



The IMF's Approach to Capital Account Liberalization and India's Experience

Sanjaya Panth
Senior Resident Representative

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- The views expressed are personal and are not necessarily those of the IMF, its Executive Board, or its management.

Outline

- I. The IMF's approach to capital account issues
 - “Integrated approach” to liberalization

- II. The economic impact of liberalization
 - Thresholds and collateral benefits

- III. India and the Fund: seeing eye to eye ?
 - Recent steps to further liberalize inflows welcome

I. The IMF's Mandate and Approach

Legal Basis

- Jurisdiction only over restrictions on payments and transfers for *current* international transactions.
- Article VI explicitly recognized members' rights to exercise capital controls—indeed, it enabled IMF to request such controls to safeguard Fund lending.
- Collapse of Bretton Woods introduced new Article IV and surveillance over exchange rate policies.

Accepted Role

- IMF does not have the authority to enforce any standard of capital account convertibility, but it has a responsibility to exercise surveillance over capital account policies as part of its mandate on exchange rates.

Integrated Approach

- Capital account liberalization should be an *integral part* of more comprehensive programs of economic reform and needs to be *coordinated* with appropriate *macroeconomic and exchange rate policies* as well as policies to strengthen *financial markets and institutions*.

Integrated Approach: Principles I

- Liberalization should be undertaken against background of sound and sustainable macroeconomic policies.
- Financial sector reforms that support and reinforce macroeconomic stabilization should be prioritized.
- Financial sector reforms that are mutually reinforced and operationally linked should be implemented together.
- Financial reform should be complemented by prudential regulation and supervision and financial restructuring.
- Liberalization of capital flows by instruments and/or sectors should be sequenced to take into account concomitant risks.

Integrated Approach: Principles II

- Pace of reforms should take into account conditions in the non-financial sector.
- Reforms that take time should be started early.
- Reforms need to take into consideration the effectiveness of capital controls in place at time of liberalization.
- Pace, timing, and sequencing of liberalization need to take into account political and regional considerations.
- Policy transparency and data disclosure should be adapted to support capital account opening.

General Implications of Approach

- No “one size fits all” recommendations. Indeed absence of sufficient “consistency” of advice across countries was source of some concern for independent evaluators.
- Gradual but *systematic* progress—ad hoc changes and attempts at fine tuning capital controls not compatible with integrated approach: hard to time, can lead to harmful inconsistencies and market confusion.

Effective Policies to Address Large Inflows

- Capital inflows best addressed by strengthening fiscal position and increasing exchange rate flexibility.
- Complementary policies: ensure continued banking system and financial market soundness.
- Institutional reforms (e.g. labor market flexibility, trade openness) important for productivity growth and competitiveness when faced with large inflows.

II. The Economic Impact of Liberalization

Tradeoffs

- Benefits
 - Growth
 - Risk sharing (consumption smoothing)
- Costs
 - Macroeconomic volatility
 - Foreigners “profiteering” ?

Red Herrings ?

- Why should non-residents making profits matter if the net benefits they bring *for the country* are positive ?
- Is the non-residents' "pain" from withdrawal different depending on whether it is from equities or long-term debt markets ?

Benefits and Costs I¹

- Growth

- Main benefit may not be financing but rather through “collateral” channels: financial market and institutional development, economic efficiency, macroeconomic discipline.
- Relationship between FDI and equity investment on the one hand and growth on the other relatively clear.
- Relationship between debt and growth depends on “thresholds” for institutional quality.

1/ See, for example, “Reaping the Benefits of Financial Globalization” by Mauro et al., IMF, 2007.

Benefits and Costs II¹

- **Risk sharing** (consumption smoothing relative to output)
 - Advanced countries have benefited.
 - Evidence for emerging markets mixed.
- **Macroeconomic volatility & crisis propensity**
 - “thresholds” important: greater openness not associated with greater volatility if thresholds met.

1/ See “Reaping the Benefits of Financial Globalization” by Mauro et al., IMF, 2007.

III. India's Experience

Broad agreement on Roadmap

“The Tarapore report outlines a road map that envisages further gradual lifting of capital controls, with accompanying steps to strengthen the fiscal position and financial sector, broadly in line with generally accepted views about the appropriate phasing of capital account liberalization.” (2006 Article IV staff report)

Less So On Reintroducing Controls

“Using capital controls for macroeconomic management could affect investment and growth adversely.” (2007 Article IV staff report)

Staff view. Tightening curbs on external commercial borrowing :

- Generally does not curb overall flows
- Raises concerns about investment financing
- Fosters uncertainty about longer-term commitment to fuller convertibility

Resumption of liberalization

Recent steps broadly consistent with Tarapore:

- Ceilings for ECBs raised.
- ECB end use restrictions loosened.
- FDI regulations liberalized.
- FII investment: ratio of investment between debt and equity funds removed.
- FII limits on government and corporate debt markets raised.

Conclusion

India's approach to capital account liberalization is consistent with Fund's views about best practice. Any differences in views have been on temporary measures that are now not in effect.