Regulatory framework for foreign capital flows to India

Ila Patnaik

NIPFP, January 2007

Part I

Framework of Capital controls

Game plan of early 1990s

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- Debt flows are bad,
- Let's open up to equity flows (FDI + Portfolio flows).

Part II

Facts about India's financial integration

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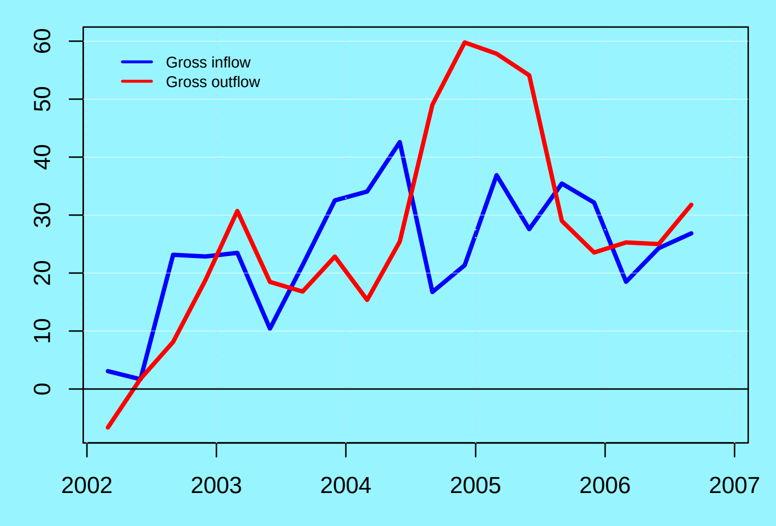
Capital flows through the current account

The current account offers scope for movement of capital.

Growth of current account



Growth of net capital inflows

Part III

FDI

Rules on FDI

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- Increasingly opened up to outbound FDI also.

FDI limits

Sector	Limit on foreign ownership (per cent)
Retail, Plantations, Real estate.	0
Broadcasting	20 / 49
Defence	26
Insurance	26
Petroleum refining	26
Airlines	49
Oil and gas pipelines	51
Trading	51
Petroleum exploration	51 to 100
Petroleum distribution	74
Mining for diamonds, precious stones	74
Coal mining	74
Telecom	74
Banking	74
Advertising	74
Airports	74/100
All other areas	100

Part IV

Portfolio flows

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- Starting to allow some outbound portfolio flows (institutional only).

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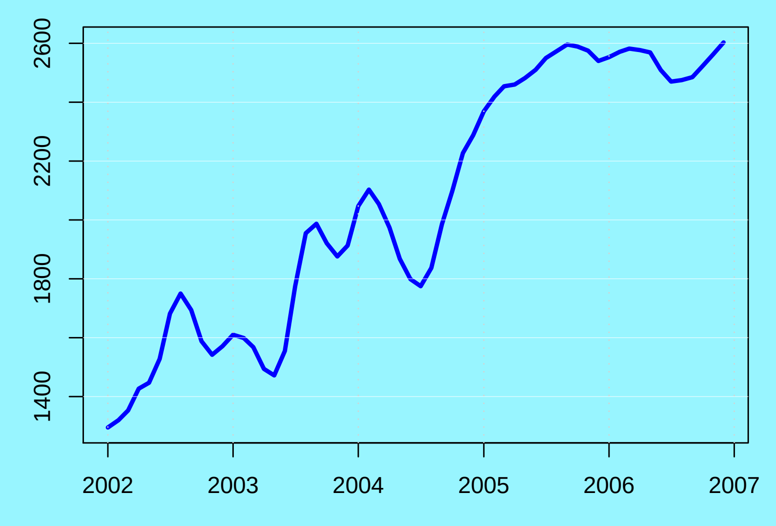
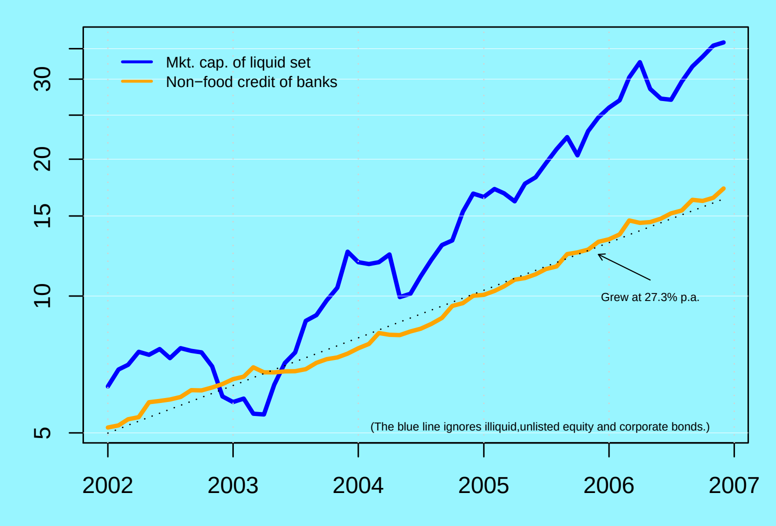
- Efforts on corporate governance.

Number of firms with trading frequency $> 66\%$



Importance of equity in firm financing



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- By 1997, domestic equity market reforms had made substantial progress.

But liquidity did not migrate to offshore trading venues

GDR/ADR issuance (million USD)

Year	Issuance	Year	Issuance
1992-93	240	1997-98	645
1993-94	1,520	1998-99	270
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- From 1997-98 onwards, ADR/GDR issuance didn't exceeded $1 billion a year.
- GDR/ADR liquidity tends to fade after issue date owing to conversion into the underlying shares. Time-zone problems. Local speculators.

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- Substantial portfolio flows: \$9.56 billion of net equity inflows in calendar 2005.

India's experience

	FII ownership		Number of firms				
Year	(%)	(Rs. Trn)	None	Low	Med.	High	Total
2001	8.5	0.45	670	121	93	184	1071
2002	8.1	0.52	733	126	76	156	1097
2003	6.9	0.44	768	117	67	154	1112
2004	10.1	1.20	663	131	93	235	1127
2005	11.1	1.83	522	185	119	332	1162

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- Domination of FDI is found in countries with the weakest institutions.

Part V

Debt

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- "NRI deposits".

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- By official classification: External debt of GOI stagnated at $45 billion over 1998-2005.
  "Contingent liability" has dropped from $10.6 billion in 1994 to $6.6 billion in 2004.

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- Para-statals like SBI

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Re-classified debt stock

	1991	2001	2005
Stock of debt (Billion USD)			
Sovereign debt	47.29	43.31	44.51
Quasi-sovereign debt	16.67	33.41	44.34
Private debt	19.84	24.61	34.46
Total debt	83.80	101.33	123.31
Ratios (in percent)			
Sovereign + quasi-sovereign debt to total debt	76.33	75.72	72.06
Private debt to total debt	23.67	24.28	27.94
Sovereign and quasi sovereign debt to GDP	22.	19.	14.
Private debt to GDP	7.	6.	5.

Part VI

Capital outflows

Outward capital flows

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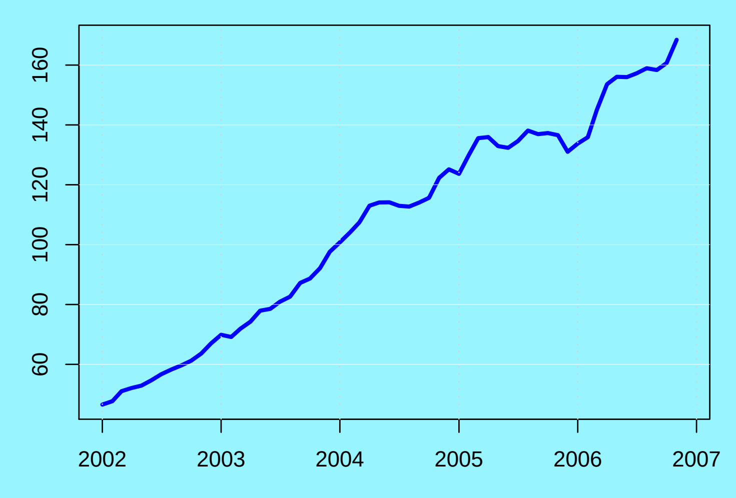
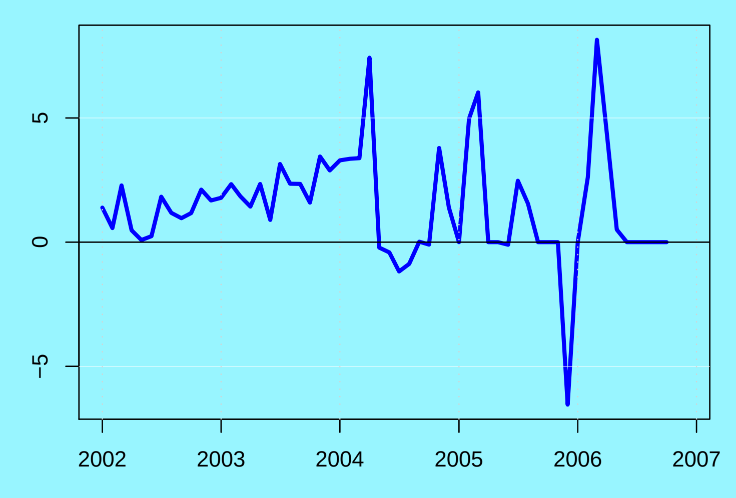
- Outbound FDI

Foreign exchange reserves



Net purchase of dollars



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- More than 300 Indian firms have invested abroad in each of these two years.

Part VII

Summary of capital controls

Current account

There are no current account restrictions, other than the limit upon individuals of purchasing no more than $10,000 per year for the purpose of foreign travel.

Outward flows by individuals

Individuals are limited to taking \$50,000 per year out of the country.

Outward flows by firms

Firms are limited to taking capital out of the country which is equal to their net worth.

Borrowing by firms

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- Borrowing upto $500 million by a firm for certain specified end-uses is allowed without requiring permissions.
- There is a ceiling whereby approvals for borrowing by all firms (put together), in a year, should not exceed $9 billion per year.

Borrowing by banks

The central bank controls the interest rate at which banks borrow from foreigners through “nonresident deposits”.

Restrictions on foreign investors

Only “foreign institutional investors” are permitted to invest in the country.

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- The total corporate bond ownership by all foreign investors cannot exceed $1.5 billion.

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- Firms are free to issue GDRs/ADRs outside the country, which can be sold to a broad swathe of global investors.

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- Foreign companies require approval of the first firm they chose to do a joint venture with in the country, if they wish to start a related business.

Part VIII

Looking forward

The capital account is fairly open

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- More importantly, gross flows on the current account doubled in the last 2.5 years.

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- Political cost of running the wrong monetary policy.

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- E.g. on FII: Shut down access products, restrict new "sub-accounts", block hedge funds, consider a Tobin tax or Chilean-style tax.
- Unlikely in a globalising world.

Set course for floating rate

- Start currency futures market

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Set course for floating rate

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- Recover monetary policy autonomy.
- Remove capital controls.

Thank you.