

**NISM First Convocation 2011**

**Some Issues in Regulation and Capital Flows**

**by**

**Dr. C. Rangarajan**

**Chairman**

**Economic Advisory Council to the Prime Minister**

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# **Some Issues in Regulation and Capital Flows**

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**It gives me great pleasure to be in your midst at the first convocation of the National Institute of Securities Markets (NISM). I am told that every year about 50,000 new professionals enter the securities markets in our country. But as of now, there is no specialized curriculum in the Indian Education System to train young people for these jobs. Much of the learning is by way of on-the-job-learning.**

**It is in this context that NISM through its long-term Education programs fills an important gap in the development of the securities markets in India. Let me at the outset congratulate all of you who are graduating today. An exciting career awaits all of you. Please maintain always a professional approach with high ethical standards and by so doing you will serve the Country best.**

**The securities markets in India have made enormous progress in developing sophisticated instruments and modern market mechanisms. The key strengths of the Indian capital market include a fully automated trading system on**

**all stock exchanges, a wide range of products, an integrated platform for trading in both cash and derivatives and a nationwide network of trading. The market regulator SEBI has provided effective leadership by putting in place sound regulations in respect of intermediaries, trading mechanisms, settlement cycles, risk management, derivative trading and takeover of companies. India's market capitalization to GDP ratio has risen from levels close to low income countries to levels substantially higher than middle income countries. Market capitalization as ratio of GDP in India stood at 55.7 per cent as of 2008. The resource mobilization in the primary market has increased**

**dramatically, rising six fold between 2000 and 2010. SEBI must continue to remain active and promote a safe, transparent and efficient market. And in this task, you who are graduating today can play a facilitating role.**

## **Failure in Regulation**

**Regulation has emerged as a major concern in the wake of the international financial crisis. What stands out glaringly in the current crisis is the regulatory failure in the advanced countries. The regulatory failure was twofold. First, some parts of the financial system were either loosely regulated or were not regulated at all, a factor which led to “regulatory**

**arbitrage” with funds moving more towards the unregulated segments. Examples of ‘soft touch’ regulation were investment banks, hedge funds and rating agencies.**

**The second failure lies in the imperfect understanding of the implications of various derivative products. In one sense, derivative products are a natural corollary of financial development. They meet a felt need. However, if the derivative products become too complex to discern where the risk lies, they become a major source of concern. Rating agencies in the present crisis were irresponsible in creating a booming market in suspect derivative products. Quite**

**clearly, there was a mismatch between financial innovation and the ability of the regulators to monitor them. It is ironic that such a regulatory failure should have occurred at a time when intense discussions were being held in Basle and elsewhere to put in place a sound regulatory framework.**

## **Elements of Reformed Regulation**

**The current financial crisis has thus exposed the weaknesses of the regulatory framework in the advanced countries. There is a considerable degree of consensus on how the regulatory framework should be reshaped. Some of**

**the key elements that should be integral to a reformed regulatory structure are:**

- (1) The regulatory framework should cover all segments of the financial markets. The rigour of regulation must be uniform among all segments to avoid “regulatory arbitrage”,**
- (2) Systemically important financial institutions should receive special attention. Apart from additional regulatory obligations, such institutions may be required to conform to stricter and enhanced prudential norms. Large institutions having operations across countries may require**

**coordinated oversight of regulators of different jurisdictions. In fact, there is a proposal to prevent financial institutions, particularly banks, growing beyond a certain size so that the dilemma of “too big to fail” can be avoided.**

- (3) Institutions may be required to set up buffers in good times to be drawn down in bad times. This may entail varying capital adequacy and provisioning requirements according to the phase of the business cycle. They may be allowed to rise and fall with the business cycle.**

**(4) Excessive leverage in institutions may be contained through additional supplements to the risk based capital ratio.**

**Most countries are convinced that the reform of the regulatory structure along these lines is very much needed. However, there is no consensus on measures such as levying a generalized tax on financial transactions. There is also no consensus on whether the financial system should have a single regulator or multiple regulators. The recent experience does not provide an unique answer. U.K. which**

**had a single regulator ran into problems, while Canada which also had a single regulator did not suffer from the crisis.**

## **Regulation and Innovation**

**The financial sector today is perhaps inherently more volatile and vulnerable than before. The very factors that have contributed to the growth to the financial sector may well have contributed to increased fragility. Close inter-dependence among markets and market participants have increased the potential for adverse events to spread quickly. They have increased significantly the scope for and speed of contagion. Some question whether the new financial**

**products serve any economically useful purposes. It has been argued that much of the recent innovations in the financial system have sought to increase the short-term profitability of the financial sector rather than to increase the ability of financial markets to perform better their essential functions of managing risk and allocating capital. It would be inappropriate to classify most of the financial innovations introduced in the last few decades as useless. The financial products satisfy a certain demand. There is no argument that the regulatory system must be restructured to discourage excessive risk taking and leveraging. However a growing economy like India needs more rather than less financial**

**innovations. Too little regulation can potentially harm consumers and may encourage financial instability but too much of it can impede financial innovations which are badly needed. In short, the policy makers must strike an appropriate balance between the need for financial innovation and the need for regulation to ensure growth with stability in the real and financial markets.**

## **Capital Flows and Their Impact**

**Let me now turn to the issue of capital flows. Capital flows in general are welcome in developing economies. They all add to the productive capacity of the country. They also**

**lead to the development of financial markets. Such flows are also viewed as vehicles for the transfer of technology and management skills. In effect, international capital markets try to distribute the available world savings among countries, with countries showing high productivity growth attracting more capital. However the problem with capital flows is their size and volatility. When the capital flows are large and that too with a high degree of fluctuation, they have a bearing on macro economic stability. If capital flows are volatile or temporary, the economy will have to go through a whole adjustment process, in both the real and financial markets which later will have to be reversed. This reversal will not be**

**without cost. Even when capital flows are not 'hot' or volatile, several consequences follow. Some of these concerns include excessive money supply and the consequent pressure on prices, impact on nominal and real exchange rate, increase in consumption and possible deterioration in the current account.**

**Capital flows into a country through a variety of channels. In India, we normally classify them into four broad categories. These are Foreign Direct Investments, Portfolio Flows, Loans and NRI Deposits. Foreign direct investment includes equity investment above a particular level in Indian**

**companies. Portfolio flows are investments made by foreign institutional investors in stock market securities. Loans include borrowings by Indian entities from banks and markets abroad. NRI deposits are deposits made in Indian banks by non-resident Indians. Countries normally prefer long term and durable funds. It is from this angle foreign direct investment is the most desired form of capital flows in all countries. While portfolio flows can fluctuate from year to year, very rarely does the stock get reduced. Net negative flows during a year are uncommon. It however happened in 2008-09 in India. There is an organic link between foreign direct investment and FII channel. Foreign direct investors**

**also need some exit route. It is found that in recent years 20 to 30 per cent of the FII inflows in India have been towards the subscription of Initial Public Offerings (IPO). They thus contribute directly to increasing the productive capacity. External commercial borrowing provides an opportunity to Indian firms to take full advantage of the conditions prevailing in international capital markets. NRI deposits no longer play a dominant role.**

### **Volatility in Capital Flows**

**Capital flows can be due to a combination of “push” and “pull” factors. “Push” factors are those conditions that**

**prevail in the host country. If the investment prospects are deemed to be low or if interest rates are low in the host country, they “push” capital out. On the other hand, the “pull” factors are the conditions that prevail in the receiving countries. Capital flows to those countries which are deemed to be attractive for investment because of either high growth prospects or high profitability. Capital flows tend to be more permanent, if they are influenced by the “pull” factors.**

**Different forms of capital flows do fluctuate from year to year. It is the desire of countries to avoid volatile flows. It is**

normally assumed that FII inflows are more volatile than other forms. However, in the 1997 East Asian Crisis in the case of most of the countries affected by it, the most volatile flow was bank credit. It was the sudden withdrawal of bank credit that put many of the countries in East Asia in great difficulty. Coming back to India, some analysis has been done of FII flows in the wake of the Lehman crisis of Sept. 2008. During the month of October 2008, gross equity sale were Rs. 68310 crores. However some FIIs still felt that the outlook for investment in India was good. In that very month, FII purchases amounted to Rs. 52014 crores. Putting these together, the exit by foreigners from the Indian equity market

**in this once-in-a-century crisis was Rs. 16296 crores. Adding up across October, November and December 2008 the overall net sale by foreigners amounted to 6 per cent of their holdings at the end of Sept. 2008. Thus even in the worst scenario, the outflows have been modest.**

## **Quantum of Capital Flows**

**The position with respect to capital flows as far as emerging economies like India are concerned has changed dramatically over the last two decades. Prior to 1990-91, our major concern was to mobilize enough capital flows to finance the current account deficit. The crisis of 1991**

**exploded because of our inability to finance a current account deficit of the order of 3.1 per cent of the GDP. That position has changed. Thanks to the development of the international capital markets, today emerging economies including India are able to attract large capital inflows. While talking of the need for controls on capital flows, we should bear in mind the benefits that countries have derived as a result of the development of international capital markets.**

**From 2002 to 2007 private net financial flows to emerging market economies increased 10 fold to reach \$ 700 billion. This trend was reversed temporarily in 2008. Overall**

**net inflows to emerging market economies fell by about 75 per cent to around \$ 200 billion in 2008 but these flows have quickly rebounded since mid 2009. Net inflows to emerging Asia returned to the pre-crisis peak levels in the first 3 quarters of 2010. We see a similar pattern in India too. 2007-08 was an unusual year when there was a heavy influx of capital and the RBI added almost \$ 100 billion to the reserves. Overall capital flows fell to a single digit in 2008-09 but they have recovered in subsequent years. In 2010-11 net capital flows amounted to \$ 62 billion.**

## **Policy Options**

**When the inflows are large, there are three options open to the policymakers. The first option is to let the capital flows pass through the foreign exchange markets fully. This will have the effect of making the domestic currency appreciate, with possible adverse consequences on the country's exports. This will be particularly uncomfortable, if the country was experiencing already a current account deficit. The second option is to absorb the inflows into reserves. If unsterilised, these inflows will lead to an expansion of money supply causing prices to rise. Domestic inflation has its own implications. Apart from this, with**

prices rising, the real effective exchange rate will rise, even when nominal exchange rate remains unchanged. If sterilized, some of the consequences of the reserve accumulation can be moderated but this will imply a cost which will depend on the return on foreign exchange reserves and the cost of borrowing. One has to balance the 'self insurance' benefit of reserves with the cost. The third option is to use capital controls to restrict the inflows and to stimulate the outflows. Capital controls are not that easy to monitor. However, as a temporary measure, restrictions on some forms of capital inflows have been attempted by several countries. In fact, the response to large capital

**inflows is always in the form of a mixture of the three options. The policy makers may let the domestic currency appreciate to some extent, absorb some part of the flows into reserves and impose some controls on capital inflows. It is impossible to maintain simultaneously free capital flows, fixed exchange rate and autonomy in domestic monetary policy. One out of the three pillars has to give way.**

## **Capital Controls**

**Capital controls to check inflows take a variety of forms. One generalized instrument to check particularly short term flows has been the Tobin tax. Under this system, a small tax**

is levied on all foreign exchange transactions. In some ways this is a blunt instrument which makes no discrimination between one type of flow and another type. More importantly, it will clutter the foreign exchange market. It may also make the collection of tax itself very cumbersome. However, several countries have imposed restrictions, both price based and quantitative, on specific types of transactions. These may not be characterized as Tobin tax. Apart from direct quantitative controls, reserve requirements have been used as tools for curbing capital inflows. IMF has recently recognized that in certain specific circumstances capital controls can be imposed and these may even be deemed as

**advisable. However, IMF's advice was directed to countries which have more or less adopted full capital account convertibility. Countries like India do not fall in this category. Even with respect to foreign direct investment, we have sector specific restrictions. While external commercial borrowing has been made easier, prior sanction from the Central Bank is required beyond specified limit. FII investment in debt has also limits. The Indian scenario is thus different.**

## **Capital Flows and Current Account Deficit**

**As mentioned earlier, there has been a dramatic change in the quantum and composition of capital flows to India. In 1990-91, total capital flows amounted to \$ 7.1 billion. Almost all of this was in the form of debt. Much of it was also official. To come to a more recent period, total capital flows increased from \$ 10.8 billion in 2002-03 to 45.2 billion in 2006-07 and further to \$ 106.6 billion in 2007-08. In 2009-10, the total capital flows are estimated at \$ 53.6 billion. Looking at the composition of capital flows in 2009-10 it is seen that foreign direct investment amounted to \$ 19.7 billion. Portfolio flows stood at \$ 32.4 billion, and loans at \$ 12.2 billion. The**

**composition has definitely shifted towards non debt creating private flows.**

**To attract and retain capital flows, domestic economic policies must be deemed to be appropriate by external investors. To this extent domestic policies are subject to external oversight. However, capital flows have their own dynamics. They flow towards countries which grow fast in an environment of low inflation and modest fiscal deficit. In some ways, these are also our domestic goals. India's balance of payment position in the post liberalization period has been strong. India's current account deficit remained**

low till 2008-09. Since then, it has started climbing and the current account deficit stood at 2.8 per cent of GDP in 2009-10. In the first half of 2010-11, the current account deficit remained very high at 3.7 per cent of the GDP. However, in the second half, exports picked up strongly while import growth was weaker. It is now estimated that the current account deficit for the year as a whole was 2.6 per cent of GDP. So far we have had no problems in financing the current account deficit. Even in 2010-11, capital flows were adequate to cover current account deficit and add to the reserves \$ 15 billion. Given the current trends in the world economy and the behavior of International capital markets,

**efforts must be made to keep the CAD around the manageable level of 2.5 per cent of the GDP. This itself will mean a larger inflow of capital in absolute amount, as our GDP keeps increasing. For this reason, we need to be proactive in attracting capital flows. So long as our economy grows at a rate exceeding 8 per cent and our inflation and fiscal deficit remain at modest levels, we should not face any problem in financing the current account deficit. However, over a longer time horizon of a decade or more we should try to achieve a balance in our current account.**