Special Report 2009/02

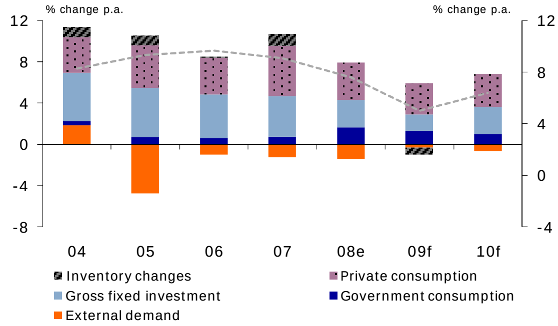
India's capital account: Open sesame

For India, the debate to fully open the capital account is a long-standing one. The Indian government has historically been reluctant to expose the economy to foreign capital. The biggest argument in favor of opening up is India's need for foreign investment to fully reach the country's widely touted potential. However, the risks of an open capital account are painfully obvious in the current global financial crisis. Foreign investors have been retracting capital out of emerging markets worldwide. To minimize that risk, India has been implementing a multitude of restrictions on foreign investment in several sectors of the economy. As a result, many view India as one of the more closed countries in Asia. This Special Report elaborates on why India needs foreign capital and demonstrates that the country has already been gradually opening the capital account. This has led to India being in fact more open than meets the eye, but still has a long way to go towards capital account liberalization.

Pros and cons of an open capital account

Several textbook examples can be mentioned regarding the advantages of an open capital account. It can promote domestic investment and growth, as a global source of funds becomes available. However, the real benefits not only entail greater funding opportunities. The indirect benefits associated with foreign capital are more important for the development of an economy. It improves macroeconomic discipline as the financial markets would penalize bad policies. Opening the capital account also implies greater competition for domestic financial institutions. Foreign banks entering the scene can increase banking system efficiency. A higher level of competition leads to a higher quality of financial intermediation. It will also stimulate financial innovation resulting in an increase of

Graph 1: Economic growth still has potential



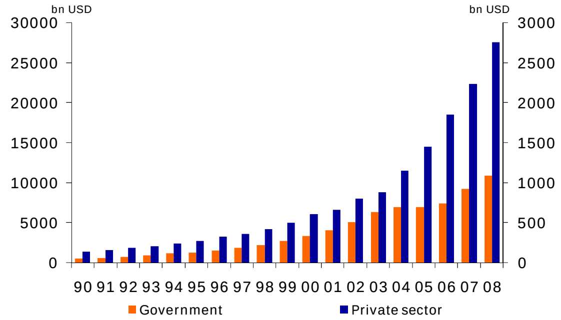
Source: EIU

the depth and breadth of financial markets. Liberalizing capital outflows also has the effect of giving domestic investors the opportunity to diversify their portfolios internationally. Disadvantages include the procyclical nature of capital flows, particularly short-term portfolio investments, which can be retracted swiftly. Such capital flows are easily misallocated, as these tend to be of a speculative nature. They tend to seek lower quality investments for higher yields and are easily withdrawn when the economy takes a turn for the worse. This will lead to a loss of macroeconomic stability and ultimately contribute nothing to long-term domestic real wealth. Additionally, entry of foreign banks can lead to cherry picking. This means foreign banks choose the most creditworthy lenders. This in turn may lead to an increase of the non-performing loans for domestic banks, since they try to counter the competition posed by foreign banks by resorting to more risky lending.

Why India needs foreign capital

India needs to further open its capital account as the economy can benefit substantially from increased long-term foreign investment. The main reason is the fact that domestic capital is allocated in an inefficient manner. Indian banks allocate capital inefficiently as they are subject to several lending directives. The first directive is intended for certain priority sectors

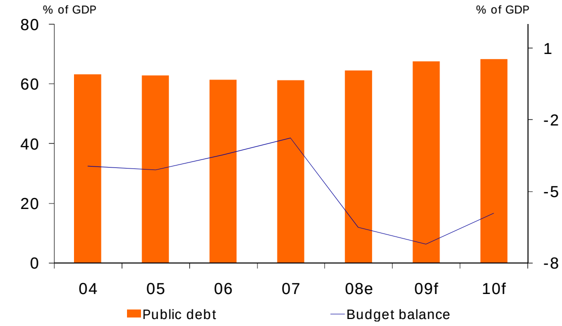
Graph 2: Claims on bank money deposits



Source: EIU

as defined by the government. The second one is directed towards the government itself.
The priority sectors as defined by the government primarily consist of agricultural firms and enterprises in the smaller segment. Despite strict lending criteria upheld by Indian banks, these loans have a high risk of becoming non-performing. Lending to these sectors means lending to low income borrowers, and a small rise in interest rates could rapidly cause defaults on debt service payments. The state-owned banks must ensure 40% of loans are directed towards these sectors. Private sector banks need to allocate 25% of loans to these priority sectors. State-owned banks control about 80% of the deposits and assets in the banking system. This implies that a very high level of capital is directed at these priority sectors.
The second directive channels bank lending to the government. The large and persistent budget deficits mean that the government regularly issues debt instruments. To secure a part of its funding, the government has made Indian banks subject to the Statutory Liquidity Ratio, (SLR). The SLR entails that banks have a legal obligation to hold 25% of their deposits in government securities. In this manner, the government is crowding out the private sector and lessens the ability for banks to act as effective intermediaries. These rules severely restrict the level of domestic credit available to Indian companies. This in turn, increases the reliance of the private sector on foreign investment.

Graph 3: Government in debt

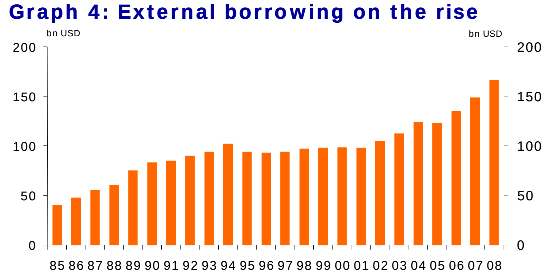


Source: EIU

A history of economic liberalization

Prior to 1991, the Indian capital account was practically closed. Direct investment was restricted and foreign equity holdings in Indian companies were not permitted. More specifically, foreign portfolio investment was channeled almost exclusively into government debt. During the 1990's, multiple economic reforms were implemented to gradually open up India's economy. Restrictions on FDI were slightly eased, Foreign Institutional Investors were allowed to invest in securities and repatriate capital and earnings since 1992. They were also gradually permitted to invest in government and corporate debt, slowly but surely leading to an increase in India's external borrowing. However, capital outflows remained restricted and tight controls remained on private external borrowing, especially short term debt.
Before 1994, the stock of foreign exchange was controlled by the government under a system of administered exchange allocations. This implied heavy restrictions on foreign

Graph 4: External borrowing on the rise



Source: EIU

currency procurement for the Indian private sector. In 1994, the economy was liberalized further by opening up the current account. This allowed Indian residents to make and receive trade related payments. That is, it was permitted to receive foreign currency for the export of goods and services and vice versa. In 1996, the government appointed the Tarapore committee to liberalize the capital account within the next three years. The timing was spectacularly bad, since the Asian crisis ensued only a year later. The Asian economies with a relatively more open capital account were hit the hardest by capital flight. Despite the rather closed capital account, India also was affected, but mostly due to a loss of export demand and a loss of confidence throughout the whole region. The recommended phased liberalization of the capital account by the Tarapore committee was put on hold. Nonetheless, it did provide for interesting conditions which India should meet to successfully open the capital account, see box 1.

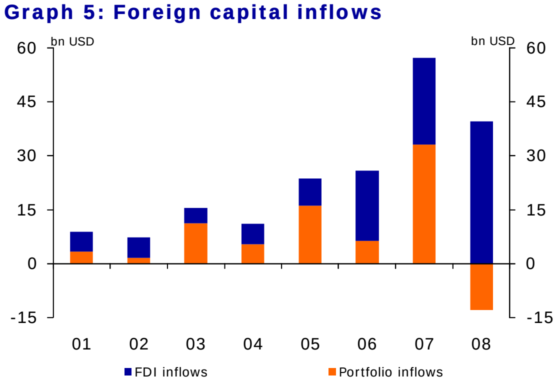
Box 1: Tarapore Committee Conditions

In 1996, a committee was set up by the Reserve Bank of India (RBI), under the chairmanship of former RBI deputy governor S.S. Tarapore. The committee set up a framework indicating the conditions for successfully opening the capital account. The first condition entails that the gross fiscal deficit should be less than 3.5% of GDP, which makes sense as fiscal discipline has to be established first. This to make sure that capital inflows are not used as an easy way to maintain a lack of fiscal discipline. Should the capital markets decide to discontinue financing these deficits; the result will ultimately be a crisis. Second, inflation should be within the 3-6% band, and inflation targeting should be the key policy of the Reserve Bank of India. Thirdly, there should be at least six months of import cover. And ultimately, the commercial banking system needed to be cleaned up by reducing the ratio of non-performing loans to below 5%. A healthier banking system exudes more confidence for foreign investors. More specifically, that capital outflows would be used for a profitable investment, instead of banks just borrowing more solely to postpone bankruptcy. Although the report was put in the freezer due to the Asian crisis, the committee did provide a sound framework for successfully opening the capital account.

Current state of the capital account

In its present state, the capital account is only partially open. A foreign investment limit of USD 15bn is maintained for private sector external borrowing and caps on foreign investment per sector still exist. Via a slew of complicated regulations, the government has been gradually opening the capital account. This has resulted in an increase in foreign capital inflows, see graph 5. Only in 2008 portfolio investment recorded an outflow as a result of the global financial crisis. However, this has not resulted in an outflow of FDI FDI inflows actually increased, mostly a consequence of easing regulations. The regulations are rather ineffective when considering that the foreign investment limits can be circumvented via other regulations. The Foreign Investment Promotion Board (FIPD) is charged with setting limits on FDI in different business sectors. As these regulations have been relaxed over the years, India seems as open as any other emerging economy in sectors

Graph 5: Foreign capital inflows



Source: EIU

such as manufacturing, ICT, and several financial services such as asset management and stock broking. However, in most sectors caps on foreign investment still exist, in particular those deemed as strategic, such as defence, the aviation industry and in state-owned petrol companies.
In February 2009, the FIPD amended the way FDI is counted to allow more foreign investment into the country. The measure actually gives foreign investors a loophole to breach the sectoral FDI limits. The new regulation implies foreign investment coming via a holding company which is majority owned by Indians will not count as FDI. For example, suppose a foreign company forms a joint venture with an Indian company with the ratio of 49:51, and this joint venture then invests in an Indian telecom company. Before the amendment, this investment would count as FDI. But since the majority of the joint venture is Indian owned, this is no longer considered FDI, but is viewed as domestic capital. This gives Indian businesses an opportunity to attract more foreign capital without being constrained by the current FDI limits. This example illustrates that the Indian economy is more open than it seems.

Conclusion

India officially does not have a fully open capital account, but its economy is more open to foreign capital flows than meets the eye. Directly and indirectly, limited foreign investment is allowed in most business sectors. This has led to an increase of foreign capital into the country. As the government does recognize the domestic financing constraints for the private sector, it has further relaxed the rules regarding foreign investment. At present, the import cover condition as stated in the Tarapore committee report has been met. The average NPL ratio for Indian banks was a mere 1% in 2008, according to central bank statistics. This is well below the 5% benchmark, however these statistics are confusing and definitions used when calculation these statistics can be interpreted in different ways. Inflation has fallen even beneath the 3-6% band, but only of late. The budget deficit for fiscal year 2008/2009 is recorded at 7.8%, way above the 3.5% recommendation. As both the global and domestic economy are in a bad shape, a further opening of the capital account now would not be the smartest of ideas. When the external macroeconomic environment has stabilized, the focus can turn to preparing the economy for a higher level of openness. First and foremost, a more transparent and simpler regulatory framework concerning foreign investment, further financial sector reform, and greater fiscal discipline are required to successfully open the capital account.

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