Capital Controls & Private Equity
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What really is Private Equity?

• It covers a wide range of finance ranging from “venture capital” that funds start-ups to funding mergers, acquisition, leveraged buy-outs of exiting companies.

• The main distinguishing characteristic is that the transactions are done in Private rather than Public markets. Typically private equity investors also play an active role in managing the investee companies.

• They play a very important role in providing finance in situations where the open market is inefficient, illiquid or unable to price an asset.
Private Equity in India

- Private Equity inflows have grown exponentially in the last few years.
- Most of the capital has gone to fund “growth” and capacity building, especially in first generation enterprises.
- Ajay Shah has estimated that there are 250 PE firms with 1500 investments. Approximately 20% went through small stakes in listed companies, 20% as large stakes in listed companies and 60% went to unlisted companies.
- It is likely that inflows could rise sharply in the next few years.
Volatility & Capital Controls

• It is a source of “growth” capital that typically takes a long term view and injects funds to innovations and first-generation entrepreneurs. Hence PE has FDI characteristics.

• It does not suffer from a “mark-to-market” pressures like other forms of portfolio capital. If anything, the money become more sticky during periods of financial stress.

• Even if private equity enters into “undesirable” transactions, the question is whether or nor capital controls hold the answer. There are many other forms of regulation that may be far more effective that capital controls.
Private Equity in the rest of Asia

• Few rules specifically targeting private equity in Asia. However, large PE investments have sometimes created problems – for instance, the Lone Star – Korea Exchange Bank episode.

• The rise of sovereign wealth funds will now cause added problems. Singapore’s Temasek has already had problems in Thailand with Shin Corp and more recently in Indonesia with ownership of telecom companies.

• However, it’s unclear how to deal with these funds. As the recent experience of Thailand and Indonesia shows, targeting them can have serious reputation risk to the host country.

• Furthermore, sovereign private equity can take many forms. Should we consider Blackstone a front for Chinese investment?
Capital Controls should be Light & General

• Capital controls cause distortions and they should be used very sparingly. At most they should be used to add a bit of friction to international capital flows.

• Inefficient to target a specific form of capital flow – such as PE – as capital can take many forms. End use restrictions are difficult to monitor and, in any case, undesirable. Even a simple debt-versus-equity distinction can be circumvented.

• Perhaps, one can look at time-determined taxes – the Chilean tax or mandatory forward hedging.

• In the medium term, the Impossible Trinity problem requires a macroeconomic solution that combines monetary policy, exchange rate policy and fiscal policy.

• Long term, supply-side reforms are needed to allow the economy to “absorb” the capital
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