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Muddling Through in the Maelstrom

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Like a kayaker caught in the midst of swirling currents, the RBI has been struggling to stay afloat and not get swept away by the surging tide of capital inflows. And the waters are treacherous, with sharks of all stripes lurking and hungry for blood.

The RBI has tried to manage the pressures on domestic inflation and the exchange rate with a two-pronged strategy of freeing up outflows of financial capital and restricting inflows. Sounds like a sensible and practical approach. Is it? While one hardly envies India's central bankers for the delicate balancing act they have to maintain in the midst of the maelstrom, the risk is that parts of this approach may end up sacrificing longer-term strategic considerations for the sake of dealing with short-term exigencies.

But first, the bouquets. The RBI created waves of its own recently by announcing an easing of controls on capital outflows. Indian firms can now invest abroad in larger amounts and with fewer restrictions than before. The ceiling on the amount that mutual funds can invest abroad has been raised and the amount that individuals can take out each year has been doubled to $200,000. Quite a change from just a few years ago when the government was doing everything in its capacity to restrict outflows and preserve foreign exchange.

The reactions to this announcement have been swift. Some observers have criticised this move as a desperate gambit to stave off pressures for a rising rupee. The RBI is seen as having taken this step in the futile hope of encouraging enough outflows to offset the inflows of foreign capital. And there will no doubt be the predictable outcries against any such moves that will increase India's entanglement with international capital markets. From the other wing, the RBI has been criticised for yet again lacking the courage to go beyond baby steps on the path to a fully open capital account.

Paradoxically, the RBI's move to liberalise outflows makes more sense mainly from a long-term perspective even if it is driven by short-run considerations of toning down the rapid appreciation of the rupee. Indeed, whether the easing of restrictions will cause outflows to rise enough in the short run to offset inflows by much is far from clear. With the Indian economy and stock markets continuing to do well, and the rupee likely to stay strong, diversification motives may now generate only modest outflows. This is partly because the legacy of tight control on financial market development has left investors with few investment vehicles for taking full advantage of these opportunities.

But there may be a subtler strategy at work here. It's interesting that the recent announcement consists of a broad range of measures to liberalise outflows. Moreover, the RBI has explicitly indicated that these are intended to accelerate the third phase of the capital account convertibility programme recommended by a government committee.

This may be a signal that the RBI is gearing up to move beyond baby steps and opportunistically push forward with capital account liberalisation.

But why bother with these reforms if the short-run benefits might be a mirage and the domestic political context makes full capital account convertibility unlikely anytime soon? After all, India now has a national government held together by a fragile coalition with some crucial partners openly hostile to capital account liberalisation.

One accomplishment is that the RBI may have, perhaps unwittingly, signalled the inevitability of an open capital account and started to shift the terms of the debate to process rather than ends. This approach also has the virtue of tying the hands of policymakers. The risks of an open capital account are greater if fiscal and other policies are out of whack, as capital could then flow out rapidly at the slightest provocation. So this forces some degree of discipline on the government.

Unfortunately, these strategic benefits have been greatly diluted by the mixed signals on inflows, with some types of inflows now coming under increasingly severe restrictions. Attempts to directly block inflows send the wrong signal that the government doesn't have enough faith in its own policies and may resort to ham-handed measures to tide over challenging times. In any case, it is difficult to keep these controls effective for long, especially in an increasingly integrated world economy. The government rarely comes out the winner in such cat-and-mouse games where it tries to stay ahead of investors (both foreign and domestic) who quickly find ways to creatively circumvent such restrictions. All of this is hardly good for promoting efficient allocation of capital.

Freeing up outflows is a good way to encourage Indian firms to spread their wings abroad and for individuals to garner the benefits of international portfolio diversification. It also creates competition for domestic savings, which helps focus the minds of local financial institutions on improving their efficiency (and friendliness to customers!). Getting these benefits of opening-up while trying to balance capital inflows and outflows, rather than adding distortions in the form of controls to achieve the same ends, makes a lot of sense.

But the benefits are likely to be small and transient if all we see are ad hoc measures to liberalise or restrict different types of flows in response to short-term pressures. Freeing up outflows in the context of a broader and better-articulated long-term plan for capital account liberalisation would be far more beneficial.

This approach would also signal some implicit commitments by the RBI. Liberalisation of capital flows works a lot better with a nimbler financial sector, so reforms and freeing-up of constraints on this sector are essential. To help firms cope with higher exchange rate volatility, for instance, it will require quicker development of markets for currency derivatives and other instruments for hedging foreign exchange risk.

There is a risk, of course, that the government may turn out to be less enlightened or more politically constrained than expected, hampering key reforms. The RBI will also need to sharpen its act in many areas, including by freeing up the financial sector to

develop and innovate. If these and other necessary reforms fall by the wayside, the perils of an open capital account will be much greater. But if the alternative is policy paralysis, it may be a risk worth taking.

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