India's experience with capital flows
Paper outline

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1 Introduction

Will be: *Self-contained 1000-word summary of the paper.*

2 Questions

In the early 1990s, important changes took place in Indian economic policy. These included the onset of a 'market determined exchange rate', entry of foreign investors, and greater trade liberalisation.

India has grappled with new questions about the currency regime, which did not arise when the exchange rate was set by the government [Patnaik, 2003]. Broadly speaking, the currency regime has been a crawling peg to the USD, barring isolated periods of greater currency flexibiilty.

Capital controls been steadily eased. Initially, there was a limited easing of constraints on inward portfolio investment and FDI. Over the last decade, these constraints have been steadily eased. Foreign investment in the domestic debt market has also commenced. Easing of restrictions against outward flows has begun. Trade liberalisation [**?**] has led to a higher measures of openness on the current account, which are generally associated with *de facto* openness on the capital account, by easing the evasion of capital controls.

In terms of capital controls, India is in an intermediate regime where there is a complex system of capital controls, with inconsistent rules governing different institutional mechanisms. The government exercises powers, reminiscent of industrial policy, in favouring or disfavouring alternative technologies of financial intermediation through rules about capital flows. For example, banks are favoured through generous flexibility in offshore borrowing, while other kinds of debt inflows are sharply constrained. At the same time, the *interest rate* at which banks engage in offshore borrowing are prescribed by the banking regulator (the central bank).

Through these changes, net capital flows have not grown sharply, when expressed as per cent to GDP. This paper argues that the economic significance of foreign capital flows has greatly risen, even though it appears that net capital flows have not grown relative to GDP.

This paper seeks to understand the composition, the factors affecting capital flows, and the consequences of capital inflows in India, over the last decade. We propose to explore the following questions:

- What is the nature of the regime of capital controls in India, and how has it evolved over the last decade?
- How has the structure of capital flows evolved, between banking flows, portfolio flows, and external securities issuance by firms?
- What was the role of currency expectations in influencing fluctuations of capital flows?
- What has been India's experience with the impossible trinity?

3 Currency controls and their evolution

This section will:

1. Document capital controls,
2. Describe the evolution of policy,
3. Offer some insights into the motivations and compulsions faced by policy makers.

4 Structure of capital flows

This section will:

1. Highlight the differential rules that affect alternative channels: banking flows, portfolio flows, FDI.
2. Document the changing composition of capital flows.
3. Analyse the extent to which capital flows have shifted from more-controlled channels to less-controlled channels.

5 Currency expectations and capital flows

This section will draw upon previous work which has proposed a unique high frequency measure of currency expectations, and attempt to use this for understanding the influence of currency expectations upon capital flows.

6 Interplay of pegging, capital flows and monetary policy

India is neither a fully closed nor a fully open capital account . It is thus an interesting grey area where the impossible trinity does not narrowly hold [Patnaik, 2004]. Fluctuations in capital flows have had important consequences for domestic monetary policy owing to the pegged currency regime.

References

Ila Patnaik. India's policy stance on reserves and the currency. Technical report, ICRIER Working Paper No 108, 2003.

Ila Patnaik. India's experience with the implemention of a pegged exchange rate. Technical report, NCAER, 2004.