

Capital Flight : Myths and Realities *

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1. I am extremely happy to be in Centre for Economic and Social Studies with you all today. I am particularly honoured that my respected guru for about 35 years, almost the whole of my adult life, Mr.Vithal, is presiding over this meeting. My profound apologies for the inconvenience caused on account of the unavoidable postponement of this talk, which was originally scheduled for last month. I am thankful to Professor Venkatramiah garu for giving me this opportunity to share with you some thoughts on a subject which has been and continues to be a source of both concern and misunderstanding. Some recent journalistic and even academic coverage on the subject of capital flight has added to the confusion prevailing in our country. On earlier occasions here, I had discussed the issue of balance of payments and also our negotiations with World Trade Organisation. Today, it gives me great pleasure to deliver an address on this subject.

2. I will begin with a brief account of popular perceptions. We could then try and answer some questions such as : What is capital flight? Why does it occur? How to measure it? Is there anything new about this phenomenon? This should help us differentiate between myths and realities. In conclusion, I intend posing some issues for further deliberation.

Popular Perception

3. The popular perception at least in our country, is that capital flight refers to the amounts of foreign currency assets that have been kept in foreign countries by Indian citizens or corporate bodies without legal sanction for doing so. It is held that, such amounts increase year after year because of the continuous capital flight. It is also postulated that, exporters under-invoice their export receipts, and the difference is kept abroad. Importers are also believed to over-invoice their imports, and draw excess foreign exchange which is kept abroad. Some people have no doubt that residents buy foreign currency in what is called hawala market (illegal market for exchanging rupees and foreign currencies), and keep it abroad. In effect, it means that some non-residents who are to remit foreign currency to India for rupee payments in India are really selling their currency abroad, and the purchasers of such foreign currency are making arrangements for rupee payments, by circumventing the legal requirement. There is a perception that, one of the sources of such capital flight is amounts accepted as bribes by some public functionaries, who receive and keep such amounts outside the country, and on occasions, bring some amounts back, when they need them. Many believe that substantial foreign currency used to finance illegal imports through smuggling, particularly gold, also represents capital flight.

4. It is conjectured that such capital flight runs into billions of US Dollars. For example, the editorial in Express Investment Week (Vol.7, No.6, Feb.3-9, 1997) alleges that in 1994 and 1995, at least US \$ 11.3 billion left India. Newspapers have also been reporting estimates of capital flight from India to the USA, based on two articles by Zdanowicz, Welch and Pak (Indian Finance, September 1995 and December 1996 issues). The articles estimate that capital flight from India to the US was in the range of US \$ 5,893-412 million in 1994 and in the range of US \$ 5,584-611 million in 1995. Surprisingly, there are many in our country who accept such estimates as reliable.

What is Capital Flight

5. There is no universally accepted definition of capital flight. Even in academic literature, scholars tend to define capital flight, keeping in view the context. Let me give you some sample definitions.

“Abnormal’ flows propelled from a country by any one or more of a complex list of fears and suspicions”.

This definition looks at abnormality.

“Outflows motivated by the desire of residents to obtain financial assets and earnings on those assets which remain outside the control of domestic authorities”.

This definition, on the other hand, refers to keeping the assets out of the country to earn returns and to escape domestic tax and other laws.

“The outflow of capital from a country to a destination considered to be safe by the decision making agents when the principal motivation is not to have a higher return in a legal way but to keep the money beyond the long arm of the law of the country”.

This definition emphasises escaping domestic laws rather than earnings.

It should be clear that these definitions do not provide a conceptual framework to appreciate the phenomenon in a comprehensive way and to aid policy responses.

6. I would, therefore, propose for your consideration, a conceptual framework. Capital flight represents capital outflow with three components, namely, abnormal legal outflows, extra-legal or illegal outflows, and outflows emanating from criminal activities. Capital flight can be viewed in three ways, namely, gross capital flight, reverse capital flight, and net capital flight. Perhaps some elaboration of these would be in order.

7. The abnormal capital flows arising out of normal business considerations including profit motive, are a matter of serious concern now in the context of large, mobile, private, global flows. Such abnormal capital flows through legal channels can be one form of capital flight. From a policy point of view, an unexpected drastic reduction in normal capital inflows has a somewhat similar impact as large unexpected capital outflows. However, in reality, they occur simultaneously. Incidentally, some academics hold that only illegal flows should be treated as capital flight. But, from a policy angle, capital flows through level channels have similar implications for managing the economy, though monitoring and policy response would be more complex in respect of extra-legal flows. Hence, for a comprehensive treatment, both legal and not so legal flows need to be looked at.

The extra-legal or illegal flows consist of the flows to create assets that are beyond the control of domestic authorities with a view to avoiding tax or other laws. While the legal flows are reported and operated through normal banking channels, the extra-legal or illegal ones are unreported and even if operated through banking channels, may not be formally traceable to the real owner of assets.

The outflows arising from criminal activities are those which move around for financing narcotics, arms trade, terrorism, bribery, money laundering, etc.

8. As regards dimensions, there can be capital inflows just as there are outflows. Hence, gross capital flight represents the outflows as defined above while reverse capital flight represents the inflows under the three components described. The net capital flight would thus be the difference between gross and reverse capital flight. There are occasions when the reverse capital flows component exceeds the outflows. This happens when the domestic laws and policy environment change, and incentives for placing the assets abroad illegally diminish.

It should also be noted that the components are not watertight and an illegal outflow could come back as an inflow through a legal channel.

Why Does Capital Flight Occur?

9. Normal movement of capital occurs through legal channels as economic agents diversify their portfolios, in search of highest return consistent with their risk preferences. Abnormal capital flows occur, mainly on account of political and economic uncertainty, and inappropriate incentive structure, often resulting from a misalignment of tax and other laws. It is also possible that, outflows occur for reasons other than economic or political factors in the country concerned, as for example in response to global developments or crises elsewhere, though this is not a significant component of total flows over a period. Outflows through illegal channels occur in search of what they perceive to be a safer place to keep their assets. The main causes of such movements are high taxes relative to world levels, fears of devaluation, financial repression often characterised by negative or low interest rates, and taxes on financial intermediation. Fears of arbitrary confiscation or harassment at home could also be proximate causes.

10. Let us recall some illustrations. In 1991-92, as a result of political uncertainty in our country and economic uncertainty due to Gulf crisis, there was a sudden and steep drop in non-resident deposits. Also, when income and corporate tax rates were very high, exporters found it attractive to keep their earnings abroad. They could use it for unauthorised purposes. In fact, such funds might have been used to finance under-invoiced imports, thus escaping high import duties.

How Do We Measure Capital Flight?

11. There are several methodologies in vogue to measure capital flight and as would be explained, none of them is very useful measure. I will refer to some of them here.

First, hot money method which just adds up two items in the balance of payments data (BOP), namely, errors and Omissions, and Private Short-Term Capital.

The second is the mismatch between balance of payments (BOP) and external debt/liabilities method. These measures use BOP and or external liabilities data and would thus reflect official data only, viz. BOP external debt data from OECD (which is based on both debtor and creditor reporting) and stock of liabilities as reported in the banking system from Bank for International Settlement (BIS). This method basically compares the sources and uses of finance and the excess or deficit is interpreted as net capital flight, either net outflow or inflow, the latter indicating reverse capital flight.

Third, faked trade invoicing method, wherein, usually, misinvoicing of trade documents is analysed to capture capital flight through under-invoicing of exports and over-invoicing of imports. A variant of the misinvoicing method of analysis is abnormal pricing method. Since over-invoicing and under-invoicing of trade have been a subject of intense debate in our country, we will go into it in some detail. The faked trade invoicing method can be used to supplement other methods, i.e, hot money and mismatch methods.

Abnormal Pricing and Weak Bargaining

12. I had made a reference earlier in this address to the estimates of capita flight from India to the USA. The particular reference was made to abnormal pricing method tried out by three professors at the University of Florida to estimate capital flight from India to the US. The basis premise of the study is that Indian exporters and importer do not buy and sell products in the US market at a price equal to the average US/world price of exports and imports. The authors interpret the deviations from the average price as the capital flight. Two methods are adopted by them.

The first method compares the prices of Indian imports from the United States to the average import prices of similar products imported from the United States by all countries in the world. The authors also compare India's export prices of similar products exported to the US/world from all the countries in the world. To calculate such average prices, they have developed a global price index for items traded between India and the US and compared these with prices at which Indian exporters/importers trade with the US. Some assumptions on product differentiation are made and the estimates are adjusted for product heterogeneity. The sum of the deviations for all products gives the total capital flight from India to the US.

In the second method, the authors compare the transaction prices of commodities imported/exported from India with the average price at which India imported/exported to the US with respect to the commodities under study. The deviations are interpreted as capital flight.

13. While it is possible that capital flight can still be a component of these numbers, an analysis by Schneider, concludes that many other factors can be responsible for the deviations found by the authors.

Firstly, the price difference in many cases can be due to the differences in the cost of production in India and the US. In such cases, the unit price of exporters will reflect the lower cost of production and the foreign trader sells it at higher prices in the US. The exporter need not necessarily get the benefit of such higher prices.

Secondly, the higher prices paid by Indian importers may not reflect over-invoicing but may actually represent lower bargaining power.

Thirdly, capital flight estimated by the authors seems to be improbable. For instance, the capital flight from India to the US during 1994 was estimated by the authors to be in the range of US \$ 411-5,893 million whereas, the volume of trade with US was US \$ 9,326 million. The upper range calculated by the authors is more than half the volume of trade with the US, and thus very unlikely.

14. Schneider argues that a more probable interpretation of the results for India based on abnormal pricing model can be that the deviation in unit prices of Indian imports and exports with that of average of US/World prices reflects India's poor bargaining position in international markets along with other rigidities. In fact, another study commissioned by the Planning Commission in 1991 and conducted by Bhatnagar arrives at a similar conclusion in respect of our exports. An important conclusion of the study was that exporters realised unit values for exports which were lower than the international unit value of exports. Major reasons for this, as reported by the respondents in this study, were lack of overseas presence, packing handicaps, lack of price intelligence, poor image of Indian products, incomplete product range, production process not being modern, etc.

Incidentally, neither of the studies point out the problem of inability of our exporters to stick to delivery schedules due to poor and uncertain infrastructural services as well as procedural bottlenecks. This could be an important element for the loss of bargaining power.

What is New?

15. There is reason to believe that in the recent past, there has been substantial reverse capital flight. Partial evidence is available from an analysis of the trade data just explained. This is plausible because both direct and indirect taxes (customs duties) have come down and also because the exchange rate is more realistic now. As a result, perhaps, the exporters and importers may find it less attractive than in the past to keep their money abroad, or cycle it to avoid taxes.

16. It is also likely that, with the adoption of current account convertibility and liberalised trade, the financing needs of illegal imports have come down. That is evident from some reduction in the difference between legal and hawala (illegal) exchange rates. The link between the hawala market and illegal imports through smuggling of gold was very clearly brought out in a discussion paper in the RBI (Gold Mobilisation as an Instrument of External Adjustment) in 1992 by Atul Sarma, A.Vasudevan, K.Kanagasabapathy, Mythili Narayan and Mahua Roy, under the aegis of the Development Research Group. Let me quote the relevant extracts here.

“Large smuggling of gold is operationally feasible only if the foreign exchange can be obtained outside the level foreign exchange market. Hawala market provides this channel. This hawala premium can therefore be reasonably expected to reflect the demand for foreign exchange for smuggling gold, it being the major commodity for illegal imports. Transaction of foreign exchange in the hawala market can be expected to depend on the availability of foreign exchange provided by non-resident Indians outside the legal supply of foreign exchange as in the case of FCNR deposits, remittances, etc. To the extent hawala premiums attract these foreign currencies, their inflow into the country through legal channels will decline. It is generally recognised that over-invoicing of imports and under-invoicing of exports have given rise to large capital flight. At least a part of this leakage provides a source of supply of foreign exchange in the hawala market. Therefore, the magnitude of annual capital flight is likely to influence the supply of fund for smuggling gold.”

Though gold import has been liberalised, there is still demand for illegal foreign exchange to finance import of gold both through smuggling and non-resident channels. However, the demand from smugglers of consumer goods seems to be down as a result of reduction in duties and liberalisation of such imports. Overall, the incentives for, as well as

magnitudes of capital flight through illegal channels appear to have come down drastically, though they still persist to some extent.

As mentioned, the introduction of current account convertibility could have reduced the financing needs of illegal imports. But, the current account convertibility provides scope for capital movement, in the guise of current transactions as long as the incentive structures encourage such capital flows. In fact, this was clearly anticipated by the High Level Committee on Balance of Payments (Chairman Dr.C.Rangarajan) in April 1993. The Report states “In the medium-term, care has to be taken to ensure that there is no capital flight through liberalised windows of transactions under invisibles.” What is significant is that, in the guise of current transactions, both capital inflows and outflows can occur – nor merely a one-way flow.

17. As regards legal flows, there is evidence to show reverse capital flight. Although there was a drop in non-resident deposits to the tune of US \$ 1.5 billion in 1991, it was soon followed by subscriptions to India Development Bonds. More important, when the Bonds matured during this year, about US dollar one billion was transferred to the residents. No doubt, there are some who argue that a part of NRI deposits are, in any case, in the nature of reverse capital flight. There are some who hold that a part of the amounts raised by our corporates may also be a channel for reverse capital flow.

18. It is hard to obtain evidence of the flows arising from criminal activities. Perhaps, it is reasonable to presume that no new developments are noticeable.

Reality

19. First, it is clear that, there is at present, no evidence of larger capital flight out of the country through legal or illegal channels after the reform process has been initiated as compared to the pre-reform period. On the contrary, there is a possibility of net reverse capital flight.

Secondly, there is no reliable basis for suspecting large capital outflow now, through trade transactions.

Thirdly, while it is true that our country, like many other developing countries, might have faced capital flight in the past, a good part of such capital has been simultaneously used for financing illegal import of gold valued at billions of US dollars each year. In fact, even now, most of gold imports may be financed through such capital flight. Hence, it would be inappropriate to estimate the stock of capital held abroad illegally as the sum of gross capital flight that took place in the past.

Fourthly, there is reason to believe that capital flight in our country now is very much a two-way process or a two-way flow. A one-way flow is a real resource transfer. A two-way flow, whenever it is in the nature of recycling of money, essentially means that there is an erosion of domestic tax base. For example, an exporter may over-invoice exports and use that foreign exchange to under-invoice imports in order to save on customs duty on imports. Such an exporter is simply avoiding tax but there is no net capital outflow.

Fifthly, the problem of capital flight was viewed, in the past, in the context of scarcity of foreign exchange and fear of devaluation. Now, our foreign currency reserves are

comfortable, and our currency has exhibited significant stability in relation to all major currencies in the world in a market-led exchange rate regime. Some observers feel that, in regard to foreign currency resources, we have moved from struggling with scarcity to managing plenty.

Issues

20. It appears reasonable to assume that, of late, there is a reduction in extra-legal or illegal gross capital flight. There are indications of reverse capital flight in the recent past which may continue for sometime. The recently approved Budget is widely believed to encourage reverse capital flight, more so when voluntary disclosure scheme takes off. These developments have the effect of enhancing normal capital inflows. Hence, the issue of managing large capital inflows assumes significance. This would call for an appropriate exchange rate, intervention and sterilisation policies.

21. In spite of substantial liberalisation and a drastic reduction in illegal transactions in the foreign exchange market, the hawala market for foreign exchange still exists and there is some, through vastly reduced, premium for foreign exchange in this market. This establishes continued existence of gross capita flight through illegal or extra-legal channels. If a reasonable assumption is made that there is little or no incentive in the current policy stance for residents to keep the capital outside the country, we have to find reasons for this still active hawala market.

Firstly, there is an inevitable demand for domestic consumption of gold. This demand is, at present, met mostly through imports by some non-residents, who are believed to specialise in this activity, and by smugglers. There is a belief that import by non-residents is financed by non-residents themselves out of foreign exchange that would not be otherwise coming into our country. Considering the large value of such imports, it is safe to assume that most of these imports are financed through the hawala market, just as almost a similar magnitude of gold smuggling is financed. In fact according to the World Gold Council Report, 1996, India was the largest importer of gold in 1996. Data indicates that total import of gold during 1996 was 379 tonnes valued at about \$ 4.7 billion, of which about 266 tonnes valued at \$ 3.3 billion was through official channels. It is possible to argue, perhaps convincingly, that as long as the unstoppable domestic demand for gold is not permitted legally and liberally, the hawala market for foreign exchange and consequent distortions will persist.

Secondly, there are some consumer goods whose import is subject to quantitative restrictions and perhaps some of them are illegally imported through smuggling using the hawala market. Currently, these magnitudes appear small, but some though not all of them, do create scope for hawala.

Thirdly, transaction costs, particularly delays in actual transfer of non-resident remittances of small amounts through official banking channels could provide scope for hawala, though this need not necessarily add to the premium over legal rate.

Fourthly, there may still be procedural bottlenecks which make it cumbersome for resident Indians to obtain foreign exchange through legal channels for meeting their genuine needs. This also gives scope for some demand, certainly not very significant, for foreign currency in the illegal market.

Any approach to eliminating capital flight through illegal channels will thus have to tackle all these issues.

22. As regards capital flight to finance criminal activities, two issues may need attention. First, whether the enforcement agencies are in a position to give adequate attention to serious crimes, since under the current FERA, very large number of routine transactions are accorded the status of crimes. The second relates to whether the existing legal framework is adequate to tackle serious crimes in areas such as money laundering. The Finance Minister had already announced that FERA will be replaced with the Foreign Exchange Management Act and that there would be a new Act to tackle money laundering.

23. There are a few other issues of a general nature which warrant attention and I will refer to some of them now. Like some developing countries, if we were to extend some facilities such as guarantees to foreign investors and if the domestic corporates do not get a similar or compensatory treatment, there would be asymmetry. In such a situation, while foreign capital comes in, domestic capital may go out. In fact, domestic investors may even try to take domestic capital out and bring it back in the garb of foreign investment. In the former case, there is an outflow of domestic capital while in the latter case there is both an outflow and a corresponding inflow of capital.

24. We are in the process of financial integration with the rest of the world. In such an integrated market, there would be both inflows and outflows of capital. Ideally, we should ensure that they occur through legal channels. Further, we should have efficient procedures for recording these flows. Unfortunately, recording procedures are not in a position to keep pace with the rapid developments in financial instruments. We have to address this issue, and we in the Reserve Bank of India, intend undertaking a special exercise for this purpose. Recently, a Sub-Group was formed in the RBI to report on foreign exchange transactions by Authorised Dealers (Ads). It recommended that data could be collected on a simplified basis on electronic media every fortnight from the Authorised Dealers' branches which are identified as 'critical' from the point of view of compilation of balance of payments data. Over a period of time, the data could be provided through online connectivity, once the entire financial sector is covered by V-Sat communication network.

25. In today's world, capital is extremely mobile and it moves wherever it perceives profit and security. It is extremely difficult to hold on to capital, both domestic and foreign, in the face of perceived economic instability or inappropriate policy framework. With capital controls, such mobility may be restricted, but now, as never before, there is increased scope for circumventing such controls and mobility occurring through illegal channels. Without capital controls, such mobility may be made easier, but the advantage is that capital flows can be monitored better and policy response could be proactive. There are advantages of some capital control, but effectiveness and benefits are being rapidly overtaken by the costs of such controls. But, the downside risks of totally dismantling capital controls could be high, if the will for and faith in sound macroeconomic management is lacking. Hence, as mentioned by our Governor Dr.Rangarjan, in his address at Carnegie Mellon University and I quote "Reduction in fiscal deficit, moderation in inflation and a flexible financial system which can adapt to the changing situation are some of the essential preconditions for capital account convertibility."

Thank you.

* Address by Dr. Y.V.Reddy, Deputy Governor, RESERVE BANK OF INDIA, at Center for Economic and Social Studies, Hyderabad, on June 21, 1997.