Remarks on capital account liberalisation and capital controls by Dr. Y.V. Reddy, Governor, Reserve Bank of India at the Central Bank Governors' Symposium convened by the Bank of England in London on June 25, 2004

I am thankful to Bank of England for the excellent arrangements and well thought out agenda for the 2004 Central Bank Governors' Symposium.

As desired by Governor Mervyn King, I will give a brief introduction in this session on capital account liberalisation and capital controls.

Professor Kenneth Rogoff's well-researched messages on effects of financial globalisation on developing countries are appropriate as governing thoughts for this session. There is evidence of a threshold effect in the relationship between financial globalisation and economic growth, and the heightened risks of volatility in capital flows to developing countries gets reduced only after a particular level of integration. In contrast, empirical evidence shows that trade liberalisation has had beneficial impact. A review of evidence provides no road map for the optimal pace and sequencing of financial integration. Many questions in this regard are best addressed only in the context of country-specific circumstances and institutional features.

In this background, based on the Indian experience, I will present some issues relating to managing capital account.

First, capital account liberalisation is a process and it has to be managed keeping in view elasticities in the economy, and vulnerabilities or potential for shocks. These include fiscal, financial, external, and even real sector – say, oil prices and monsoon conditions for India. Professor Rogoff's presentation places special emphasis on government borrowings as a vulnerability.

Second, caution is needed in moving forward with each step in capital account liberalisation, recognising that reversal of any step in liberalisation is very difficult since markets tend to react very negatively to reversals, unless there is already a crisis situation.

Third, the capital account itself needs to be managed during the process of capital account liberalisation. There is a hierarchy in the nature of different types of capital flows in real life. For example, foreign direct investment is preferred for stability, and quantum of short-term external debt, by residual maturity, should not be excessive. Furthermore, adequate reserves, keeping in view the national balance sheet considerations, which include public and private sectors, provide comfort. Public policy can achieve these desirable conditions only through some sort of management of capital account.

Fourth, the management of capital account will be effective under enabling conditions, such as, reasonable confidence in macro policies, in particular tax regimes, and safeguards against misuse of liberalised current account regime to effect capital transfers. Sound management will also avoid dollarisation of the domestic economy and internationalisation of domestic currency.

Fifth, operationally, management of capital account involves a distinction not only between residents and non residents or between inflows and outflows but also between individuals, corporates and financial intermediaries. The financial intermediaries are usually a greater source of volatility amongst these. If such financial intermediaries operating in the developing countries are owned or controlled by foreign entities / investors, there is perhaps greater tendency to volatility in the flows. It is noticed that such foreign owned / controlled intermediaries are often influenced by considerations other than domestic economy and have less appreciation of local conditions – apart from the issues relating to cross-border supervision of financial intermediaries by the host country supervisor.

Sixth, the prudential regulations over financial intermediaries, especially over banks, in respect of their forex exposures and forex transactions must be effective and a dynamic component of management of capital account as well as financial supervision. Such prudential regulations should not be treated as capital controls.

Seventh, capital controls should be treated as only one of the components of management of capital account. As liberalisation advances, the control-regime would contract, and thus, it is the changing mix of controls that charecterises the process of liberalisation in management of capital account.

Eighth, capital controls may be price based, including tax-regimes, or administrative measures. Depending on the legal framework and governance structures, the mix between the two would vary. As liberalisation advances, the administrative measures would get reduced and price-based increased, but the freedom to change the mix and reimpose controls should always be demonstrably available. Such freedom to exercise the policy of controls adds comfort to the markets at times of grave uncertainity.

Finally, as mentioned by Professor Kenneth Rogoff, a distinction needs to be made between *de jure* and *de facto* financial integration in general and hence, in the context of capital account in particular. In practice, there are difficulties in measuring the degree of financial integration. However, the institutional structures, both of public policy and markets, need to be evolved to meet the imperatives of liberalised capital account. In the final analysis, the basic issue in any policy context is whether capital controls lead to distortions in exchange rate or the liberalised capital flows that lead to distortions in exchange rate. In respect of emerging economies, the conduct of market participants shows that automatic self-correcting mechanisms do not operate in the forex markets. Hence, the need to manage capital account – which may or may not include special prudential regulations and capital controls. There are many subtleties and nuances in such a management of capital account which encompasses several macro issues and micro structures.

Thank you for your patience.
