

Capital Account Management and Financial Markets

CAFRAL, September 17, 2013

Capital Account : Concepts and Semantics

- Capital Account – Transactions in assets between residents and non residents
- Capital Account and Financial Globalization
- Capital Account openness for real sector and capital account openness for financial sector
- Capital Account and derivatives
- Capital Account Convertibility, Capital Account Liberalization and Capital Account Management

Why Capital Account Convertibility?

- Efficient allocation of resources globally
- From emerging market perspective : Access to global capital markets to augment domestic savings : Promotes growth
- Portfolio diversification
- Supports international trade and commerce
- All developed countries are capital account convertible : inevitability for EMEs?

Why Not?

- **Sudden cessation or reversal of flows**
(Thailand, Mexico)
 - Temptation to borrow : adverse selection
 - Speculative asset bubbles
 - Domestic macroeconomic shocks
 - Exogenous economic, geopolitical shocks
- Sharp fall in currency, spiraling outflows
- Asset price crash, demand deflation,.....
- Difficulty in financing CAD, Reserves drawdown.....

Why Not?

- **Surge in inflows**

- Strong growth momentum
- Buoyant profitability of corporate sector
- Large investment requirement
- Global liquidity glut
- Exogenous economic, geopolitical shocks
- Sharp rise in currency
- Erosion in Export competitiveness
- Intervention : monetary implications
- Sterilization : Fiscal cost
- Capital Account Measures : Restriction on Inflows? Incentive for outflows?
- Tobin Tax?

Evidence for benefits of Open Capital Account?

- Open Capital Account neither a necessary nor a sufficient condition for growth
- Many African Countries are capital account open – yet growth eludes them
- Many countries that registered fast growth did so with capital controls – China, Europe and Japan in Post-bellum years, India.....
- Lucas Paradox
- Countries with weak institutional framework do not benefit from capital inflows

Why CAC, Then?

- Inevitable consequence of globalization?
- Natural corollary of an open current account?
- Collateral benefits : Development of financial sector
- CAC – A commitment to
 - sound macroeconomic management
 - Inflation Control
 - Government Finances and Fiscal Deficit
 - Robust and Resilient banking Sector
 - Strong Macro and micro prudential regulation
 - good governance in corporate sector
 - Transparency
 - Disclosure

Taxonomy of Capital Account Transactions – Assets (1)

- Equity
 - Direct Investment
 - Greenfield
 - Brownfield
 - Portfolio Investment
- Debt
 - Contracted Debt
 - Long Term
 - Short Term

Taxonomy of Capital Account Transactions – Assets (2)

- Debt
 - Marketable debt
 - Government bonds, corporate bonds, commercial paper
 - Financial Sector Borrowings
- Immovable Property
 - Construction, Township development
 - Agricultural Land, Plantation

Taxonomy of Capital Account Transactions – Participants

- Firms
- Individuals
- Financial sector
 - Banks
 - Non-Bank Financial Companies
 - Insurance Companies
 - Mutual Funds
 - Pension Funds, Trusts

FDI – No concern

- Foreign Direct Investment not reckoned a threat
- Long term engagement
- Better technology, management practices
- Embodied technology through capital goods
- Boost to Exports ?
- Only caveat is strategic interest – security, defence, socio-political.....
- Home Country Bias taints approach to FDI
- Some asymmetry in approach to inward direct investment and to outward direct investment

Capital Account and Financial Globalization

- Capital Account Openness is about globalization of Financial Sector
- Bond-Currency-Derivative nexus
- Any foreign entity, using any foreign currency, can buy any domestic liability (bond or equity) and can hedge the risk using any derivative product
- Focus on Portfolio equity flows, debt flows and derivatives
- Foreign Bank participation

Capital Account & Flexible Exchange Rate

- Capital Account Openness has a close connection with Flexible Exchange Rate Regime
- A post Bretton Woods theme
- Global Financial Markets too registered phenomenal growth post Bretton Woods
 - First Currency Futures introduced in 1970, but took off only after 1975
 - First Interest Rate Futures Contract in 1975
 - First Interest Rate Swap done in 1981
 - First Stock Options in 1973

Capital Account & Flexible Exchange Rate

- The 'Impossible Trinity' – you cannot have Fixed Exchange Rates, Independent monetary policy and an open capital account at the same time.
- One has to give – capital account openness or fixed exchange rate?
- Capital Flows are fickle, anywhere, anytime
- Exchange rate volatility inevitable in an open economy
- Increasing capital account openness possible only with increasing tolerance of exchange rate movement, either way

Capital Account Openness and Derivatives

- A foreign investor in international financial markets faces various risks
 - Currency risk
 - Interest Rate risk – in currencies of liability as well as asset
 - Credit Risk
- How to hedge? Access to domestic market?
- For portfolio investors who dynamically manage the composition of their exposure, is dynamic Hedging possible?
- Internalization of currency – Non-Deliverable currency, interest rate, credit markets?

Capital Account Openness and Derivatives

- Derivatives can be used to hedge but to speculate as well.
- Can camouflage risk, leading to erroneous decisions
- Can change the meaning of capital flows data
- Can generate liquidity demand in response to events in financial markets
- Tesobono swaps (Mexico), Structured debt(Grece)...

Indian Context

Prior to 1991: License-Permit Raj and Financial Repression

- Fixed Exchange Rate
- Administered interest rates
- Restrictive FDI Regime
- Portfolio Investment open to NRIs and OCBs
- Very restrictive debt flows : Sovereign the principal borrower
- Weak Banking System
- Fragile Institutional framework

Indian Context

Post 1991

- Flexible Exchange Rate Regime
- Banking Sector progressively strengthened
- Institutional Framework being built gradually
 - SEBI and Stock Market Reforms
 - Comprehensive Institutional regulation
 - FRBM and Government Debt Market Infrastructure
 - Money Market reforms
 - How do we fare in macroeconomic parameters?
 - Inflation
 - Consumer inflation
 - Fiscal Deficit
 - External Liability

Indian Context

- By 1996, with some reforms in place and looking at the experience of Asian Tigers, the first Tarapore Committee on Full CAC
- Followed by Asian Crisis, Post-Pokhran II problems
- By 2006, sufficiently recovered to the Second Tarapore Committee
- Followed by Global Financial Crisis
- Crisis continues
 - US: Threat of Taper, Exit from accommodative monetary policy
 - US: Debt limit
 - Europe : Hesitant recovery
 - China: Slowdown?
 - Geopolitical : Middle East at flashpoint?
- Whither CAC?

Indian Approach

- Cautious gradualism
- Driven by global and domestic developments, forced to be more reactive rather than proactive?
- Have been troubled by currency appreciation as well as depreciation
- Devaluing our way out of distress : Marshall-Lerner condition?
- Complex regulatory regime : too much micro-management?

Indian Context – How we have progressed?

- Inflows

- FDI almost completely open – except strategic/sensitive sectors
- Portfolio Investment in Equity – subject to some holding restrictions
- Contracted Debt: Twin Regime of automatic and approval route; long term, limit on cost, informal limit on quantity
- Portfolio Debt: Progressively increasing access to sovereign debt and corporate debt
- Derivatives : Anyone with exposure can hedge with plain vanilla products; restrictions on dynamic hedging

Indian Context – How we have progressed?

- Outflows

- Overseas Direct Investment for Indian Firms enabled
- Banks setting up subsidiaries, branches possible
- Individuals acquiring assets – allowed with limits

Indian Context: Two episodes

- Episode I - 2007-08 : Surge in inflows
 - Sharp appreciation of Rupee
 - Aggressive but reluctant Intervention
 - Sterilization through MSS : Fiscal cost of Rs. 15,000 crore during 2007-08
- Capital Account measures
 - Inflow discouraging
 - Discouraging Non-Resident Accounts
 - Discouraging ECB
 - Outflow Encouraging
 - Relaxation in Overseas Investments
 - Relaxation in Individual asset acquisition
 - Market Measures
 - Introduction of currency futures and options
 - Introduction of interest rate futures
 - Freedom in hedging

Indian Context: Two episodes

Episode II – 2009 (Post-Lehman) and 2011- (Post US downgrade)

- Sharp depreciation in Rupee
 - Intervention : very sparingly
- Capital Account measures
 - Inflow encouraging
 - Encouraging Non-Resident Accounts
 - Encouraging ECB
 - Outflow discouraging
 - Restrictions in Overseas Investments
 - Restrictions in Individual asset acquisition
- Market Measures
 - Restrictions on freedom to hedge
 - Restrictions on positions of banks
 - Restriction on currency futures : position, margins
- Monetary Measures
 - Tight liquidity
 - Hiked interest rates

Capital Account : the present predicament

- Crisis management
- Get inflows, somehow : Financing CAD of paramount importance
- Current account inelasticity : gold and more importantly, oil : implications for inflation and government budget
- Equity inflows either autonomous (portfolio) or dependent on macroeconomic and ease-of-doing-business conditions; cannot be influenced greatly, at least in the short run
- Only inflows possible : debt inflows
- Who borrows?
 - Corporates : Do they have need for funds? Is it economical?
 - Banks : Deployment of funds? Economy? Prudential concerns?
 - Sovereign : Stability concerns?

Capital Account : the present predicament

- Market Developments

- Depreciating currency invites speculation: shorting the Rupee
- Bank balance sheets impaired
- Rupee trading abroad : The specter of NDF, Rupee futures in overseas exchanges
- Domestic futures market : A derivative contract in the OTC market based on underlying; Free access in Futures Market : How compatible?
- Some restrictions on hedging in the OTC markets to prevent panic reaction; how to do that in futures segment?
- Subsidized swap for FCNR(B) deposits, bank borrowings

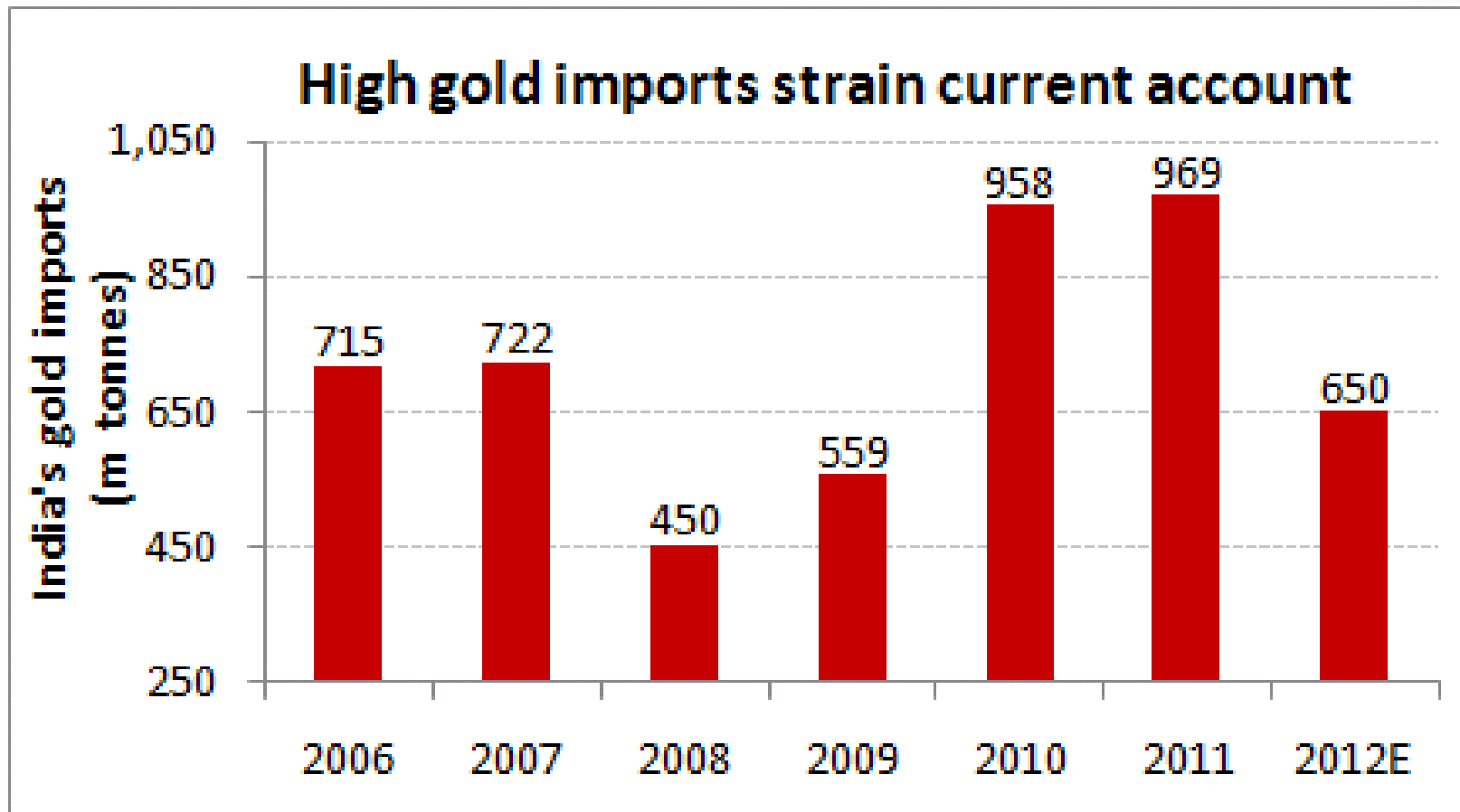
Capital Account : Where do we go from here?

- Capital Account Convertibility a long term goal
- Capital Account Liberalization a process
- Capital Account Management a tool to deal with emergent crisis situation : Does it not imply reversal of some measures?
- Further Financial Market Development and Capital Account Liberalization intimately related
- Both not possible without tolerance for Rupee volatility, speculation
- Institutional reforms

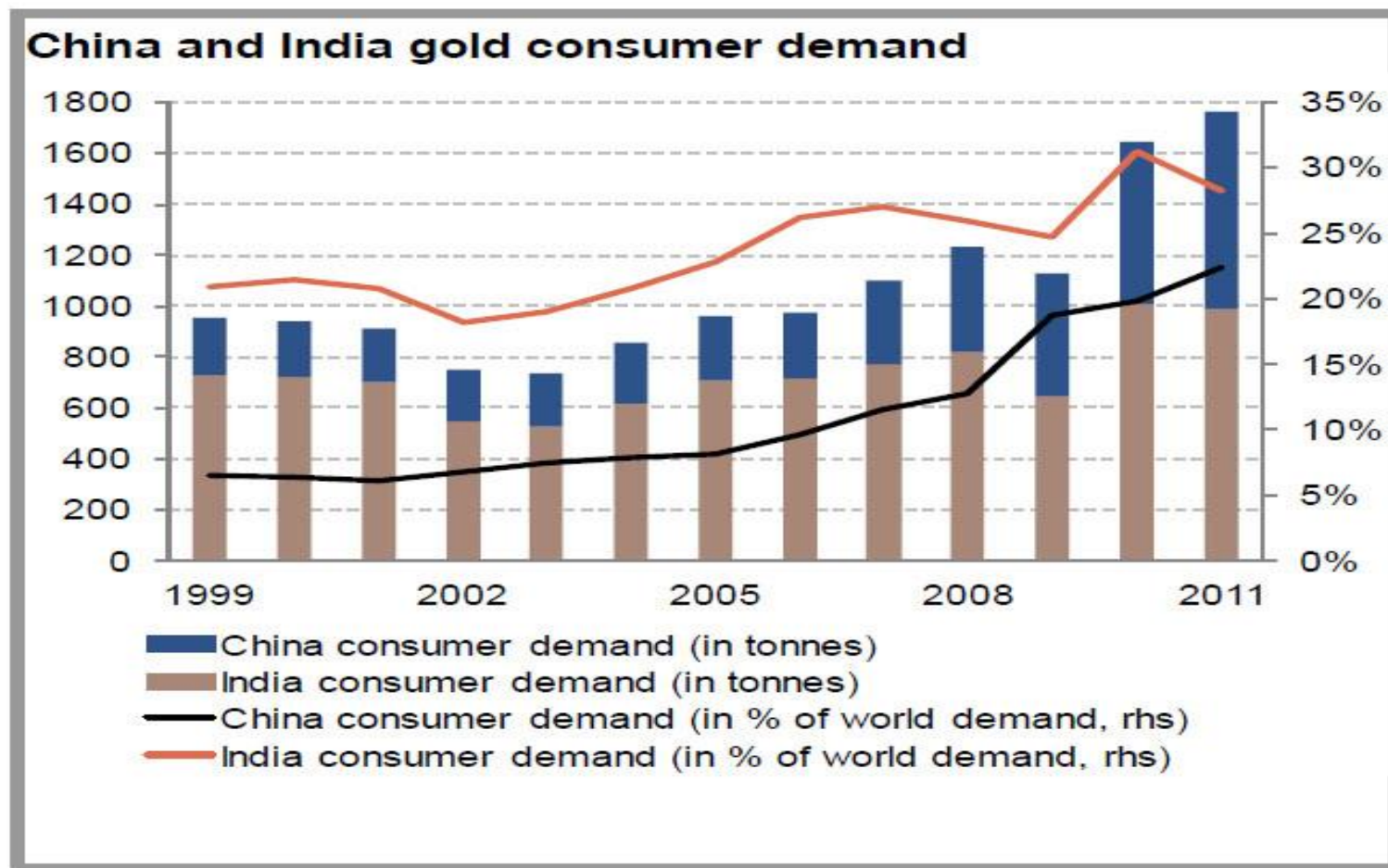
Capital Account : Proximate actions

- Review of Legal Framework
- Rationalization of FDI and Portfolio investment regime
- Strengthening preferential regime for long term debt
- Deepening market for hedging by long term investors
- Enriching on-shore currency and interest rate markets to attract foreign investors
- But find ways and means to cope with off-shore markets as well
- Facilitate entry of new banks, expansion of foreign banks (on a reciprocal basis, of course)
- Approach to financial products : Credit Derivatives, Interest Rate Derivatives, Currency Derivatives , Securitization
- Improving literacy of finance

India Gold Imports

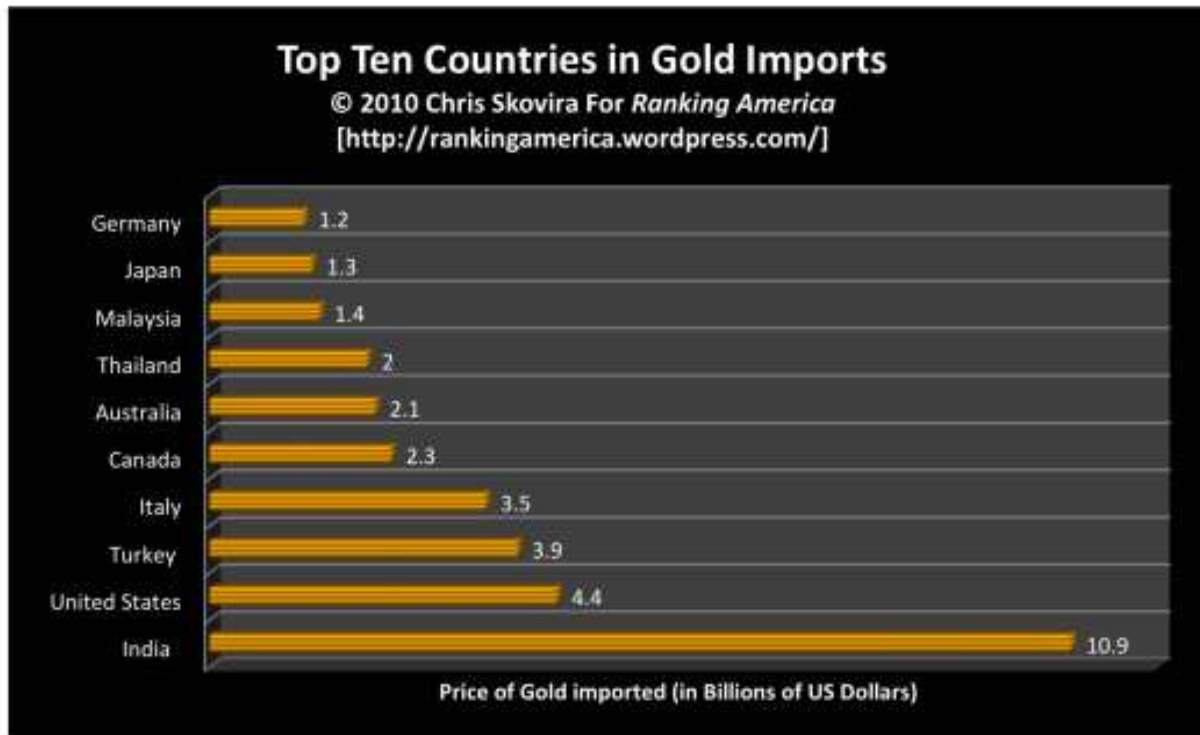


Gold Demand – India and China



Source: SG Cross Asset Research, Datastream, World Gold Council

Gold Import : Top 10 countries



Data from International Trade Centre [<http://www.intracen.org/menus/products.htm>]

Gold

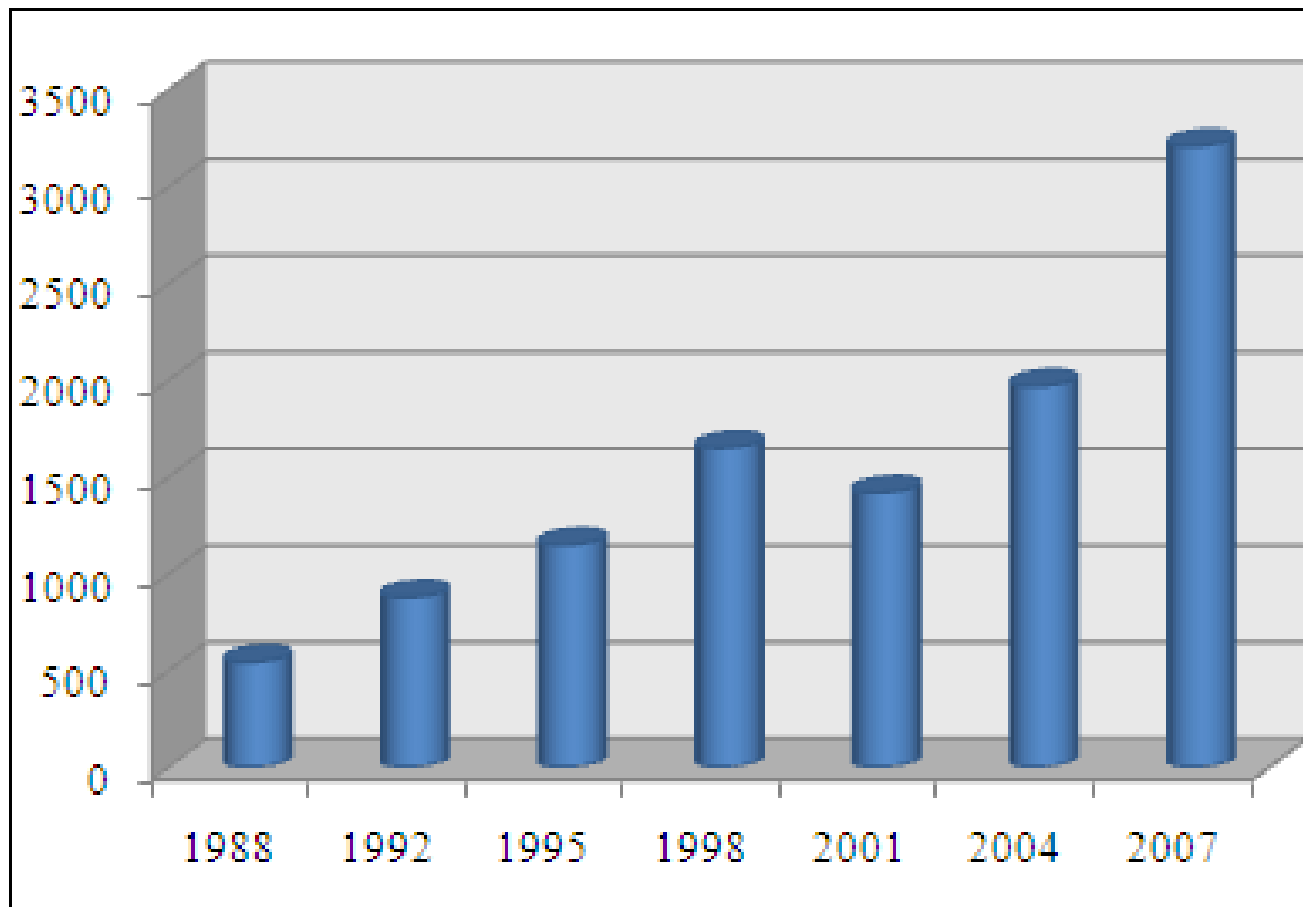
- Indian appetite for gold is insatiable
- Gold demand for consumption or as an asset? Can the two be distinguished?
- Consumption demand a function of Income, therefore with growth in income surge in demand natural
- Demand as an asset depends on risk adjusted return on alternative assets. What assets are available?
- In India is gold an inflation hedge?

How to wean people away from gold?

- Gold control: Tried earlier, not very successful
 - Gold smuggling
 - Hawala and fall in remittances
 - Only a temporary solution
- Gold ETFs : No solution, units backed by gold held with bullion depositories, might even increase demand for gold.
- Gold Deposits : No solution either, postpones gold purchase by the production cycle of the goldsmiths.
- Inflation linked Bonds : Retail Reach? A hedged product – is it attractive? With high inflation, cost to the issuer?
- Derivative based product : Partial return of gold, Product not for common people, with gold price likely to correct, is it attractive?

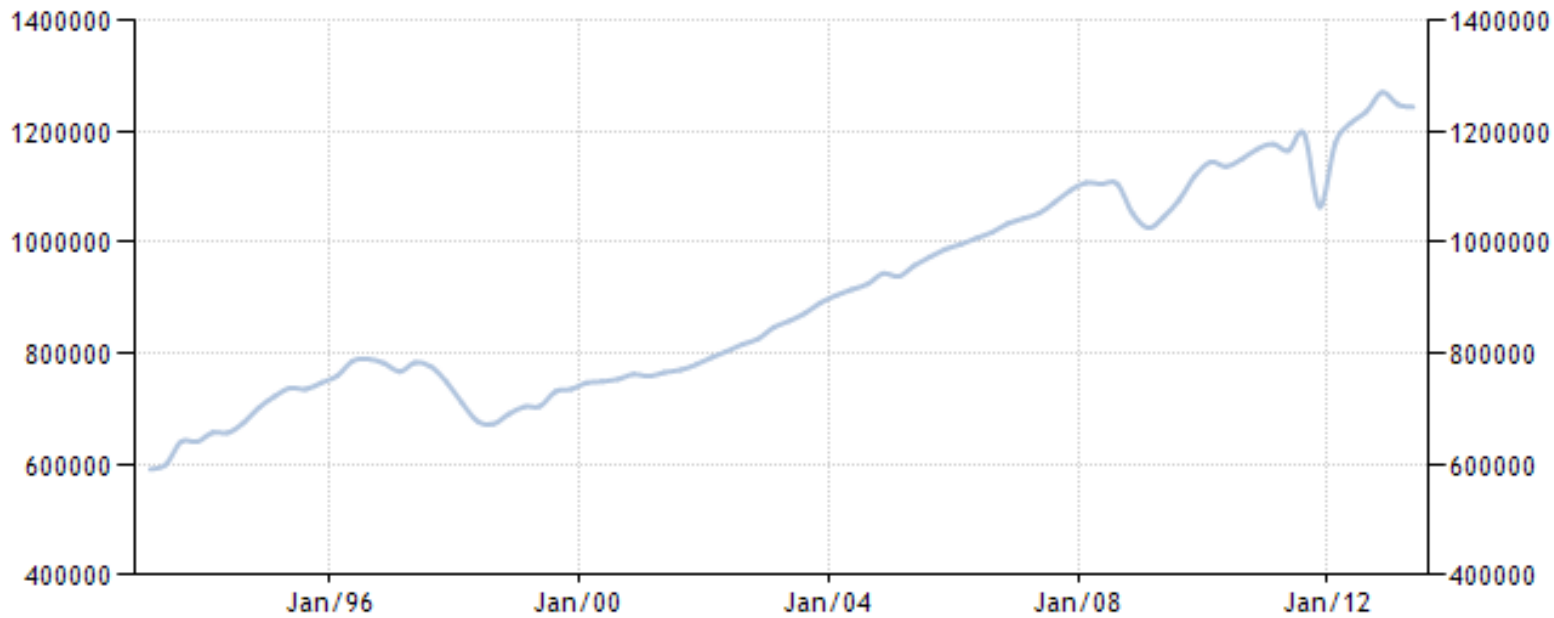
Thank You.....

World Forex Turnover



Thailand

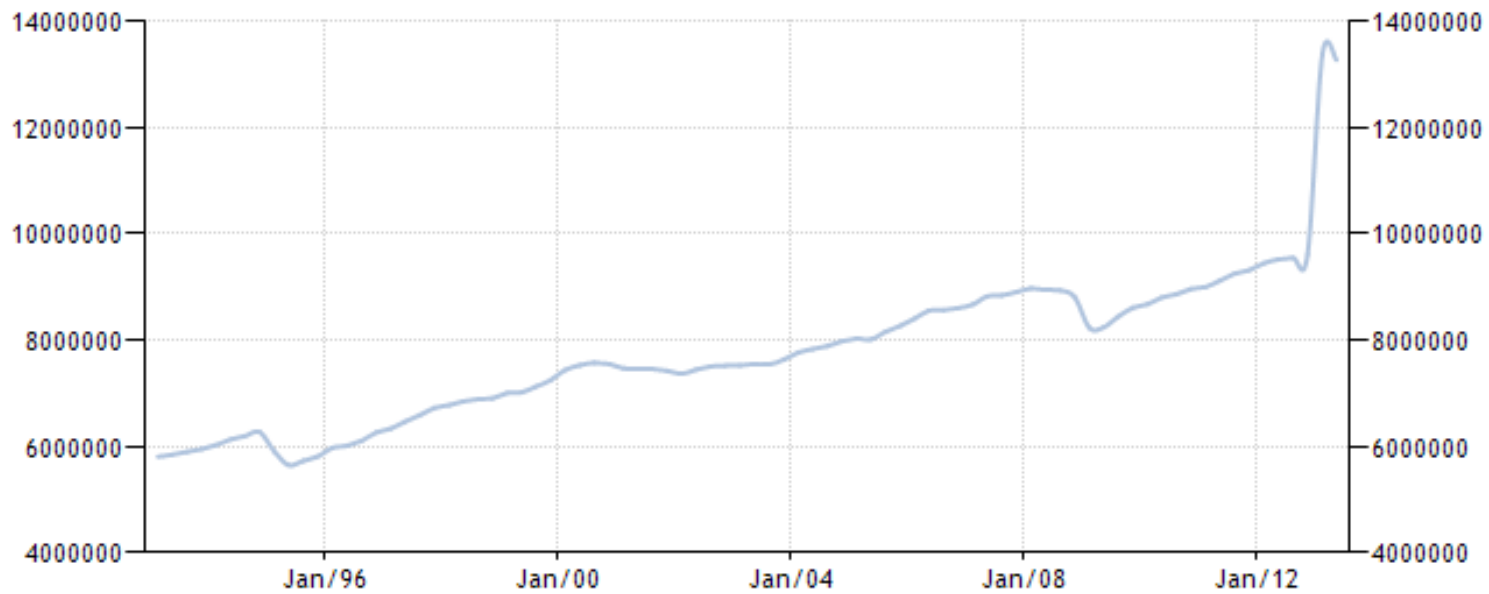
THAILAND GDP CONSTANT PRICES



SOURCE: WWW.TRADINGECONOMICS.COM | NESDB, THAILAND

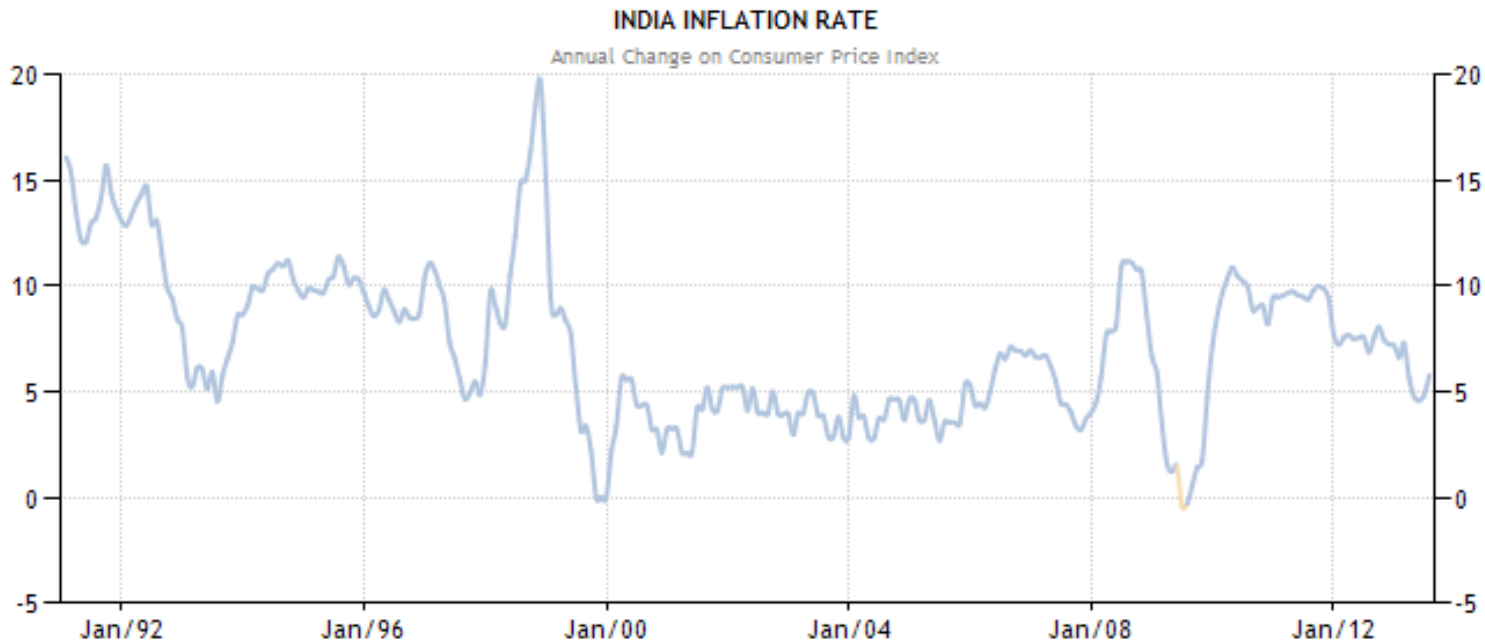
Mexico

MEXICO GDP CONSTANT PRICES



SOURCE: WWW.TRADINGECONOMICS.COM | INEGI, MEXICO

India Inflation



SOURCE: WWW.TRADINGECONOMICS.COM | MINISTRY OF COMMERCE AND INDUSTRY

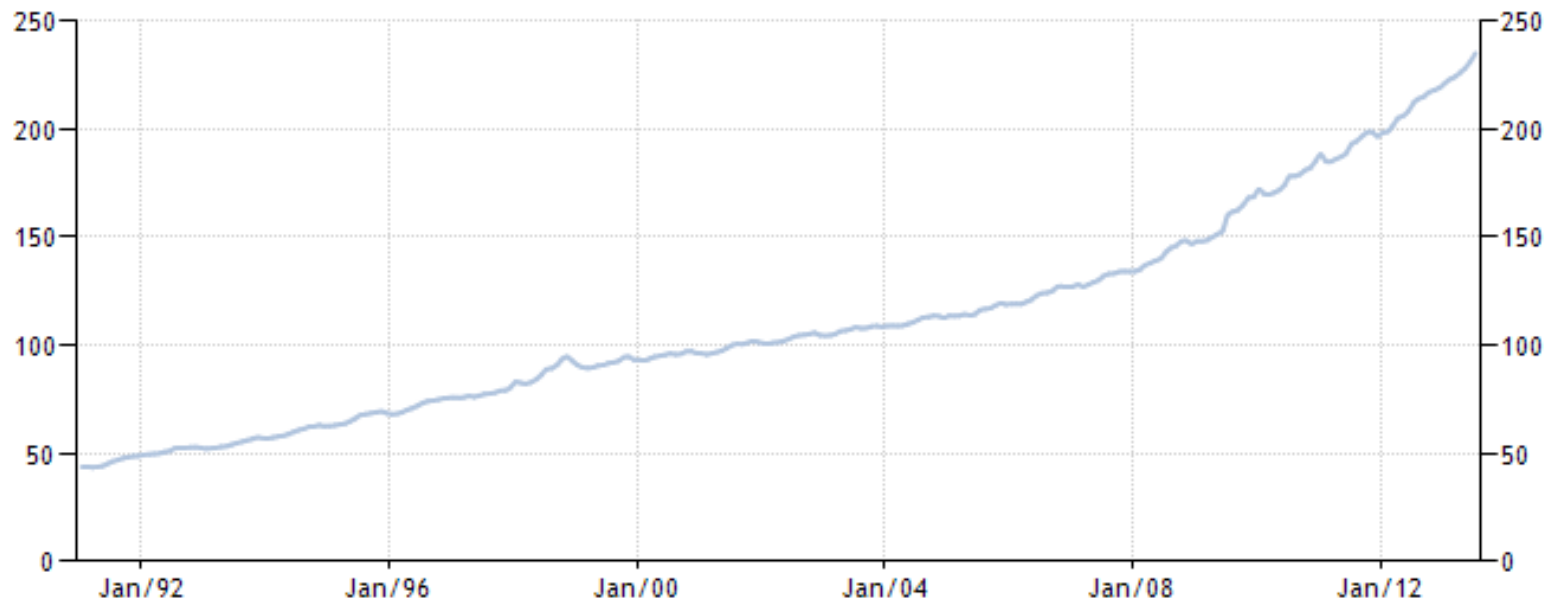
India External Debt (USD Mn)



SOURCE: WWW.TRADINGECONOMICS.COM | MINISTRY OF FINANCE, INDIA

India Inflation - CPI

INDIA CONSUMER PRICE INDEX (CPI)

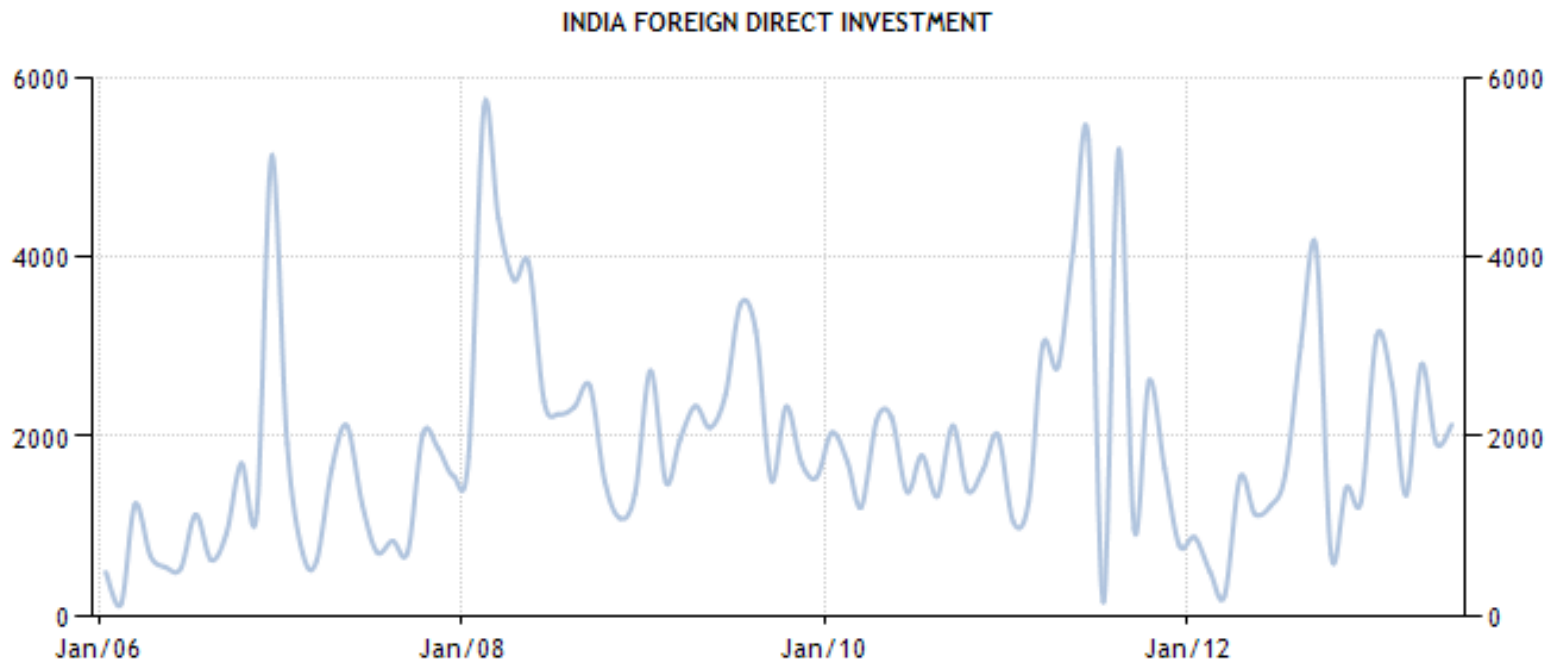


SOURCE: WWW.TRADINGECONOMICS.COM | LABOUR BUREAU, GOVERNMENT OF INDIA

India Currency

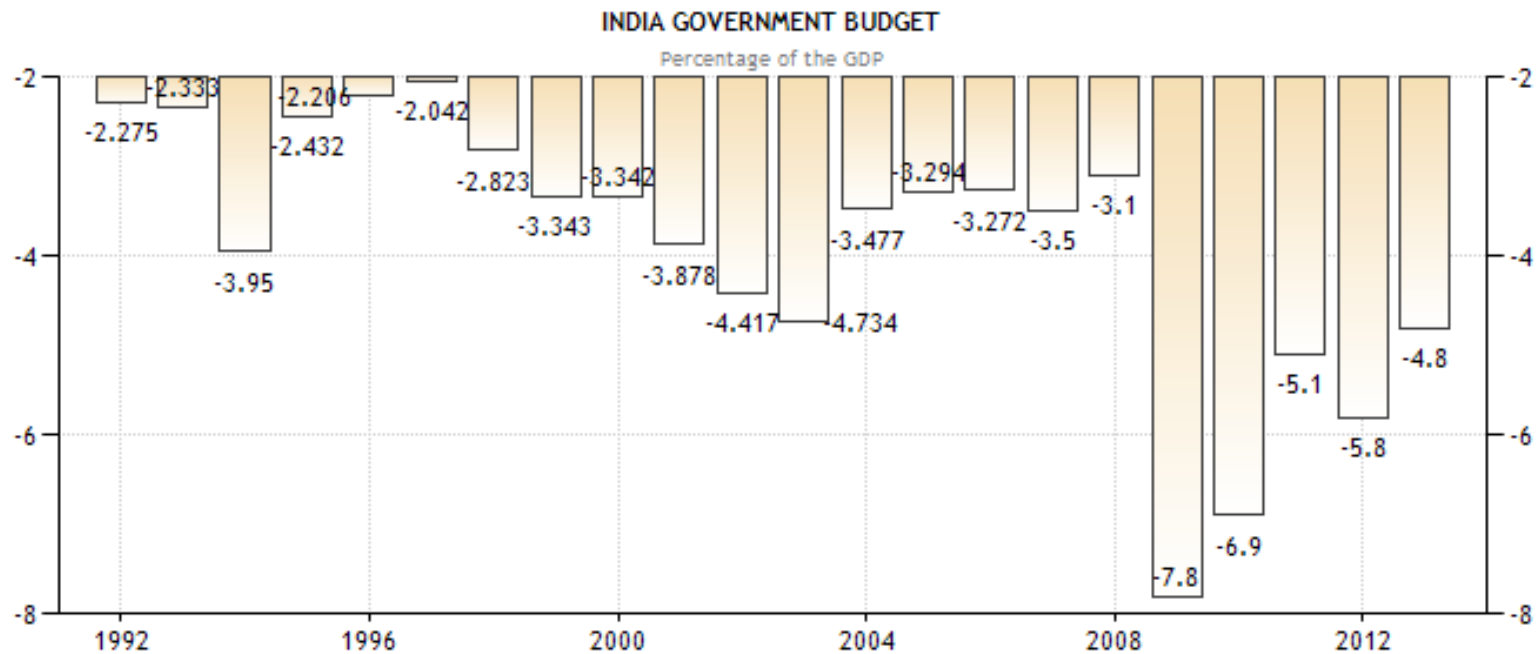


India FDI (USD MN)



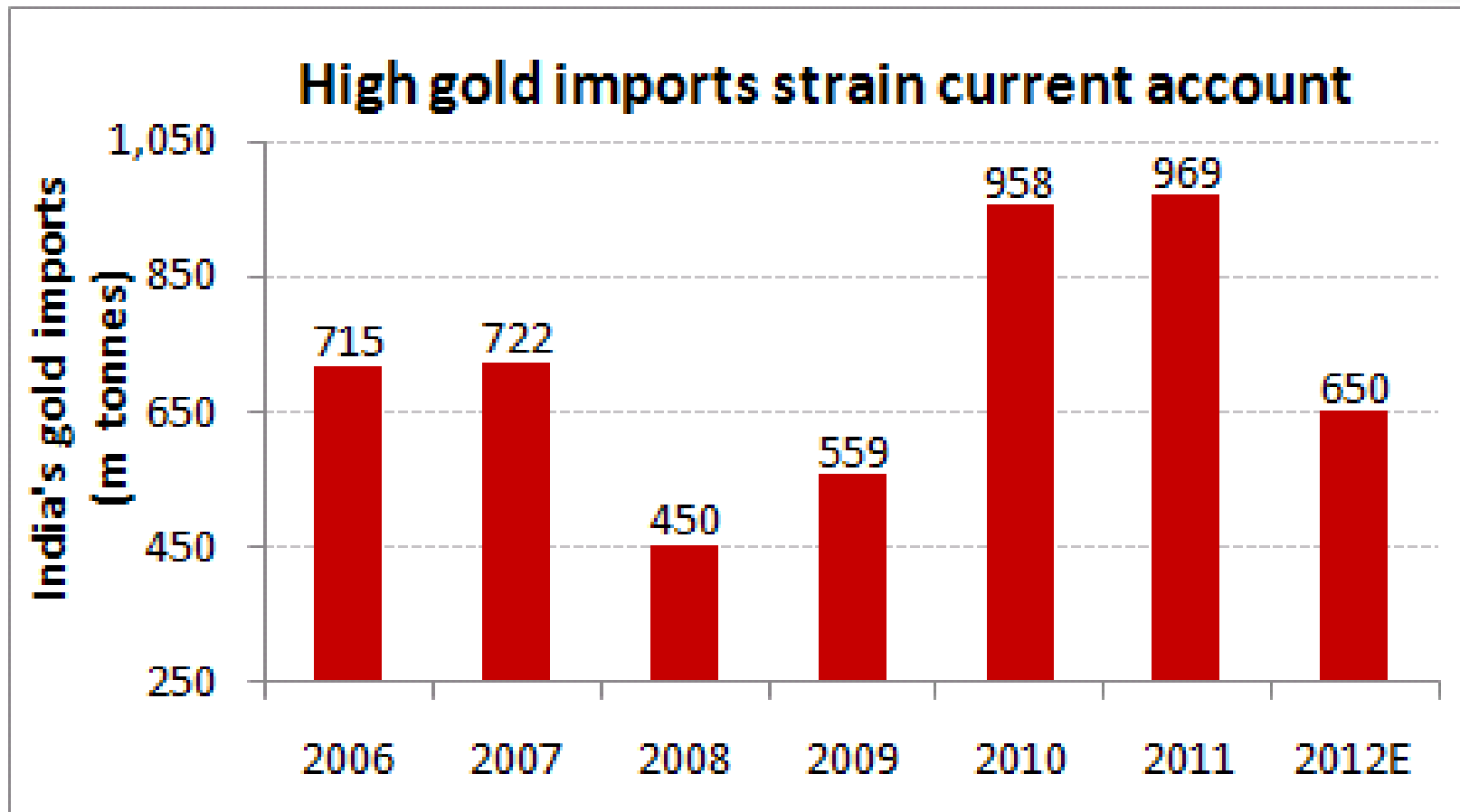
SOURCE: WWW.TRADINGECONOMICS.COM | RESERVE BANK OF INDIA

India Fiscal Deficit

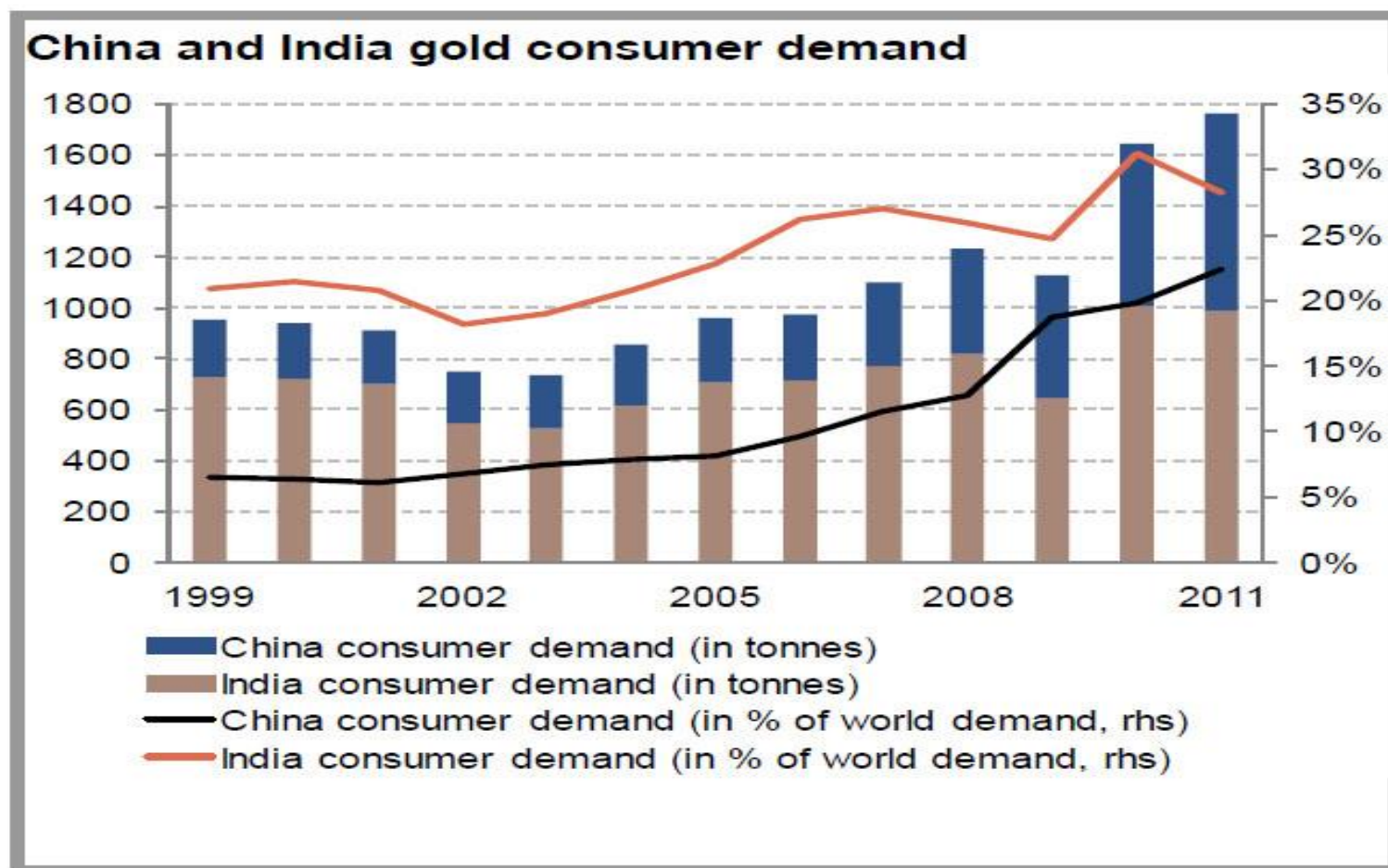


SOURCE: WWW.TRADINGECONOMICS.COM | MINISTRY OF FINANCE, GOVERNMENT OF INDIA

India Gold Imports

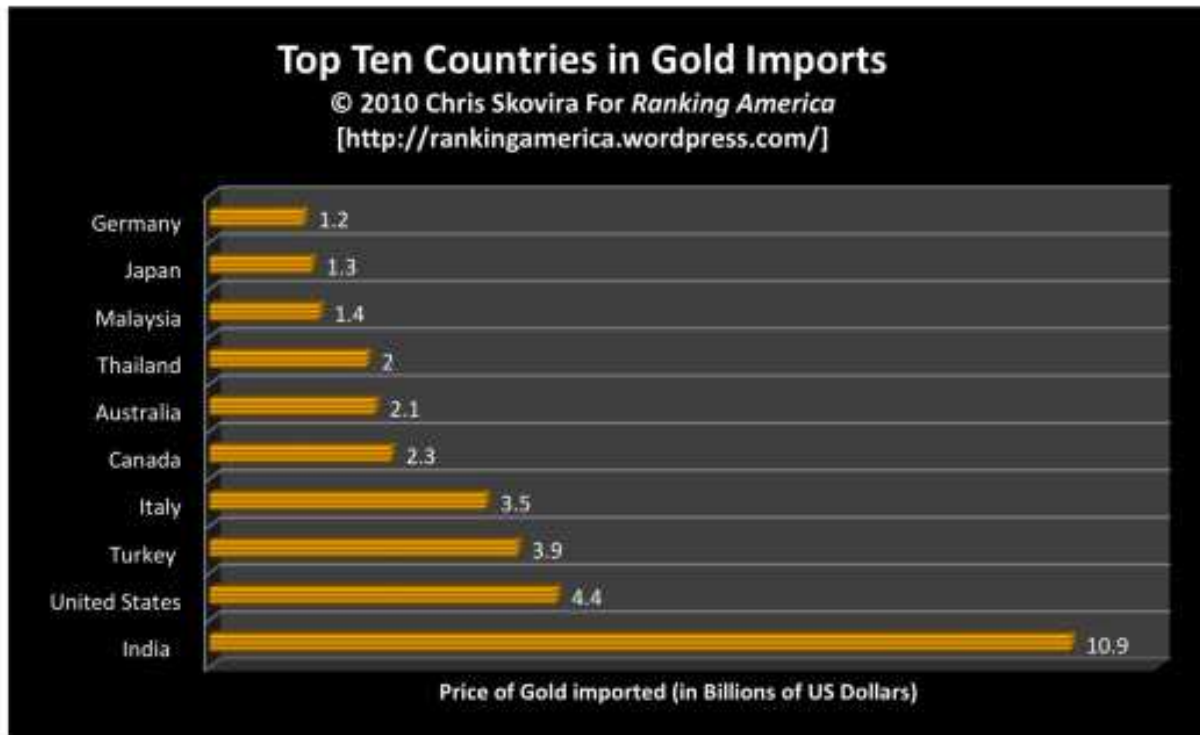


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Gold Import : Top 10 countries



Data from International Trade Centre [<http://www.intracen.org/menus/products.htm>]

Gold Price : Due for correction?

