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Top Stories

PNs: Knee-jerk reactions erode policy credibility

D.Murali

Chennai: Controls on capital flows cannot be a substitute for sound macroeconomic policy including reform of the monetary policy framework, says Mr Ramkishan S. Rajan, Associate Professor of International Economics, School of Public Policy, George Mason University, Virginia, US.

Reacting to the recent moves concerning PNs (participatory notes), he argues, "What the market does not need is further government-induced turmoil via piecemeal approaches and knee jerk reactions, which will surely erode the credibility of policy makers and regulators."

While the proposed curbs on the issuance of PNs with underlying derivatives as well as restrictions on PNs with underlying shares caused a sharp sell off on the equity markets, his opinion is that the market was looking for "any reason to climb down from its unprecedented heights."

So, if not the proposals in the SEBI (Securities and Exchange Board of India) consultation paper, "the ongoing US sub prime issues, anniversary of October 1997 global equity market crash, ongoing political uncertainties with the on again-off again US nuclear deal, or something else could just as easily have led to a reversal of the ongoing bull run," adds Mr Rajan, during the course of an e-mail interaction with Business Line.

Of more concern than the actual decline in the Indian bourses has been the policy confusion surrounding the new SEBI proposals, he observes.

Excerpts from the interview.

How justifiable are the new clamps?

Two reasons have been suggested for the reasons behind the new policy, viz. regulatory concerns and macroeconomic management in the wake of massive capital inflows.

The regulatory concerns are genuine in view of the anonymity afforded by the PNs. From the perspective of "know-your-customer" or KYC norms, it may make sense for the SEBI to be concerned about sources of capital inflows.

However, what the SEBI should have done was to simultaneously put in place/announce procedures to hasten the process of FII (foreign institutional investor) registration. (Some 'fire fighting' did happen on October 22.)

Indeed, a common complaint of financial agents is that the length of time and administrative hurdles involved in getting licensed and registered has forced them to use the PN channel to gain exposure to the Indian bourses. There are also other broader questions...

Such as?

Such as: Why and if there should be any licensing of FIIs with the SEBI per se

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(which is effectively a means of controlling entrants) and why offshore derivatives are given any legal status. Why not allow a foreign agent to freely operate onshore while simultaneously creating a wedge between the onshore and offshore market?

Are inflows posing a dilemma?

Presumably. Part of the reason for not streamlining procedures, it appears, is in order to curb capital inflows which have been the primary reason for balance of payments surplus and reserve accumulation and Rupee appreciation. The increasing difficulties with managing the large-scale capital inflows (including the escalating costs of monetary sterilisation) have been suggested as reasons behind the proposed curbs, with PNs having accounted for about two-fifths of foreign investments in India's stock market. If this is the reason for the SEBI policy, it highlights two concerns.

Concerns?

Yes. One is the question of autonomy of SEBI policy goals from that of the RBI (Reserve Bank of India). Two is the general attitude of Indian policy makers towards capital account openness. The curbs on PN and those on ECB (external commercial borrowing) by firms earlier on are clear indications of India's attempts to roll back some of the de facto capital account convertibility as it is complicating exchange rate and monetary policy management by the RBI.

While one could argue as persuasively for capital account openness as one could for some form of controls, the manner in which India is adopting controls in a rather ad hoc and piecemeal manner is arguably causing more damage than benefits.

What can be a better option to control inflows?

In the event that the decision has definitely been made to moderate capital inflows via policy measures (the Finance Minister's "assurances" notwithstanding), it would be better to use a more transparent mechanism such as the Chilean-type unremunerated reserve requirements (URRs).

Research suggests that such controls have helped in lengthening the maturity of capital inflows though having uncertain impact on controlling overall magnitude of inflows (See: 'Restraining International Capital Flows: What does it Mean?' by Ramkishan S. Rajan and Graham Bird in 'Global Economic Quarterly')

But how do we address inflation?

If the concerns pertain more to the aggregate demand and inflationary consequences of capital inflows, the first best policy measure would be to undertake fiscal consolidation by reining in fiscal expenditure and broadening the tax base. Needless to say that such expenditure-reducing measures are much less attractive to policy makers as they are much harder to implement compared to imposing ad hoc controls.

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