Did the Indian capital controls work?

Ila Patnaik Ajay Shah

National Institute of Public Finance and Policy

March 15, 2011

The conservative view

- Capital account liberalisation is dangerous
- India has been served well by the approach of slowly opening up in a highly controlled manner
- India fared well in the global crisis, thus validating the capital controls regime.
- Capital controls have been useful as a tool for macroeconomic and financial policy.
- It ain't broke, don't fix it.

Three tangible questions

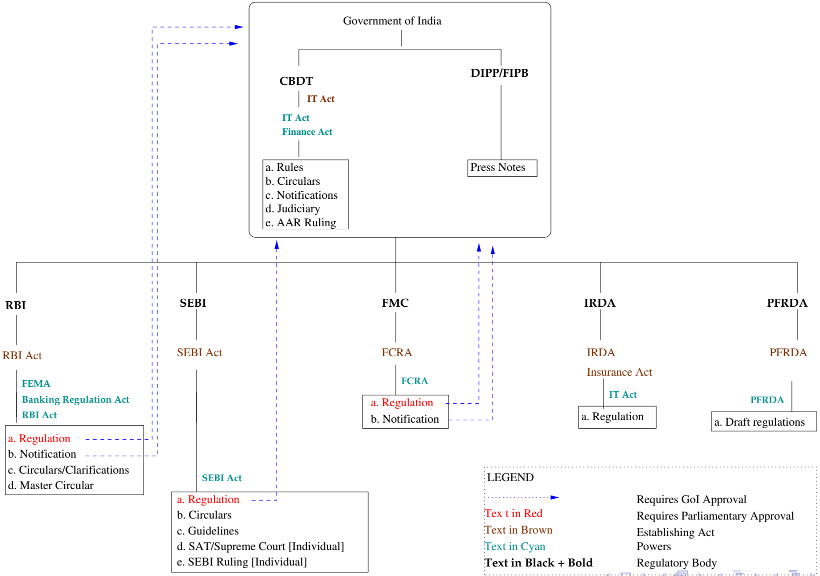
1. Did the capital controls regime succeed in limiting inflows?
2. Did it preserve India's exchange rate and monetary policy regime?
3. Did it assure financial stability?

India and her peers

Country	Openness Score (2008)
India	-1.13
Brazil	0.99
South Africa	-1.13
South Korea	0.18
Turkey	-1.13
BSST average	-0.27
China	-1.13
Russia	-0.09

Source: Chinn and Ito (2008)

System of capital controls



No single manual

- Foreign Exchange Management Act, 1999
- Regulations, notifications, circulars, master circulars of Reserve Bank of India
- Notifications of Ministry of Finance
- Rules differ according to asset class: listed equity, unlisted equity, debt, derivatives and foreign investment
- Rules differ according to investor class: Individual investors, foreign corporations and non-resident Indians are treated differently under the law from broad based funds, charitable trusts or university endowment funds.

FEMA

The Foreign Exchange Management Act and its regulations provide

- No appeals mechanism
- No indication of time limits for permissions or denial
- No obligation to provide reasons for denial of permission
- Decisions for publication not made public.

Listed equity: FII

Listed equity has the most liberal regime:

- FIIs are allowed investment in listed equity under the portfolio investment scheme subject to specified investment ceilings applicable to listed or unlisted equity.
- There is a ceiling of 10 percent for each FII or sub-account.
- The investments of all FIIs and sub-accounts in a given firm are capped at 24/98 percent.

Listed equity: FII

Listed equity has the most liberal regime:

- FIIs are allowed investment in listed equity under the portfolio investment scheme subject to specified investment ceilings applicable to listed or unlisted equity.
- There is a ceiling of 10 percent for each FII or sub-account.
- The investments of all FIIs and sub-accounts in a given firm are capped at 24/98 percent.
- All manner of intricacies. Example:

"If a sub-account belongs to an individual or foreign corporation (as opposed to a broad based fund, charitable trust or university fund, endowment, foundation or proprietary fund of a registered FII), then the limit is 5 percent."

Listed equity: FVCI

- Foreign venture capital funds (FVCI) are allowed to invest up to one-third of their funds in specified forms of listed equity.

Listed equity: FVCI

- Foreign venture capital funds (FVCI) are allowed to invest up to one-third of their funds in specified forms of listed equity.
- All manner of intricacies. Example:

> *"Foreign venture capital funds may invest in IPOs of venture capital undertaking where the shares are proposed to be listed, debt or debt instruments of venture capital undertakings where the foreign VC has already made an investment by way of equity and preferential allotment of equity shares of a listed company subject to a lock-in period of one year."*

Present approach: More liberal on dollar denominated debt

- *Dollar denominated*: Companies other than financial intermediaries are eligible to borrow in foreign currencies within a variety of stipulated limits without prior approval. Company borrowing is capped at USD500 million under the automatic route with detailed restrictions on end-use, maturity and price.

Year	Stock of ECB (USD billion)
2000-01	23.3
2006-07	41.1
2007-08	62.3

Present approach: More liberal on dollar denominated debt

- *Dollar denominated*: Companies other than financial intermediaries are eligible to borrow in foreign currencies within a variety of stipulated limits without prior approval. Company borrowing is capped at USD500 million under the automatic route with detailed restrictions on end-use, maturity and price.

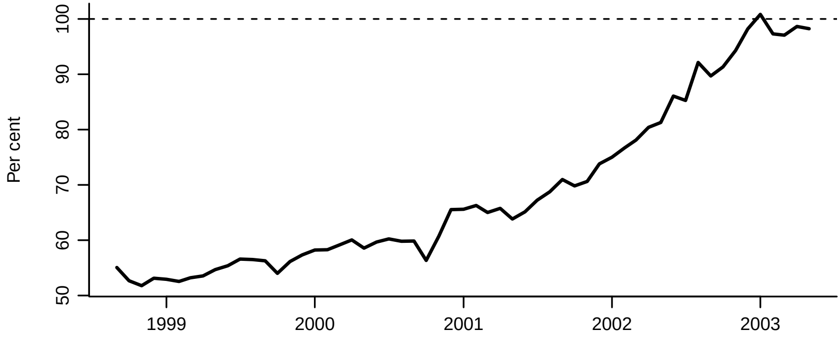
Year	Stock of ECB (USD billion)
2000-01	23.3
2006-07	41.1
2007-08	62.3

- *Rupee denominated*: FII's allowed to invest. There are caps on all India, all FIIs, total stock of rupee denominated corporate bonds:

Period	Cap (USD billion)
Till Jan 2009	6
Till Sept 2010	15
From Sept 24, 2010	20

Phase 1: Pegging with sterilised intervention

Share of foreign exchange reserves in reserve money in Phase I



Sterilisation bonds

- In January 2004, Reserve Bank of India ran out of government bonds.
- Sterilisation bonds called the “Market Stabilisation Scheme” bonds were issued.
- Proceeds from the sale of bonds were sequestered in a separate account
- Interest cost of these bonds was shown explicitly as an on-budget cost.

Phase 2: Emphasis on capital controls

Example 1: Hindering foreign borrowing

In 2004, a capital control was introduced upon this borrowing, where the interest rate paid by the borrower was capped. For loans of a maturity between three to five years, this ceiling was set to 200 basis points, and for loans of a maturity of above 5 years, this ceiling was set to 350 basis points.

Example 2: Hindering venture capital

- Tax pass-through for *all* venture capital was restricted to nine sectors: poultry, dairy, nanotechnology, biofuels, hotels and hospitality, seed research, etc.
- Permissions for opening FVCI bank accounts granted by the RBI were tied to requirements such as investment in only the nine sectors mentioned for tax-pass through treatment in the Income Tax Act.

Example 3: SEBI registration

- SEBI did not register investment managers as FIIs even if they otherwise met SEBI's norms for registration, if the investment manager was owned or substantially owned by NRIs.
- There is no explicit provision in SEBI regulations on this.

Example 4: Automatic route

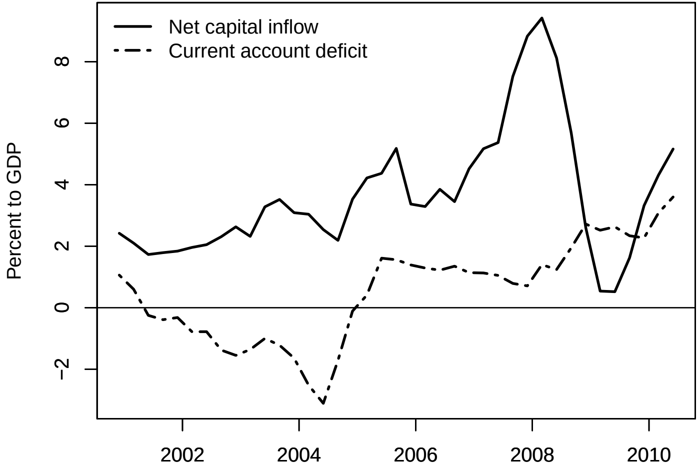
- In certain situations, India had placed foreign investment on an "automatic route".
- Meetings needed to be held by the RBI to approve the same.
- Inflows were controlled by not holding meetings for automatic route investments for many months. control inflows.

Example 5: Restrictions on offshore derivatives

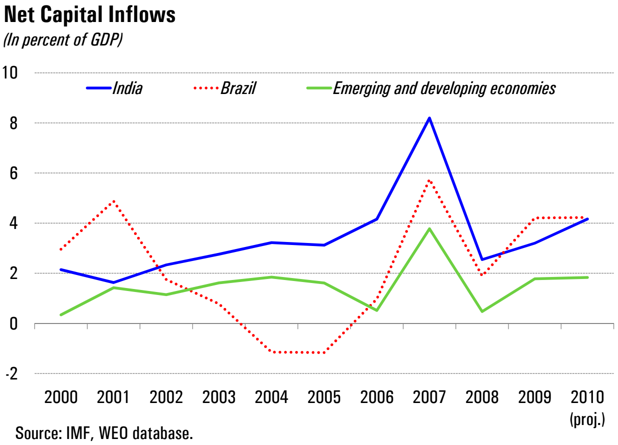
- The term ‘participatory notes’ (PNs) refers to the market for OTC derivatives on Indian underlyings that trades offshore.
- The book runners on this market are registered FIIs in India, and they lay off the risk of their overall book using transactions on the onshore market.
- These overseas transactions are outside the jurisdiction of the Indian authorities.
- In October 2007, the Indian authorities restricted registered FIIs from their transactions overseas on this market.

Q1. Held down the magnitude of capital inflows?

Magnitude of capital inflows

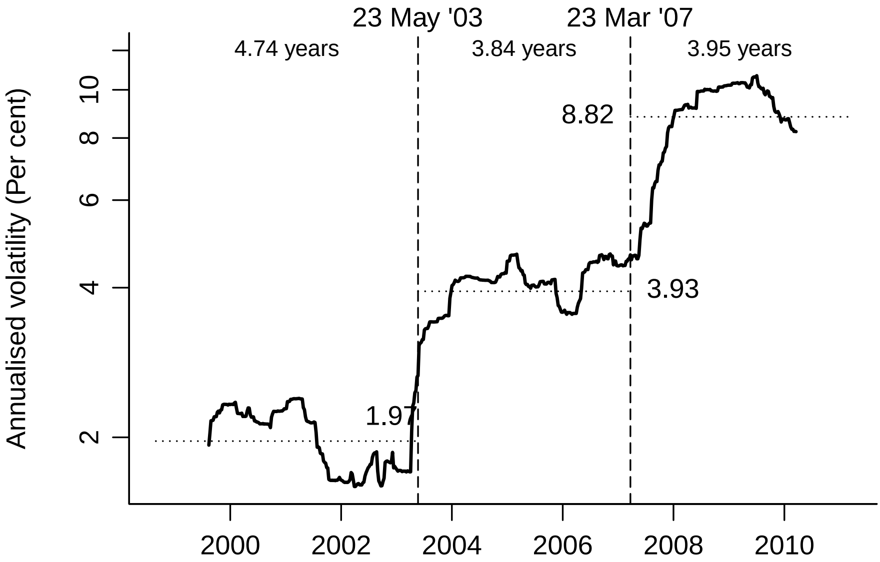


Comparison against other emerging markets



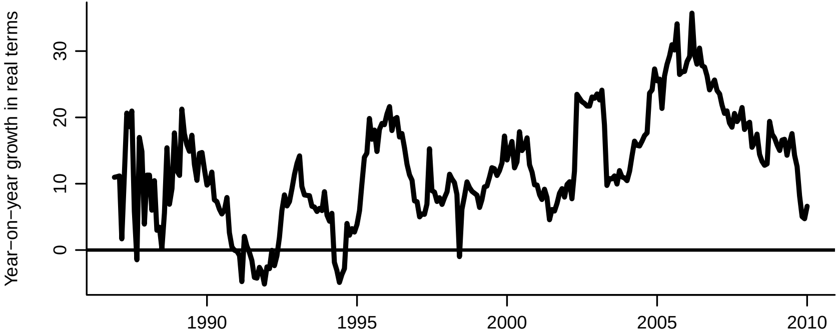
Q2. Upheld the exchange rate regime?

Breakdown of exchange rate pegging



Q3. Helped achieve financial stability?

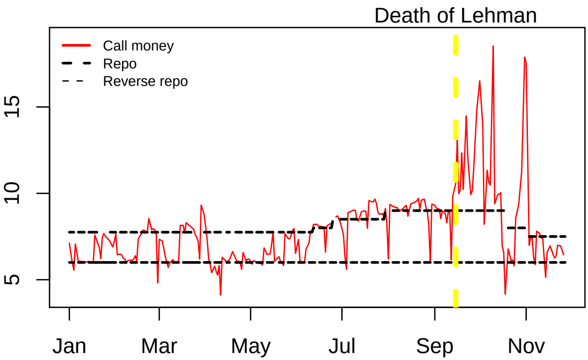
The credit boom



Rupee flexibility and currency risk

Period	Daily INR/USD volatility	Average currency risk of firms
1 April 1993 to 17 February 1995	0.16	5.899
17 February 1995 to 21 August 1998	0.93	0.540
21 August 1998 to 19 March 2004	0.29	3.753
19 March 2004 to 31 March 2008	0.64	2.066

Lehman and money markets



Asset price boom

Rank	Country	Lowest	Highest	Ratio
1	Taiwan	5316.87	9809.88	1.85
2	Malaysia	781.05	1516.22	1.94
3	Chile	7074.51	15618.38	2.21
4	Israel	526.97	1189.04	2.26
5	Philippines	1388.15	3873.50	2.79
6	Argentina	839.93	2351.44	2.80
7	Korea	719.59	2064.85	2.87
8	Turkey	15922.44	58231.90	3.66
9	Russia	6378.83	26196.44	4.11
10	Brazil	17604.00	73517.00	4.18
11	Indonesia	668.48	2830.26	4.23
12	India	1388.75	6287.85	4.53
13	China	1011.50	6092.06	6.02
14	Peru	2493.81	23789.75	9.54

The direction for reform

Big ideas of U. K. Sinha Working Group

- Capital controls should be seen as an integral part of financial regulation
- All our thinking about good governance, as applied in financial regulation, is relevant for capital controls.
- “While regulators should have the freedom to formulate policies specified in the law, applying policies to individual entities must be consistent, uniform, and transparent.”

A case for changes in the foreign investor regime

The report finds evidence that

- Distinctions between different classes of investors creates lack of transparency, uncertainty and violates rule of law.
- Prevention of money laundering laws and Know Your Client norms require a fresh set of rules.

Recommendations of WG

- Legal process: Applelate tribunal, public consultation, transparency, certainty, real time access to the law.
- Qualified foreign investor: Single window for portfolio investment, registration with DP. Possible for a retail investor to be QFI is she satistifies KYC norms.
- Outflows into equity: Entities structuing and offering equity rated products should register with SEBI.
- Debt: Numeric caps on rupee denominated corporate debt removed or replaced with percentage caps.

Budget 2011 announcements

- Increase in FII investment in cap corporate bonds from USD 20 billion to USD 40 billion
- Allow foreign retail investors to invest in Indian mutual funds

Conclusion

- India's capital controls have not delivered on the goals of macro and financial policy
- They have not served India well
- India's process of capital account liberalisation continues with the Budget Speech announcements of 28 February.

Thank you.