

Managing Capital Flow

What is capital flow?

Capital flow in an economy means the net capital movement in the economy i.e. the total capital flowing into the economy and going out of the economy. Capital flows into the economy when the economy is chugging along well. Investors get interested in the assets of such an economy and start investing in them.

International purchases and sales of existing real and financial assets are recorded in the capital account of a country's balance of payments.

- ▶▶ Real assets include production facilities, capital goods and real estate
- ▶▶ Financial assets include stocks, bonds, loans, etc.



Capital flows affect capital accounts

At a given exchange rate, a country often will want to collectively purchase more goods, services and assets than the rest of the world will buy from it. Such an imbalance is called a balance of payments deficit.

A country is said to have a deficit in its capital account if it is purchasing more assets and/or taking more loans from and owes money to the rest of the world than it is receiving.

For example, a country, like Japan, with a capital account deficit is also said to experience a capital outflow or flight of capital from Japan.

Conversely, a country is said to have a surplus in the capital account—or a capital inflow—if the rest of the world owes money to that country as is the case with the United States which is a net exporter.

Just as individuals must avoid borrowing excessively, policymakers must make sure that their country as a whole borrows less and lends more from the rest of the world.

Why manage inflows then?

A. Short Term money:

Hot money is the term used for money which can come in a gush and exit out of the system at the same pace. In emerging economies where growth rate is much higher compared to developed economies there is always flood

CAPITAL ACCOUNT

Capital account transactions often are classified into portfolio investment and direct investment.

- Portfolio investment encompasses trade in securities like stocks, bonds, bank loans, derivatives etc.

E.g. – When U.S. investors buy Indian government bonds, this is portfolio investment.

- Direct investment involves purchase of real estate, production facilities, or equity investment.

E.g. - If German Corporation, BMW, builds an automobile factory in New Delhi this is direct investment.

of money coming into tap this growth and gain exuberant returns. But in this process many times the money that comes in, captures instant returns and moves out quickly damaging the economy in the process. This short term money triggers surge in the asset price (e.g. shares of a company) and once it captures the returns and moves out there is a sudden jolt in this asset price. Hence in order to avoid such a scenario one needs to control this flow.

1. For instance, SEBI has stopped capital inflows by means of PN route into our capital markets due to
 - a. Short-term nature of the money having the potential to destabilize the economy.

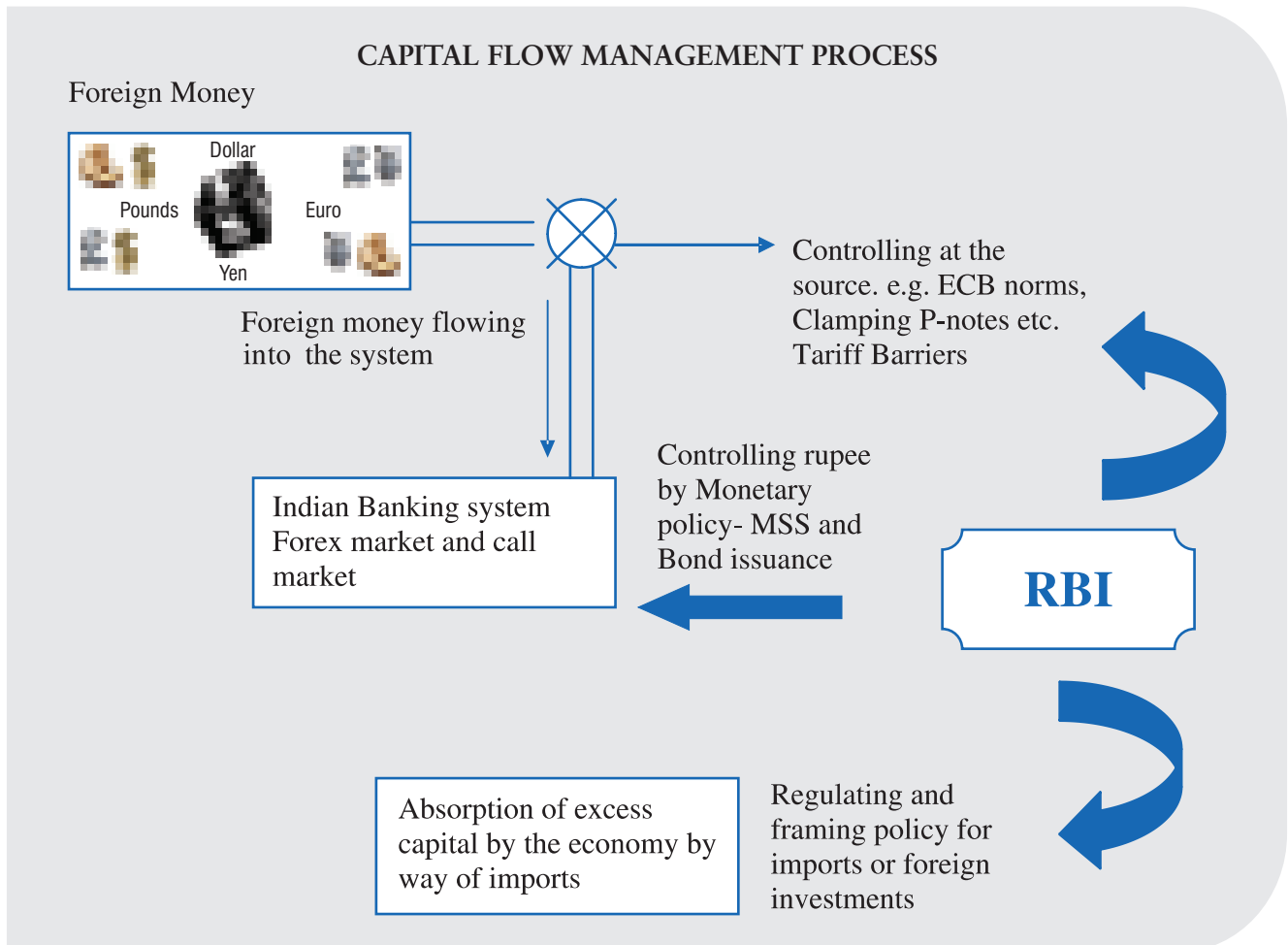
- b. Unknown source of money

2. **Manage using tariff barriers:** Governments can propose changes in tax laws regulate the capital that enters the economy. Increase in capital gains taxes on assets can limit hot money from entering. Those who seek a quick gain from asset appreciation will desist from active participation due to these taxes.

Another method would be a Fixed Deposit by the foreign entity to ensure that the money will not vanish overnight.

B. Appreciation of currency and Inflation:

In any country, the law prescribes that all financial transactions should be done in the country's own currency.



Hence foreign investors need to buy Indian rupee from the forex market before they can invest here. The increase in demand for the Indian rupee makes it dearer for borrowers and its value appreciates vis a vis the currency of the borrowing country (in the current scenario, we are referring to the US dollar). However, since exporters sell their goods in US dollars, it implies that due to this appreciation on conversion their rupee earnings decrease. Hence exporters like IT, Textile, BPO get affected.

Hence capital inflow has to be managed and there are several methods to enable efficient management.

1. Efficient absorption by the economy:

It is prudent to use the huge capital inflows emerging economies are witnessing in developing the economy as a whole. Some mechanism should be put in place so that effective and efficient utilization of these capital inflows is done.

In India the government has been devising various reforms and policies in order to give proper vent to the foreign capital and curb accumulation that are fuelling Indian stock markets to dizzying heights.

In the spirit of giving proper channel to these foreign inflows, government has kept no cap FDI in NBFC's (Non banking finance companies). Moving ahead we might see more reforms of this kind taking shape to utilize the monies efficiently.

2. Sterilization of excess dollars:

The government, in order to avoid rupee appreciation can start creating artificial demand for the dollars in the system by printing more rupees and exchanging the same for the additional dollars flowing in. However, this causes inflation as more rupees chase the same amount of goods in the economy.

Another method of sterilization by the government (RBI) is by releasing bonds. Bonds do not fuel inflation in the short term because they represent future money. However, there is a cost to this exercise due to the interest that has to be borne by the bonds on maturity.

3. ECB Controls:

Another method adopted is through tightening of the ECB (External Commercial Borrowing) limits. ECBs are loans raised in foreign currency by Indian companies interested in imports. ECBs allow them to supplement domestically available resources and to take advantage of lower international interest rates. Since additional dollars in the system by this route will further strengthen the rupee, the Govt. has set limits and conditions to this borrowing.

One of the methods being prescribed is to park the money in the country of borrowing and thereafter deploy it without bringing the money into the country.