REVIEWING CAPITAL CONTROLS

A more open financial sector is necessary for global economic recovery, says DEEPAK LAL

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RECENTLY, there has been much lamentation about the US Fed's policy of quantitative easing (QE), which has led to a decline in the dollar and sparked fears of global inflation. China has been vociferous in condemning QE2 since it rightly fears that this might be the first sign of its largest debtor taking the time-honoured route towards the euthanasia of its rentier. It has argued unsuccessfully for an alternative reserve currency to replace the dollar, and has even talked of the renminbi becoming a key currency. The International Monetary Fund is reconsidering its opposition to capital controls to deal with "hot money". Brazil, which recently adopted capital controls to slow these down, has given up owing to their ostensible failure, and has now joined the chorus of voices condemning China for running large current account surpluses and not appreciating the renminbi sufficiently to reduce them. The continuing "global imbalances" are perceived to be on the way to generating another global financial crisis.

In India, concerns are being raised about its seemingly large current account deficits, and official reluctance remains to end capital controls, making the rupee fully convertible. Meanwhile, the eurozone, with its fixed exchange rate, is imploding even as the contradictions of a monetary union without fiscal and political union become clear. How should one make sense of all these contradictory themes in the current global macro policy environment?

To think clearly on these issues, some elementary economic concepts need to be kept in mind. First, the current account deficit is by definition the difference between a country's savings and investments, matched as a matter of accounting by equivalent net inflows or outflows on the capital account of the balance of payments. Current account deficit worries are, therefore, about the size of the capital inflows, which, *ceteris paribus,* will supplement domestic investment and raise it above what could be financed by domestic savings. This should raise growth rates, if the investment is productively employed. It clearly was not the case in the US, where the inflows primarily went to finance the politically-determined entitlements in the sub-prime housing market to Ninjas (borrowers with no income, no job and no assets). But, in India, which has vast infrastructure investment needs, capital inflows would be productive and the size of the corresponding current account deficit should not be a matter of concern to policy makers.

Second, it follows that the purported "global imbalances" are also not of any public policy concern. They may concern Chinese citizens since the build-up of reserves based on China's current account surpluses represents the state's chosen deployment of a large part of Chinese savings. This has meant that since China adopted its state-led capitalist model after the Tiananmen incident, growth of per capita personal income accruing to households between 1989 and 2002 was only 5.4 per cent per annum, while per capita GDP growth was 8.1 per cent per annum. The difference was appropriated by the state through its continuing financial repression (*Rethinking the Beijing Consensus, Asia Policy 11,* Y Huang).

Third, a free floating exchange rate remains the ideal means of balancing the changing trade and capital flows in an integrated world economy. India's adoption of a flexible managed float allowed the "sudden stop" of foreign portfolio investment in the global financial crisis to be smoothly accommodated by the flexible exchange rate.

Fourth, linked to this is the fact that fixing the *nominal* exchange rate cannot fix the *real* exchange rate (the relative price of non-traded to traded goods), which is relevant for resource allocation and the price level. Fixing the nominal exchange rate leads with a capital inflow to an unavoidable rise in the real exchange rate, occurring entirely through a rise in the price of non-traded goods and the price level. The nominal appreciation of the rupee has, thus, dampened any inflationary pressures from any required real appreciation.

Fifth, an appreciation of the exchange rate with capital inflows will necessarily lead to a relative increase in the price of non-traded goods, and thence to their relative profitability. This implies a boost to infrastructure, which is wholly desirable for India. The worry that this damages tradeables is misplaced. This is particularly because the distortions in the labour market, such as switching of expenditure to infrastructure and non-traded services, would benefit unorganised sector labour.

Sixth, the ideal free floating exchange rate regime (which, like the fixed exchange regime, is non-discretionary) requires full currency convertibility without any capital controls. A managed float with capital controls is less efficient, since it requires the authorities to take a view on the "correct" exchange rate when confronted with constant shocks to the macro economy. When in India there are not even index-linked bonds to judge changing inflation expectations, for instance, the requisite information to bureaucratically manage a flexible rate efficiently is unavailable.

Finally, a free floating exchange rate allows domestic monetary policy some independence in an integrated world economy. Ideally, this should be based on an inflation target implemented by an independent central bank, following some equivalent of the "Taylor rule".

Given these simple precepts, should the world complain about US' QE2? It is arguable if this is in the US' interest, at a time when politics continues to dictate a loose fiscal policy. But with continuing low inflation expectations it may be justified. However, there is no reason for the rest of the world to complain. With a free floating exchange rate and an independent monetary policy, the import of US-generated inflation could be tamed by tightening money and allowing currency appreciation, as Australia has successfully done during the mineral boom and the yen-Australian dollar carry trade.

Nor are Chinese hopes that the renminbi can replace the dollar as the world's reserve currency likely to be fulfilled. Unlike the US, China is a financially repressed economy where the "rule of law" does not rule. In the grave uncertain times of the global financial crisis, the US provided a safe haven, with investors flocking to buy US bonds, not to China. Moreover, for a convertible currency China would have to end capital controls and financial repression. If India ends capital controls, opens up its capital market and promotes Mumbai or the National Capital Region as a financial centre, while maintaining sound monetary and fiscal policies, it has a much better chance of making the rupee a reserve currency.