

## Why Capital Account Convertibility in India Is Premature

*At this stage, full capital account liberalisation promises no large benefits while it increases the risk of things going badly wrong. Variations in the flow of short-term capital, like bank loans, give rise to pro-cyclicality of the capital account, which provides the main mechanism by which free capital flows create problems. For the next 10 years at least, many other liberalising reforms need to take priority over capital account liberalisation.*

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During the 1990s there was a rather widespread belief that free international capital movements were as much a part of a liberal economy as free product markets, a liberalised domestic financial system, or free trade. So strongly was this belief held that in 1997 the IMF was on the verge of extending its remit to include supervision of controls on international capital flows, with an objective of helping its member countries to move progressively to a situation where they had no such controls. The IMF's Interim Committee (now renamed the International Monetary and Financial Committee) affirmed its intention of having the IMF amend its articles to that effect during the annual meeting in Hong Kong in September 1997, after the Asian crisis had already swept through south-east Asia but before it had engulfed Hong Kong and Korea. Considered reflection on the causes of that crisis subsequently led to abandonment of the project to extend the Fund's remit to cover capital flows, with its presumption that freeing capital movements was a priority on the reform agenda.

Since then the main pressure for liberalising capital flows has come from the US treasury. When countries wanted to negotiate bilateral free trade agreements with the US, they found the treasury insisted that US negotiators demand that the partner country should commit itself to never

reimposing effective capital controls for any length of time. Several of the partner countries that had made effective use of such controls in the past, like Chile and Singapore, found themselves forced to choose between abandoning their aim of securing a free trade agreement with the US and abandoning their ability to control capital movements with the object of avoiding or at least attenuating crises. Given that governments, like markets, typically take a rather short-term view of costs and benefits, and that the countries could not see the prospect of a crisis on the horizon at the time the negotiations were taking place, the US treasury got its way.

But elsewhere the pressure to move to capital account liberalisation seemed to have disappeared. In particular, IMF research – which one may assume was inclined to find support for capital account liberalisation if a serious case could be made – concluded that there is at best mixed evidence of net benefits from free capital flows [Prasad et al 2003].

Note that this does not argue that there are no benefits from certain types of capital flow. There is overwhelming reason (and abundant empirical evidence) to think that foreign direct investment is highly beneficial, because it provides an efficient mechanism for spreading the fruits of technological innovation and intellectual property around the world. There is also solid empirical evidence to believe that liberalising the flow of portfolio investment

is beneficial, because it reduces the cost of capital to enterprises and it enables investors to gain the benefits of diversification [Henry 2000a, b]. Hence it is not at all surprising that in some empirical studies [such as Quinn 1997], where the question asked is whether liberalisation of the capital account is beneficial, a positive result should have been obtained, since many of the liberalising moves that provide the independent variable in such studies referred to liberalisation of FDI or portfolio investment.

But the studies in Prasad et al (2003) are not of this type. They ask whether countries without capital controls do better than countries with them, and they failed to find evidence to support the conjecture that a complete absence of controls brings faster growth or other economic benefits. What this surely suggests is that what is usually the last step in liberalising the capital account, namely, the liberalisation of short-term loans, may bring costs that outweigh the benefits. It is not difficult to believe this. All the evidence is that bank flows – which are the part of the capital account that is separately recorded and that falls most clearly in the short-term loan category – are highly volatile. As soon as a developing country hits a difficult patch, whether because of low prices of the commodities it exports or political uncertainties or contagion from neighbours, bank loans are liquidated – and (unlike equity investments, where the investor at least tends to pay through the nose for surrendering to panic) they can be liquidated without cost to the lender.

### Risk of Short-Term Loans

The charge of critics is that short-term loans contribute nothing to welfare. They cannot safely be used to expand investment, since they may be withdrawn before the investment project matures. They tend to disappear just when they could play a useful role in helping to smooth consumption. (Remember the old adage that a banker only lends to those who do not need the money.) And inherently they do not provide an instrument for portfolio diversification. Yet it is primarily variations in the flow of short-term capital, like bank loans, that give rise to the pro-cyclicality

of the capital account, which provides the main mechanism by which free capital flows create problems. (Some people would add tax evasion as another channel for creating problems, but I do not discuss that consideration in this article.)

Why, then, was there so much pressure in India for liberalisation of the capital account in 1997, when the first Tarapore Committee (1997) proposed “gradual” (over three years!) liberalisation of the capital account? For two main reasons. First, because that was the spirit of the age, (before the Asian crisis), as manifest in the pressures on the IMF recalled at the beginning of this article. Second, and doubtless more important, because of the desire for cheaper credit on the part of Indian business, which looked with envy at the relatively low dollar interest rates prevailing in the outside world and contrasted them with the high rupee interest rates then prevalent in India. Indian business wanted to be able to access cheap external credit without having to ask permission of the Reserve Bank of India.

The desire was understandable, but the cost of giving in to it would have been to expose India to the danger of contagion similar to that which laid the whole of east Asia low when Thailand had a balance of payments problem. For there is no serious doubt that the countries that suffered crises in 1997 were those that had accepted a large volume of short-term capital and not those that were particularly corrupt. Like China, India was not among them, not because there is no corruption in China or India, but because they did not have an open capital account and therefore had not imported a lot of capital that could flee when investors panicked.

### Tarapore Conditions

Should India now change its policy and allow free flows of capital, including short-term loans, by all and sundry? The first Tarapore Committee specified three preconditions that needed to be satisfied before it would be sensible to move to capital account convertibility. First, the country needed to have established fiscal discipline to make sure that capital inflows did not provide an easy way of perpetuating what is ultimately unsustainable. A failure to do this would eventually lead to a crisis when the market finally decided to cease financing the deficit. Second, the country needed to reduce the rate of inflation to the range of 3 to 5 per cent per year, and

to make the pursuit of an inflation target the central mandate of the Reserve Bank of India. Third, India needed to have cleaned up its banking system, so that one could be confident that capital inflows would be efficiently intermediated to where they would be profitably invested, rather than used by banks to borrow more with the object of postponing bankruptcy. These conditions come squarely out of the economic literature on capital account liberalisation, and all three are completely reasonable. In addition, the literature suggests that countries need to have liberalised their trade regime before accepting large capital inflows, so that one could expect the profitability of investment to be closely correlated with the social returns to the investment, rather than having investment flow into profitable but socially inefficient import-substituting industries.

### Progress in Two Areas

In the nine years since it last considered capital account liberalisation, India has made important progress in two of the three areas specified by the first Tarapore Committee as preconditions, and in liberalising trade. Inflation has fallen from over 7 per cent in 1997 to under 4 per cent in 2005, and the RBI has been told to pursue an inflation target. The percentage of advances classified as non-performing – which is the best single measure of the health of the banking system – has fallen from 13.7 per cent in March 1997 to 5.2 per cent in March 2005. And while Indian trade is still far from completely free, it is now far less restricted than it then was: in particular, the quotas on imports of consumer goods have now been phased out. Unfortunately that still leaves one important area in which India has not made progress, which concerns fiscal discipline: the total size of the public sector deficit has actually risen from 7.3 per cent of GDP in 1997-98 to an estimated 7.7 per cent of GDP in 2005-06 (with even higher figures in between), while the ratio of public debt to GDP has increased from under 65 per cent to over 83 per cent. So even on the conditions suggested by the first Tarapore Committee, a quick move to capital account convertibility would be premature.

It is worth noting also that the first Tarapore Committee rightly argued that acceptance of capital account convertibility presupposed a pretty flexible exchange rate policy, so that a change in capital flows could be absorbed by a change in

the exchange rate rather than a surfeit of reserves or their possible exhaustion. But this in turn is something that is easier for an advanced industrial country to fully accept than it is for an emerging market, in which growth has to be largely export-led. I am not arguing that emerging markets benefit themselves by running undervalued exchange rates and continuous export surpluses; real resources are best used for real investment at home, not for buying lots of US treasury bills. But it is a mistake, especially critical for an emerging market, to allow its exchange rate to be pushed up to an uncompetitive level. This consideration suggests that current Indian exchange rate policy is sensibly balanced, whereas any rapid move to liberalise capital flows could create problems for maintaining that balance.

The conditions suggested by the first Tarapore Committee omitted one important consideration. Specifically, the committee did not acknowledge the fundamental importance of having become completely trusted in international markets. When a mature industrial country gets into trouble and wishes to borrow more in order to tide over bad times, it can always do so, because lenders do not doubt that it will be able and willing to continue servicing its debts. Markets may charge more, or exchange rates may depreciate, but ultimately industrial countries can continue to borrow if they need to and are willing to pay the price. Unfortunately this is not true for emerging markets, even if they have an exemplary past record of debt service. And the fact that some of them don't (think of Argentina as the most recent example) does not make it easier for the others. Situations in which markets simply will not lend, on any terms, have continued to recur in recent years, until the cyclical upswing started in 2003 and avoided further crises for the moment. Think of Latin American countries, like Brazil in 2002 or Chile in 1998. Or think of the Asian crisis (a particularly vivid example). Or, to go slightly further back in history, think of India itself in 1991.

This is not to argue that India and other emerging markets never should or will have capital account convertibility. As they grow and as per capita income increases, it is to be expected both that market trust will increase and the efficacy of capital controls will fall. If a country becomes a net creditor to the rest of the world, it can expect greater returns if it allows most of its investments to be made by private

investors than if they are all invested by the authorities in US treasury bills or similar low-yielding instruments they like to hold (so as to avoid the charge of losing public money, which they do not expect to be levelled against them as long as the securities do not depreciate in terms of the US dollar). A time will therefore come when it will be entirely appropriate for the state to allow free capital flows. Judging by the European experience after the second world war, it takes about 30 years from when a country starts the process of liberalisation and financial integration before it makes sense to move to capital account convertibility. That is why I told an Indian newspaper in 1997 that I thought the first Tarapore report's proposals were about 30 years premature. Maybe I suggested five or 10 years more than is necessary, but I still don't think I overestimated by 21 years.

Of course, countries do not suffer capital flight when their central banks are sitting on reserves of \$ 140 billion odd (approaching 20 per cent of GDP) and a world boom is in progress. But the case for restraint in moving to capital account convertibility does not rest upon a conviction that any short-run danger lurks through such a move. The question is whether when circumstances turn difficult, the country will be in an equally solid position to maintain its growth if in the interim it has taken on a load of short-term debt and given investment banks the right to play games with its money. For example if, as some of us fear is quite likely, the US one day confronts a crisis caused by a collapse of the dollar, the consequence for the rest of the world is likely to be even more traumatic. Recession in the US will be tempered in the medium run by the shift in expenditure toward American-made goods caused by the dollar depreciation, but in other countries expenditure-switching and expenditure-reduction will reinforce each other in making for recession. Countries whose exchange rates float uncontrollably upwards will suffer the most. I am not for a moment suggesting that India should not be willing to play a role as a responsible member of the international community in accepting its fair share of the dollar depreciation, but simply that it would be advantageous to avoid the greater burden that might be thrust upon it by a market in which the free flow of capital dictates how far exchange rates move. And if India sought to maintain spending during a world recession through expansionary macroeconomic policies, it might well find that its

reserves got run down even without a strong initial effective appreciation. At that point, the danger would be the more traditional one of a run out of the rupee.

I therefore see a series of reasons for India to take a go-slow approach in moving to liberalise the capital account. That it would be wise to liberalise one day I do not doubt. That there are some liberalising measures that should be made early – of FDI, of portfolio investment, of small private transactions – I find compelling. But there are many other liberalising reforms – from electricity pricing to making the courts work expeditiously to pruning the fiscal deficit – that deserve to be priorities over complete capital account liberalisation for the next 10 years (at least). At this stage full capital account liberalisation promises no large benefits, while

it increases the risk of things going badly wrong. **EW**

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