Management of Capital Flows: Indian Experience [1]

Ladies and Gentlemen,

One of the most significant developments in India in the recent years has been the spectacular surge in international capital flows. With the increase in capital flows and participation of foreign investors and institutions in the financial markets in India, the capital account has been the focus of attention. It is noteworthy that the expansion of capital flows has been much larger than that of international trade flows. A striking feature of the capital flows to India in the recent period is that private (debt and equity) flows, as opposed to official flows, have become a characterised portion in the composition of total capital flows. The capital account has been dominated by flows in the form of foreign direct

loans including short-term borrowings and deposits from non-resident Indians (NRIs), and the third phase (1991 onwards) with large capital flows as a result of massive liberalization of both current and capital account.

Since the initiation of the reform process in the early 1990s, India has encouraged all major forms of capital flows, though with caution from the viewpoint of macroeconomic stability. The broad framework for reforms in the external sector was delineated in the Report of the High Level Committee on Balance of Payments (Chairman: C. Rangarajan) in the aftermath of the balance of payments crisis in 1991. The Committee recommended, inter alia, liberalisation of current account transactions leading to current account convertibility; need to contain current account deficit within limits; compositional shift in capital flows away from debt to non-debt creating flows; strict regulation of external commercial borrowings, especially short-term debt; discouraging volatile elements of flows from non-resident Indians; gradual liberalisation of outflows; and disintermediation of Government in the flow of external assistance. Following changes in exchange rate regime, as well as trade and investment policies' reform, there was a spurt in capital flows to India.

Drawing on the experience of the past decade and a half, India's approach to capital account liberalisation can be treated as a process and not an event with a distinction made between households, corporates and financial intermediaries, along with the recognition of a hierarchy of preferences for capital flows. Capital account liberalisation in India is kept in tune with other reforms sequencing with other concomitant developments such as strengthening of banking, fiscal consolidation, market development and integration, trade liberalisation, and the changing domestic and external economic environments. A hierarchy is

- Foreign investment in Rupee debt (Government bonds and corporate bonds) is subject to a ceiling of USD 4.1 billion (2.6 for government debt and 1.5 for corporate bonds).
- Overseas borrowings by banks in India are restricted to 25% of Tier I capital. Borrowings for export finance, perpetual debt and subordinated debt are outside this ceiling.

There has been a steep decline in official capital flows with increase in non-debt flows, particularly private foreign investments, have gained in importance in the recent period, during 2006-07, however, there is a steep rise in the debt creating flows, mainly on account of rise in external commercial borrowings by Indian corporate (Table 2). The sharp rise in external commercial borrowings may be attributed to favourable liquidity and the interest rates in the global markets on the one hand, and rising financing requirements for capacity expansion domestically, on the other hand.

Table 2: Composition of Capital Inflows to India

	1990-91	2000-01	2003-04	2005-06	2006-07	Apr-Dec 2007
Net Capital Flows (US $ million)	**7,056**	**8,840**	**16,736**	**25,470**	**45,779**	**81,942**
of which (in per cent)						
1. Non-Debt Creating Flows	**1.5**	**66.3**	**82.1**	**73.6**	**34.5**	**50.5**
a) Foreign Direct Investment	1.4	37.0	14.3	20.2	18.8	10.2
b)Foreign Portfolio Investment	0.1	29.3	67.9	53.4	15.7	40.3
2. Debt Creating Flows	**71.1**	**30.3**	**7.7**	**29.6**	**51.2**	**41.5**
a) External Assistance	31.2	4.6	-17.1	7.2	3.9	15

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growth, positive investment climate, progressive liberalisation of FDI policy regime and simplification of procedures (Table 3). Sector-wise, manufacturing industries and services, particularly finance and business services, remained the major beneficiaries of FDI inflows. In a major break from the past, the spurt in FDI flows to India in the recent period has been accompanied by a jump in outward equity investment as Indian firms establish production, marketing and distribution networks overseas to achieve global scale along with access to new technology and natural resources. Overseas direct investment from India jumped to US $ 11.3 billion in 2006-07 from US $ 3.8 billion in 2005-06 (Table 4).

Table 4: India's Direct Investment Abroad

(US $ million)

Industry	2003-04	2004-05	2005-06	2006-07
1	2	3	4	5
Manufacturing	893	1,068	1,538	1,678
Financial Services	1	7	156	17
Non-Financial Services	456	283	531	7,681
Trading	113	181	215	532
Others	31	108	239	934
Total	**1,494**	**1,647**	**2,679**	**10,842**

Note: Data includes equity and loan components.
Source: Reserve Bank of India, Annual Report 2006-07

In India, portfolio investment mainly constitutes investment by foreign investors in equity and debt securities, funds raised by Indian mutual funds abroad (Off-shore Mutual Funds) and funds raised by Indian corporates abroad in the form of Global Depository Receipts (GDRs) and American Depository Receipts (ADRs). Among these, FII investment in Indian Stock Market constitutes the most important component of portfolio flows into India. FII investment has increased significantly from just US $ 2.0 billion in 1995-96 to US $ 31.0 billion mainly due to major liberalization of Indian equity market, simplification of rules and regulations for investments, and prominent growth of Indian economy (Table 5).

Table 5: Net Portfolio Investment Flows to India

(US $ million)

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While the foreign savings in the 1950s and 1960s largely emanated from concessional external assistance flows in the form of official aid/multilateral and bilateral credits, the 1970s, witnessed additional sources of external finance in the

also greater risk appetite of global investors for emerging market bonds. External assistance, which consists of external aid flows from bilateral and multilateral sources, has been declining in India's capital flows steadily during the last three decades. The share of external assistance in India's total capital flows has declined from 31.2 per cent in 1990-91 to 1.5 per cent in April-December 2007.

Table 7: External Commercial Borrowings to India

(US $ million)

Year	Approvals	Gross Disbursement	Total debt service (amortization and interest)

capital account and discretion in monetary policy has to be managed in what could be termed as ‘fuzzy’ manner - a problem that gets exacerbated due to

commensurately. Since there are limits to sterilization, the capital account management becomes important. In this context, it would be relevant to have a look at the broad policy framework towards capital flows in India along with the various monetary and regulatory measures adopted by the Reserve Bank of India to for the management of capital flows.

Another important development is that the determinants of exchange rate behavior seem to have altered dramatically over the last decade and half. Large capital inflows put upward pressure on the rupee and affected the exports in small and marginal sectors which provide large employment. It is also important to note that there is evidence of co-existence of higher trade deficit and appreciating real effective exchange rate (REER) in the recent period. In the recent period, despite a large trade deficit, rise in capital inflows has led to appreciation of the exchange rate, rather than depreciation. Capital flows are dominating the exchange rate movements, rather than movements in the trade account or current account.

(b) Financial Market Development

The capital inflows into India helped in improving depth of the financial markets with the increase in liquidity. The capital flows along with import of managerial skills substantially contributed to the development of financial markets, which made our financial system more robust and resilient to unexpected shocks. Of the different segments of the Indian financial markets, the forex and the equity markets provide the channel through which global crisis can spread to the Indian system. The BSE which had touched a peak of 20,873.33 on January 8, 2008, declined to 17,824.48 on February 28, 2008 mostly due to withdrawals by the FIIs in the wake of concerns over recession in the US economy. The decline was not so prominent because the economy is domestic led with strong growth

risks. In the medium-term, more durable policy responses need to be fashioned for enabling the absorption of capital flows into building productive capacity and a credible commitment to price and financial stability will continue to be necessary for desired positive outcomes.

The instruments used in sterilization of capital inflows need to be continuously refined. Each instrument, namely, Market Stabilization Scheme (MSS), Liquidity Adjustment Facility (LAF) and Cash Reserve Ratio (CRR), has different features and interactions. Utilization of each of these will also depend on what is the permanency of the components of the flows and how they should be sterilized in the aggregate. The quasi-fiscal cost of such sterilization would have an impact on the fiscal position. The cost should be visualized in terms of comforts associated with market stability, export competitiveness and possible crisis avoidance in the external sector. Sterilized interventions and interest rate policy are generally consistent with overall monetary policy stance that is primarily framed on the basis of the domestic macro-economic outlook. The cost of sterilization in India is usually shared by the Central Government (the cost of MSS), Reserve Bank (under LAF) and the banking system (in case of increase in the reserve requirements). Continuous assessment of indirect cost of sterilization and also the quantum of sterilization are important judgments which need to be made in conjunction with domestic mmTd[ar is uattnd ism-term, more)]TJ02Tc 0.2274 4w -18

it has to be combined with other measures to manage the flows depending on their intensity.

Third, from the viewpoint of the active management of capital account, the nature of capital flows to India assumes critical importance. It is important that the public policy makes a conscious choice in terms of a hierarchy of capital flows by pitching for a priority for more stable components of capital flows. The flows on account of equity, foreign direct investment (FDI) into green field issues may be considered to be of a more permanent nature. Furthermore, long-term capital flows are generally preferred over short-term capital flows. Although the combined fiscal deficit of Centre and States is around 6 percent of GDP, it is less exposed to volatility of foreign capital flows since the investors in the debt market are largely domestic investors and there are limits on investments by foreigners in domestic government debt.

It has been the endeavour of the Reserve Bank to develop sound and efficient intermediaries and markets so as to provide foundations for a robust, efficient and diversified financial system, a key requisite for effective transmission of monetary policy. Although capital inflows are generally free except for a negative list in a few sectors, a number of initiatives have been taken by the RBI in the capital account- encompassing both inflows and outflows- to further develop and integrate financial markets with a view to enhancing allocative efficiency.

Fourth, in the face of large capital flows, the exchange rate policy of the Reserve Bank would continue to be guided by the broad principles of careful monitoring and management of

when expected, tend to disturb the markets and hence, there would be a need to even-out the impact of such lumpy flows through policy interventions and statements, appropriately managing the expectations in the market.

Fifth, at the present juncture, the effects of financial turbulence on capital flows would be any of these three: (a) r

To sum up, India’s foreign exchange reserves are at present comfortable, although pursuing this policy