. Other indirect regulatory controls have the characteristics of both price- and quantity-based measures and involve discrimination between different types of transactions or investors 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).

Table: Types of Capital Transactions Possibly Subject to Controls

Inflows	Outflows
1	2
1. 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
2. Derivatives And Other Instruments	
Purchase Locally by Nonresidents	Sale or Issue Locally by Nonresidents
Sale or Issue Abroad by Residents	Purchase Abroad by Residents
3. Credit Operations	
Commercial Credits	
To Residents From Nonresidents	by Residents to Nonresidents
Financial Credits	
To Residents From Nonresidents	by Residents to Nonresidents

Inflows	Outflows
1	2
4. Guarantees, Sureties, and Financial Backup Facilities	
To Residents From Nonresidents	by Residents to Nonresidents
5. Direct Investment	
Inward Direct Investment	Outward Direct Investment
	Controls on Liquidation of Direct Investment
6. Real Estate Transactions	
Purchase Locally by Nonresidents	Purchase Abroad by Residents
	Sale Locally by Nonresidents
7. Provisions Specific To Commercial Banks	
Nonresident Deposits	Deposits Overseas
Borrowing Abroad	Foreign Loans
8. Personal Capital Movements: Deposits, Loans, Endowments, Inheritances, And Legacies	
To Residents From Nonresidents	by Residents to Nonresidents
9. Settlements Of Debts Abroad by Immigrants	
Transfer Into the Country by Immigrants	Transfer Abroad by Emigrants
10. Provisions Specific To Institutional Investors	
	Limits on Securities Issued by Nonresidents and on Portfolio Invested Abroad. Limits on Portfolio Invested Locally

Source: International Monetary Fund, 1999 and other IMF Documents.

8.40 These experiences reveal certain commonalities, particularly with regard to motives for and design of capital controls. By implication, they also offer certain lessons relating to the speed and sequencing of capital account liberalisation.

Speed and Sequencing of Capital Account Liberalisation

8.41 The sequencing literature argues that capital account liberalisation should be delayed until non-traditional export industries are well established, fiscal discipline is secure, and both trade and financial systems have been liberalised. It has been argued that restrictions on trade in goods and services should be liberalised prior to liberalisation 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 liberalisation (McKinnon, 1991). The emerging consensus is that capital account opening has to be accompanied - and preferably preceded - by an overhaul of the country's capacity to supervise, regulate and manage financial institutions, so that the domestic financial system can cope with the complexities arising from free capital movements (McKinnon and Pill, 1996). Second, strengthened market discipline and self-regulation of banks and other corporate entities is an important pre-condition, given the rapidly changing business environment in a global economy, especially in the financial markets. The main challenge in this area is to design and maintain a regulatory framework flexible enough to encourage market development while enhancing market discipline and self-regulation. Third, pursuing sound macroeconomic policies and avoiding domestic and external imbalances are important to preserve stability in financially open economies. Fourth, improvements in the reporting and monitoring of capital flows, especially private sector short-term flows related to inter-bank transactions, and of direct placements and consolidated debt of the corporate sector in emerging economies assume importance in this context. Finally, due to market failures there is room for prudential regulation of the capital account, aimed at changing the composition of capital inflows and giving monetary policy more flexibility to pursue inflation or current account targets.

8.42 The empirical literature generally emphasises the following preconditions to liberalisation of the capital account: (i) substantial narrowing of the differences between domestic and external financial market conditions; (ii) establishing a flexible interest rate structure; (iii) reducing fiscal deficit and financing the lower level of deficit in a non-inflationary way; (iv) limiting/reducing taxes on income, wealth, and transactions to international levels; (v) an appropriate exchange rate policy with greater flexibility as the degree of openness increases; (vi) strengthening prudential supervision of financial institutions; (vii) enforcing domestic competition to foster allocative and operational efficiency within the financial sector; (viii) restructuring and recapitalisation of domestic financial institutions; and (ix) reducing restrictions which inhibit wage price flexibility. Theory, however, has its limitations in approximating the challenges posed by capital flows in reality. Even with the best possible sequencing, mistakes will be made and crises will occur (Gilbert *et al.,* 2000). Costs outweigh the benefits when the sequencing of liberalisation becomes faulty and it is the attainment of preconditions that should determine the sequencing of liberalisation.

8.43 In the current debate on international financial architecture, there is no settled position on several of the actions being considered. In respect of liberalisation of capital account, however, there appears to be a broad consensus: it should be gradual, well-sequenced and undertaken in conjunction with several other measures at the micro and macro levels. In most cases, the desirability of limiting total external debt, especially short-term debt is generally advocated. Clearly, therefore, there is need for developing countries to choose among or prioritise alternative forms of capital flows on the basis of costs and benefits. The components of the capital account need to be managed by each country taking into account its own specific characteristics.

IV. APPROACH OF MULTILATERAL INSTITUTIONS TOWARDS CAPITAL ACCOUNT CONVERTIBILITY

8.44 The approach of multilateral institutions towards capital account convertibility assumes particular relevance in this context in view of the recent initiatives towards a new international financial architecture within which such institutions are expected to play a major role in assisting national governments prevent and manage capital account related crises. The IMF has certain conditions attached to the aid it offers to EMEs. IMF conditionalities often relate to changes in policy regimes within these economies with an orientation towards greater liberalisation and fiscal prudence. Among developed countries, such institutions serve as

fora for coordinating the extent and timing of capital account liberalisation.

8.45 The approach of multilateral institutions over time towards capital account convertibility has generally followed the prevailing consensus, though sometimes with a lag. Since the early 1990s, policies of the International Monetary Fund (IMF) towards emerging market economies have been dominated by the "Washington consensus", which looked at financial (and trade) liberalisation as the way to growth and prosperity (Miller and Zhang, 1999). Consequently, EMEs were encouraged to liberalise markets as quickly as possible. Prior to the Asian crisis, the IMF generally discouraged tightening of controls over capital movements in response to large capital flows and encouraged adjustments in fiscal, monetary, and exchange rate management. An implicit assumption was that financial markets are usually efficient in deciding the right amount and composition of capital flows to a country. Hence further improvement in market discipline to promote private capital flows was recommended (Goldstein and Mussa, 1993). Thus, although the IMF recognised the freedom accorded to members under the Articles to maintain or impose capital controls in order to achieve balance of payments and exchange rate stability, it urged members to undertake capital account liberalisation if it was deemed a crucial element of broader structural reforms.

8.46 In developed countries, the IMF has been supportive of liberalisation of capital account transactions in the context of Article IV consultations, drawing mainly from the framework of EU directives and the OECD Code of Liberalisation of Capital Movement. With respect to developing countries, the IMF followed a case-by-case approach. Although, the IMF generally supported a gradual approach to capital account liberalisation, it encouraged an acceleration of this process in some cases when it was felt that further liberalisation of capital outflows could help mitigate the macroeconomic complications associated with strong inflows (RBI, 2001).

8.47 In April 1997, the then Interim Committee of the IMF came out in favour of amending the IMF's Articles of Agreement to make liberalisation of the capital account as one of the objectives of the IMF (Eichengreen, 1999). Even as late as October 1997, the Fund's World Economic Outlook (WEO) recommended further liberalisation of the capital account noting the linkage between 'rapid growth and large capital inflows'. It was argued that although developing countries might experience increased volatility, these should be managed with greater exchange rate flexibility without imposing capital controls.

8.48 In the wake of the Asian crisis, however, IMF's active support for capital account convertibility was challenged by a number of country authorities, institutions and academics. The basic premises of pursuing capital account liberalisation was questioned, as was the advocacy of vesting the IMF with responsibility for promoting the orderly liberalisation of capital flows (Eichengreen and Mussa, 1998). In the face of such intellectual opposition to its policies, a moderation of the IMF's stance became evident. The imposition of capital controls in Malaysia in September 1998 did not find favour with the IMF initially, but eventually, the IMF recognised the role of capital controls and acknowledged that, "controls appear to have provided some breathing space in which to implement more fundamental reforms" (IMF, October 2001). The IMF also favoured imposition of capital controls on short-term capital inflows as in the case of Chile to increase the potency of monetary policy. The IMF acknowledged the existence of important preconditions for an orderly liberalisation of capital movements. Since then, the IMF, in general, favours a gradual approach to opening the capital account if the preconditions of effective liberalisation are not in place. It underscores the importance of the creation of conditions and institutions that can encourage foreign capital.

8.49 In the light of the Asian crisis, the World Bank (1999) also came out with the suggestion that capital account liberalisation should proceed cautiously, in an orderly and progressive manner in developing countries, given the large risks of financial crises – heightened by international capital market failures. Benefits of capital account liberalisation and increased capital flows have to be weighed against the likelihood of crises and their costs. The World Bank called for a policy of openness on the grounds that the benefits from FDI and longer-term capital inflows outweigh the costs associated with the increased likelihood of financial crisis. However, in the case of more volatile debt portfolio and inter-bank short-term debt flows under full capital account convertibility, there are associated risks of financial crises and greater uncertainty about the benefits. The World Bank also called for tighter prudential regulations on banks and market oriented restrictions on more volatile short-term inflows that minimise distortions (*e.g.*, taxes) where the domestic regulatory and prudential safeguards are weak.

8.50 The OECD code stemmed from the primary objective of establishing the organisation in 1961 of reducing or abolishing obstacles to the exchange of goods and services and current payments as well as maintaining and extending the liberalisation of capital movements. Detailed codes to this effect were adopted in 1961 and amended four times (1964,1973,1983 and 1989) to widen their coverage with the evolving situation. The gradual approach adopted by the OECD had two major steps. In the first step, mainly direct investment, long-term capital movements and trade transactions were liberalised in 1964. The second step, undertaken in the late 1980s/early 1990s, liberalised short-term financial operations. The year 1989 can be regarded as a turning point, since all types of capital movements were covered by the Code from that year. In the context of financial integration in the EU, liberalisation of the capital account gained momentum in the 1980s culminating in the ratification of the Single European Act in 1987. The Act specifically required all restrictions on capital movements to be removed and explicitly recognised full liberalisation as a necessary condition for creation of the common market. The objectives of the OECD Code of Liberalisation of Capital Movements and the EU directives have been fully attained and their rules apply to the industrial countries. The World Trade Organisation (WTO) is another organisation which aims at promoting liberalisation of trade in services including financial services and the associated capital flows (OECD, 2003).

8.51 While several initiatives are being proposed at the global level, the task of preventing a crisis is essentially a national responsibility though an enabling international environment is sought to be put in place to facilitate action by individual countries. While prevention of crises as well as mitigating their effects when they occur require multilateral efforts in today's globalised world, the social consequences of such crises have to be met by the national governments concerned. In this sense, the ultimate responsibility in regard to crisis prevention and management rests primarily on the policy makers of the countries concerned (Reddy, 2000a).

V. THE INDIAN EXPERIENCE

Approach

8.52 The Indian approach to capital account convertibility has been one of gradualism, treating liberalisation of the capital account as a continuous process rather than a single event. The Indian approach is akin to construction of dams which " ... do not stop, but only temper the flow of water from the top of a mountain... without the dams there are floods that bring with them death and property reduction. By contrast, with the dam, not only is the death and destruction reduced, but the water itself can be channelled into more constructive uses" (Stiglitz, 1999). This stance has been vindicated in the wake of the Asian crisis.

8.53 In India, there is a strong opinion in favour of cautious liberalisation, with a greater weight attached to stability. The policy in India is to approach liberalisation on capital account cautiously, gradually, in a sequenced manner, and in response to domestic monetary and financial sector developments as also the evolving international financial architecture (Reddy, 2000a).

8.54 A qualitative change, however, has been brought about in the legal framework by the enactment of the Foreign Exchange Management Act (FEMA) in June 2000 by which the objectives of regulation have been redefined as facilitating trade and payments as well as orderly development and maintenance of foreign exchange market in India. The legal framework envisages both the developmental dimension and orderliness or stability. The legislation provides power to the government to re-impose controls if public interest warrants it.

8.55 In India, like in several other EMEs, liberalisation of the current account preceded the liberalisation of the capital account. Capital account transactions were gradually liberalised during the 1990s. Restrictions on inflows were relaxed first, with an emphasis on encouraging FDI and portfolio equity investment and discouraging short-term debt-creating inflows. In the recent period, restrictions on capital outflows have subsequently been relaxed. Convertibility of non-resident investment has all along been a basic tenet of Indian foreign investment policy, *albeit* subject to administrative procedures. In the context of the liberalisation of capital account in India, it was noted that "the current framework of controls needs to be analysed from different angles for capturing operational reality. First, there is a differentiation between current (convertible) and capital account (subject to some controls) transactions. Second, there is a distinction and asymmetrical treatment between inflows (less restricted), outflows associated with inflows (free) and other outflows (more restricted). Third, residents are treated differently (more restrictive) than non-residents (less restrictive). Non-resident Indians have a well-defined intermediate status between residents and non-residents. Fourth, there are also differences in

treatment of individual (highly restrictive), corporates (restrictive) and financial intermediaries such as institutional investors (less restrictive) and banks (more restrictive)" (Reddy, 2000b).

Report of the Committee on Capital Account Convertibility

8.56 The Report of the Committee on Capital Account Convertibility (Chairman: S.S. Tarapore), submitted in May 1997, provided the framework for liberalisation of capital account transactions in India. The Committee recommended a phased implementation of Capital Account Convertibility (CAC) in India to be completed by the year 1999-2000 and prescribed the macroeconomic framework for implementing full convertibility in terms of the preconditions for greater liberalisation. The Committee had suggested that implementation of the measures in each of the three phases should be based on a continuous monitoring of certain preconditions and attendant variables identified from the lessons of the international experiences and related to the specifics of the Indian situation.

8.57 While there is no formal definition of CAC, the Committee recommended a working definition for purposes of its report. CAC refers to the freedom to convert local financial assets into foreign financial assets and *vice versa* at market determined rates of exchange. It is associated with changes of ownership in foreign/domestic financial assets and liabilities and embodies the creation and liquidation of claims on, or by, the rest of the world. CAC can be, and is, coexistent with restrictions other than on external payments. It also does not preclude the imposition of monetary/fiscal measures relating to foreign exchange transactions which are of a prudential nature.

8.58 The Committee recognised that the implementation of financial sector reforms in India brought into the open weaknesses which had been in the system for a long time. The introduction of CAC would require more proactive policy action as an open capital account could bring these weaknesses into a sharper focus. CAC would impose a strong discipline upon the financial system, expedite the rectification of infirmities in the system and lead to widening/ deepening of markets to enable the spreading/ distribution of risks.

8.59 A significant feature was that the Committee did not recommend unlimited opening up of capital account, but preferred a phased liberalisation of controls on outflows and inflows over a three year period. Even at the end of the three-year period, capital account was not to be fully open and some flows, especially debt would continue to be managed. An obvious corollary of this approach was that the mere attainment of preconditions may not be enough for implementing full liberalisation of the capital account. The approach towards full convertibility must be consistent with the overall policy framework that is assigned to the objective of growth and stability (Jadhav, 2003).

Preconditions/Signposts for CAC

8.60 The three crucial preconditions laid down by the Committee for attaining CAC were fiscal consolidation, a mandated inflation target and strengthening of the financial sector. In addition, the Committee stressed that a few important macroeconomic indicators should also be assessed on an on-going basis (Box VIII.3).

Experience

8.61 In India, most categories of capital account transactions like foreign direct investment, portfolio equity investment, external commercial borrowing, non-resident deposits, short-term credit and outward investment were subject to a number of restrictions prior to 1991. During this period, FDI was seen primarily as a vehicle for transfer of technology that would be costly or difficult to develop domestically. A selective policy of case-by-case approvals was designed to channel FDI into areas that required sophisticated technology; where critical production gaps existed; or where there were prospects for substantial export potential. Foreign investment in the form of foreign collaborations was also regulated. Portfolio equity investment was generally not permitted. External commercial borrowings (ECBs) required prior approval by the Government of India on a case by case basis and the permission was granted after taking into account the purpose of the borrowing, export potential of the projects, and the capacity to generate foreign exchange to meet debt service and other payments. A new, more liberalised ECB policy has been announced (Box VIII.4). Non-Resident Indian (NRI) deposits were permitted under a variety of schemes with interest rates significantly above international levels, besides exchange rate guarantees from the Reserve Bank and certain tax concessions (see Chapter VI).

Box VIII.3

Report on Capital Account Convertibility: Preconditions and Current Status

Precondition	Recommendation	Current Status
Fiscal Consolidation	Reduction in Gross Fiscal Deficit as percentage of GDP from 4.5 (budgeted) in 1997-98 to 4.0 in 1998-99 and further to 3.5 in 1999-2000.	Gross fiscal deficit as a percentage of gross domestic product stood at 5.9 during 2002-03.
Mandated Inflation Rate	The mandated rate of inflation for the three year period 1997-98 to 1999-2000 should be an average of 3 - 5 per cent.	The realised (not mandated) inflation rate averaged 4.6 per cent between 1997-98 and 2002-03.
Strengthening of Financial System	Reduction of CRR from 9.3 per cent as of April 1997 to 3 per cent by 1999-2000.	CRR reduced to 4.5 per cent by December 2003.
	Reduction in gross NPAs of banks as a percentage of total advances from 13.7 per cent in 1996-97 to 9 per cent by 1998-99 and to 5 per cent by 1999-2000.	NPAs of banks as a percentage to total advances have declined to 8.8 per cent by end-March 2003.
	Interest rates to be fully deregulated in 1997-98 and any formal or informal interest rate controls must be abolished.	All interest rates (except savings bank interest rate) have been deregulated.
	100 per cent marked to market valuation of investments for banks.	The concept of 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'.
	Best practices on risk management and accounting /disclosure norms be implemented.	Risk management guidelines have been issued, broadly covering credit risk and market risk.
	Banks to follow international accounting disclosures norms.	Disclosures on banks' balance sheet have been gradually expanded.
	Capital prescription to be stipulated for market risks.	Since March 2000, standard assets have been given a risk weight of 0.25 per cent
Important Macroeconomic Indicators	A monitoring band of +/-5 per cent around the neutral Real Effective Exchange Rate (REER) to be introduced.	No such band is maintained in India.
	Over the three year period 1997-98 to 1999-2000, rising trend prescribed for current receipt/GDP ratio from the level of 15 per cent in 1997-98.	Current receipts/GDP ratio has increase from 14.3 per cent in 1997-98 to 18.7 per cent in 2002-03.
	Reduction in debt service ratio gradually from 25 per cent in 1997-98 to 20 per cent in 1999-2000.	Debt Service ratio has steadily declined from 21.6 per cent in 1997-98 to 14.7 per cent in 2002-03.
	Four indicators were prescribed on foreign exchange reserves - Reserves (i) not be less than 6 months of imports, (ii) not be less than three months of imports plus 50 per cent of debt service payments plus one month's exports and imports, (iii) ratio of short-term debt and portfolio stock to reserves to be lowered to 60 per cent and (iv) NFA/Currency ratio should be prescribed by law at not less than 40 per cent.	At present, foreign exchange reserves meet all the four criteria.

8.62 During the post-1991 period, the initial liberalisation of capital account transactions was an integral part of the programme to address the balance of payment crisis of 1991. Liberalisation was accompanied by exchange market reforms in order to move over to the era of market-determined exchange rate. The major reforms in the capital account were the liberalisation of FDI and portfolio equity investment. Liberalisation of FDI gathered momentum and took a definite shape with the

Box VIII.4

Recent Capital Account Liberalisation Measures in India

- Resident individuals and listed Indian companies have been permitted to invest in overseas companies listed on a recognised stock exchange and which have the shareholding of at least 10 per cent in an Indian company listed on a recognised stock exchange in India (as on 1st January of the year of the investment). Such investments by corporates shall not exceed 25 per cent of the Indian company's net worth, as on the date of latest audited balance sheet. Investment by resident individuals is without any monetary limit.
- Limit on banks' investment from/in overseas markets has been raised. In case of resident banks, ADs have been given freedom to undertake investments in overseas markets, subject to the limits approved by the banks' Board of Directors. Banks in India have the freedom to invest the undeployed FCNR(B) funds in overseas markets in long-term fixed income securities rated at least AA(-) by Standard and Poor, or Aa3 by Moody's or AA by Fitch IBCA.
- Banks are allowed to invest their unimpaired Tier I capital in overseas money market or debt instruments without any percentage or absolute limit subject to approval by their Board of Directors.
- Indian companies are allowed to access ADR/GDR markets through an automatic route without prior approval subject to specified norms and reporting requirements. They can invest abroad funds raised through ADRs/GDRs in bank deposits/certificates of deposit (CDs), Treasury Bills and other monetary instruments pending repatriation/utilisation of such funds.
- Indian companies with a proven track record were eligible to invest upto 100 per cent of their net worth within the overall limit of US $ 100 million for investment in a foreign entity engaged in any *bonafide* business activity. The overall limit of US $ 100 million has been done away with.
- Exporters are permitted to extend trade related loans/ advances to overseas importers out of their exchange earners' foreign currency (EEFC) balances without any ceiling.
- A unit in domestic tariff area (DTA) can receive foreign exchange out of the foreign currency account of a unit in Special Economic Zones (SEZs) which is permitted to be treated as eligible for credit to its EEFC account.
- Foreign investment by non-resident corporates/NRIs under the Reserve Bank's automatic route has been substantially expanded to include almost all items/ activities, for investment under FDI (excepting 6 prohibited items and 12 items included in the negative list).
- With the new External Commercial Borrowings (ECBs) policy announced in January 2004, ECBs have been allowed under an automatic route up to US $ 500 million (for ECBs with average maturity of more than five years) and up to US $ 20 million (for ECBs between three to five years of average maturity). Borrowings which fall outside purview of the automatic route will be subject to a transparent process and will be decided by an Empowered Committee of the Reserve Bank.
- Indian companies have been permitted to prepay existing FCCBs subject to certain conditions.
- Residents have been allowed to open Resident Foreign Currency (RFC) (Domestic) Accounts without any ceiling.
- Resident individuals are permitted to remit foreign exchange for acquisition of foreign securities under employees' stock option plan (ESOP) scheme without any monetary limit.
- Resident shareholders of Indian companies are permitted to offer their shares for conversion to ADRs/ GDRs and to receive the sale proceeds either in foreign currency or by way of credit to their EEFC/ RFC(Domestic) accounts or to their rupee accounts in India at their option.
- Non-resident Indians (NRIs)/persons of Indian origin (PIOs) and foreign nationals are permitted to remit up to US $ 1 million per calendar year out of balances held in non-resident ordinary (NRO) accounts/sale proceeds of assets.
- The lock-in period for repatriation of sale proceeds to the extent of funds brought in or paid by debit to NRE/ FCNR(B) account for acquisition of immovable property (other than agricultural land/farm house/plantation property) purchased in India by NRIs/PIOs has been removed.
- ADs are permitted to issue international credit cards (ICCs) to NRIs/PIOs and to remit refund of funds received for purchase of shares.
- Any non-resident Indian is permitted to purchase/sell shares and/or convertible debentures of an Indian company through a registered broker on a recognised stock exchange, provided the NRI routes all his transactions through designated branch of an authorised dealer in India.
- NRIs/PIOs have been permitted to repatriate assets in India acquired by way of inheritance / legacy, in addition to other facilities. Full repatriation of current income like rent, dividend, pension and interests of NRIs even without holding an NRO account in India has also been permitted.

Industrial Policy Statement, 1991 effecting significant policy liberalisation in the context of FDI. During the course of the 1990s, most sectors have been brought under the ambit of automatic approval route for FDI with permissible foreign equity participation being significantly enhanced. In 1992, foreign institutional investors (FIIs) were permitted to invest in the primary and secondary markets for listed equity securities and Indian companies were also permitted to raise funds abroad through the issue of global depository receipts (GDRs) and foreign currency convertible bonds (FCCBs).

8.63 There has also been a gradual liberalisation of international credit operations since 1991 with a shift in emphasis on lengthening of maturities. In this connection, NRI deposits, external commercial borrowings and the operations of authorised dealers (ADs) received policy focus. New deposit schemes for non-resident Indians were launched to attract stable deposits while schemes which carried exchange guarantees were phased out (see Chapter VII for details). The emphasis on preconditions and a policy of gradual liberalisation have enabled the country to reap the benefits of liberalisation while avoiding the sources of vulnerability.

8.64 The purpose and the spirit of measures undertaken by the Reserve Bank since 1997-98 to open up the capital account have been broadly in line with the recommendations of the Report, while the timetable itself has assumed lesser significance (Annex VIII.1).

8.65 In terms of the standard indicators of efficacy of capital controls, it may be pointed out that controls have been effective in India because: (i) there has been no major real appreciation of the exchange rate despite strong inflows; (ii) monetary independence has not been lost and a wedge has been created and maintained between domestic and foreign interest rates; and (iii) black market premia on the exchange rate have declined to negligible levels (Jadhav, 2003).

8.66 Capital account liberalisation has impacted the Indian financial system in a number of ways. There are two channels through which this has occurred. The first is a direct channel in which the greater degree of operational flexibility in foreign exchange operations has affected the portfolio of financial entities, especially commercial banks, which are typically the ADs in foreign exchange. The second is an indirect channel in which the globalisation of the economy in general has affected the balance sheet of the financial system. The twin channels of globalisation have brought about a number of changes in the functioning of the Indian financial system. First, the process of opening up has facilitated foreign investment adding to the liquidity in the financial system, including equity markets. Second, there is the process of integration of prices in the domestic financial markets with the international markets, requiring financial entities, including commercial banks, to optimise portfolios across markets. A related issue has been the management of foreign exchange risk. Finally, the process of capital account liberalisation has strengthened the process of imparting a degree of market discipline to the functioning of the financial system through greater alignment towards international standards and codes.

8.67 With significant opening up of the capital account, particularly on inflows, there were sustained foreign inflows during the 1990s. Capital inflows picked up sharply since the latter half of 2000-01 leading to a surge in foreign exchange reserves and necessitating active sterilisation. In the absence of sterilisation, there could be excessive volatility in the financial markets, interest and exchange rates, leading to erosion of competitiveness of the economy; this would have an adverse impact on the economy at large and the non-government sector in particular. In this context, a Working Group was set up in the Reserve Bank review the various instruments used in India and in other countries and examine the various trade-offs involved in the choice of such instruments to deal with the emerging situation and the extent of their use (see Chapter VI).

VI. CONCLUDING OBSERVATIONS

8.68 The volatile nature of the capital flows triggering instability and leading to a crisis situation and the subsequent contagion effect has been reflected in various episodes of crisis in the 1990s. The experience of the Asian crisis revealed that large and volatile capital flows influenced the exchange rates and interest rates, leading thereby, to overshooting of exchange rates in some cases as expectations and reactions to news drove capital flows and exchange rates often out of alignment with fundamentals. Policy makers in developing countries, therefore, have to manage their capital accounts to ensure an orderly process of liberalisation. The success of policy would lie essentially in managing the flows to reduce their volatility and limit their negative impact while reaping the benefits of such flows to enhance growth prospects of the economy.

8.69 The approach of multilateral institutions towards capital account convertibility has undergone a significant shift after the Asian crisis. In April 1997, the then Interim Committee of the IMF had come out in favour of amending the IMF's Articles of Agreement to make liberalisation of the capital account as one of the objectives of the IMF. Noting the linkage between rapid growth and large capital inflows, it was argued that although developing countries might experience increased volatility, it should be managed with greater exchange rate flexibility without imposing capital controls. In the wake of the Asian crisis, however, the basic premises of pursuing capital account liberalisation were questioned, as was the advocacy of vesting the IMF with the responsibility for promoting orderly liberalisation of capital flows. In the face of intellectual opposition to its policies, a moderation of the IMF's stance became evident. The IMF recognised the role of capital controls and acknowledged the existence of important preconditions for an orderly liberalisation of capital movements. Since then, the IMF, in general, has favoured a gradual approach to opening the capital account if the preconditions for effective liberalisation are not in place. The World Bank also came out with the suggestion that capital account liberalisation should proceed cautiously, in an orderly and progressive manner in developing countries, given the large risks of financial crises – heightened by international capital market failures. The multilateral institutions now underscore the importance of creating appropriate conditions for encouraging capital flows.

8.70 In India, several measures to liberalise specific aspects of capital account transactions have already been implemented. The stress in the process has been on achieving certain preconditions related to health and strength of the financial sector, sustainability in the fiscal sector and inflation to reduce the vulnerability of the economy to crises. Two areas where extreme caution would be needed are unlimited access to short-term external commercial borrowing and providing unrestricted freedom to domestic residents to convert their domestic bank deposits and idle assets. In respect of short-term external commercial borrowings, there is already a strong international consensus that emerging markets should keep such borrowings relatively small in relation to their total external debt or reserves. As regards free convertibility of domestic assets by residents for an emerging market economy like India whose currency is not globally traded and is exposed to external shocks, any expectations of depreciation of the local currency may induce the residents to convert a part or whole of their stock of domestic assets into foreign assets from domestic currency to foreign currency, which may be self-fulfilling, leading to a severe external crisis. Financial institutions play a major role in perpetuating and exacerbating crises related to capital flows. Hence, sound balance sheets and sound operational procedures of financial institutions, mainly banks, are an essential ingredient of the package for mitigating the vulnerability of the financial sector to crises.

8.71 The plans for further liberalisation of the capital account would have to be built over the progress made so far and take into account domestic and international developments in addition to achievement of the preconditions set out by the Committee. The importance of strong macroeconomic fundamentals and cautious approach towards CAC became evident during the Asian crisis when India successfully withstood the contagion. In India, the policy of hierarchy followed with regard to liberalisation of outflows has been in the order of corporates, financial intermediaries and individuals. Further liberalisation of inflows is expected to be continued and dovetailed into the objective of minimising risks associated with them. However, if the momentum of capital inflows is maintained, it may be possible that with limits to sterilisation, further capital account liberalisation would follow logically. The pace of liberalisation would, however, depend on domestic factors, especially further progress in financial sector reforms, fiscal consolidation and the evolving international financial architecture.