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BACKGROUND PAPER

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IMF Advice on Capital Flows to People's Republic of China and India

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Prepared by Ila Patnaik* and Eswar Prasad†

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The views expressed in this Background Paper are those of the authors and do not necessarily represent those of the IEO, the IMF or IMF policy. Background Papers report analyses related to the work of the IEO and are published to elicit comments and to further debate.

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ABBREVIATIONS

AE	advanced economy
BRI	Belt and Road Initiative
CFM	capital flow management measure
EM	emerging market
FDI	foreign direct investment
FSAP	Financial Sector Assessment Program
FX	foreign exchange
FXI	foreign exchange intervention
GDP	gross domestic product
GFC	global financial crisis
IV	Institutional View on the Liberalization and Management of Capital Flows
PBC	People's Bank of China
RBI	Reserve Bank of India
SDR	Special Drawing Right
UMP	unconventional monetary policy
WEO	*World Economic Outlook*

I. INTRODUCTION

1. This paper evaluates IMF advice to China and India on whether and how to proceed with capital account liberalization while addressing substantial volatility in capital flows triggered by global events as well as domestic developments.

2. China and India historically maintained relatively closed capital accounts but moved to progressively reduce restrictions on both inflows and outflows starting around 2000. By the mid-2000s, China and India were already receiving large capital inflows reflecting declining interest rates in the advanced economies and their own rapidly growing economies. Both countries employed a variety of measures to manage these flows, including capital account measures and foreign exchange intervention (FXI), while continuing to gradually liberalize their capital accounts. Their responses to the global financial crisis and in subsequent periods of volatility thus involved deploying policies with which these countries already had some experience. Nevertheless, the developments of the past decade proved quite challenging, and policymakers in both countries did look to the IMF for advice and support, both on future capital account liberalization and on handling episodes of volatility.

3. This assessment is based on a review of the annual Article IV reports and related documents prepared by the IMF staff for China and India between 2008 and 2019; spillover reports; and internal Fund documents. This material was complemented by interviews with many IMF staff members on the country teams for China and India, particularly current and former mission chiefs and resident representatives; current and former officials at the central banks and other agencies; and experts in academia and at think tanks.[1] The assessment also draws upon relevant material from the background paper on China and India (Mohan, 2019) that was prepared for the IEO's evaluation of *IMF Advice on Unconventional Monetary Policies*.

II. CHINA[2]

A. Economic Developments Since the Global Financial Crisis

4. China registered strong macroeconomic performance prior to the global financial crisis. Annual real GDP growth exceeded 10 percent in the five years preceding 2008, the current account surplus peaked at around 10 percent of GDP, foreign exchange reserves exceeded US$2 trillion in 2009, and the fiscal situation was satisfactory.

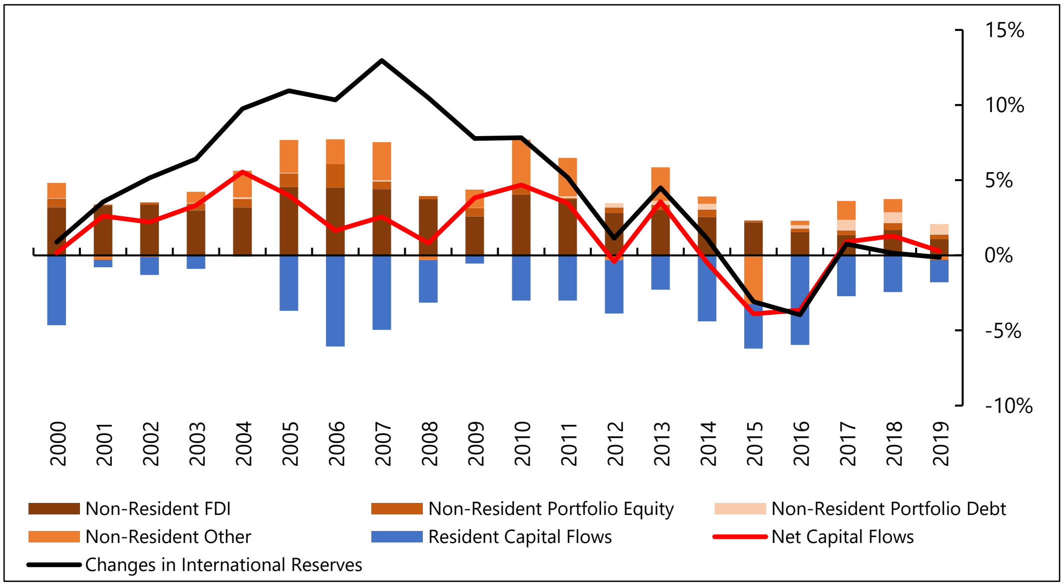
5. The country started a process of capital account liberalization from 2002 onward, actively pursuing inward foreign direct investment. Initially, China provided tax incentives for inward foreign direct investment, then permitted foreign strategic investors to take equity stakes in state-

[1] The interviews and document review were largely completed before the onset of the COVID-19 crisis. While the study has been updated to report on recent developments, it does not seek to evaluate the recent experience.

[2] Prepared by Eswar Prasad.

owned banks and opened up a dedicated channel to the equity market for foreign investors (Prasad, 2017). Over 2005–07, non-resident capital inflows (excluding FDI) averaged 3 percent of GDP (Figure 1). The continuation of a very large current account surplus and a sizable capital account surplus drove massive foreign exchange intervention—more than 10 percent of GDP in 2007—to resist upward pressure on the currency.

Figure 1. China: Net Capital Flows, 2000–2019
(In percent of GDP)



Sources: Institute of International Finance; April 2020 *WEO* database.

6. The global financial crisis posed a severe challenge to the Chinese economy. China eased monetary policy through lower interest rates and quantitative measures to increase credit, initiated a large fiscal stimulus to finance infrastructure investment and support individual industries, and introduced some consumption subsidies. The earlier move toward greater flexibility in exchange rate management was halted. The policy stimulus succeeded in maintaining GDP growth at about 9 percent in 2009.

7. In 2010, with worries about the effects from the global financial crisis receding, monetary policy accommodation began to be withdrawn through both interest rate and quantitative credit measures and the fiscal stimulus was removed gradually. The exchange rate regime was returned to a managed float in June 2010. China also embarked on a slightly more aggressive approach to capital account opening, although it continued to do this in a selective and calibrated manner that was intended to mitigate risks of capital flow volatility. Both non-resident inflows and resident outflows were liberalized through a variety of special schemes for both debt and equity investments that aimed to control the quantity and timing of inflows and outflows.

8. China weathered the so-called "taper tantrum" of mid-2013 quite well though growth edged down to 8 percent. In 2014, when net capital inflows diminished and there were depreciation pressures on the currency, the government tightened up on capital controls to limit what it considered speculative outflows. On the monetary policy front, there were gradual and measured moves to liberalize interest rates, exchange markets were made more open and market determined, and cautious financial sector liberalization continued. By 2015, interest rate liberalization was largely complete, the monetary policy framework was adjusted with an interest rate corridor centered on a seven-day repo rate, and progress towards the internationalization of the renminbi led to its inclusion in the IMF's Special Drawing Rights (SDR) basket.

9. Despite the care it exercised to maintain economic stability, China faced a challenge to market confidence starting in the summer of 2015, when first domestic equity markets took a tumble and then the exchange rate was allowed to weaken unexpectedly, sending ripple effects across global markets. Some observers blamed unclear policy communication about the exchange rate policy adjustment and the deflation of a stock market bubble for the unsettled market conditions. There were large capital outflows in the second half of 2015 as Chinese corporates scrambled to reduce their foreign currency borrowing, portfolio inflows dried up, and Chinese residents sought to move assets offshore. In response, the authorities reimposed some capital controls and adopted a "macroprudential framework for managing cross-border flows," as well as clarifying the exchange rate policy. Sizable FXI was also deployed to resist substantial downward pressure on the renminbi. While net outflows remained large in 2016, the situation stabilized during the first half of that year, helped by greater market confidence in the exchange rate regime.

10. During 2016–19, China continued to open up its fixed income markets (for both corporate and government securities) to foreign investors and took further measures to reduce restrictions on foreign investor inflows into and outflows from equity markets. Capital flows benefitted from a rebound in non-resident inflows and diminished resident outflows. China also ramped up external lending through its "Belt and Road Initiative" (BRI) aimed largely at funding large infrastructure investments in other emerging market and developing economies; those investments have involved sizable "south-south" capital flows.

11. China's net capital flows fell sharply in March 2020 as the outbreak of the COVID-19 pandemic led to a retrenchment from emerging markets (EMs). The net outflow was not as significant as during the 2015–16 period of intense pressures, though the drop in portfolio equity flows appears to be comparable in the two episodes. Moreover, flows began to recover in April, ahead of those in other emerging markets, as China brought the spread of COVID-19 under control**.** The focus of the policy response has been to support the domestic economy through a fiscal stimulus of more than 4 percent of GDP and various forms of monetary easing (though unlike many other EM central banks the People's Bank of China (PBC) has not pursued quantitative easing). The renminbi was allowed to depreciate but downward pressure was limited

and there was no resort to intervention. The government relaxed controls on cross-border borrowing but took no steps to limit capital outflows.

B. Engagement with the IMF

Policy advice and analytic work

12. Prior to the global financial crisis, IMF advice to China had consistently been for a policy strategy consisting of greater exchange rate flexibility; interest rate liberalization; modernization of monetary policy by using price instruments rather than quantity/credit-based instruments; development of the financial sector, particularly bond markets; and cautious further opening of the capital account.

13. At the start of the GFC, the staff supported departures from this medium-term direction, such as the deployment of directed credit measures to stimulate aggregate demand and the greater use of capital account measures. The IMF also endorsed the fiscal and monetary policy stimulus by the Chinese authorities in 2008–10. According to the staff, the Chinese authorities—while regarding their policy response as essential under the circumstances—expressed their unhappiness at having to slow down progress toward economic liberalization because of difficult global conditions.

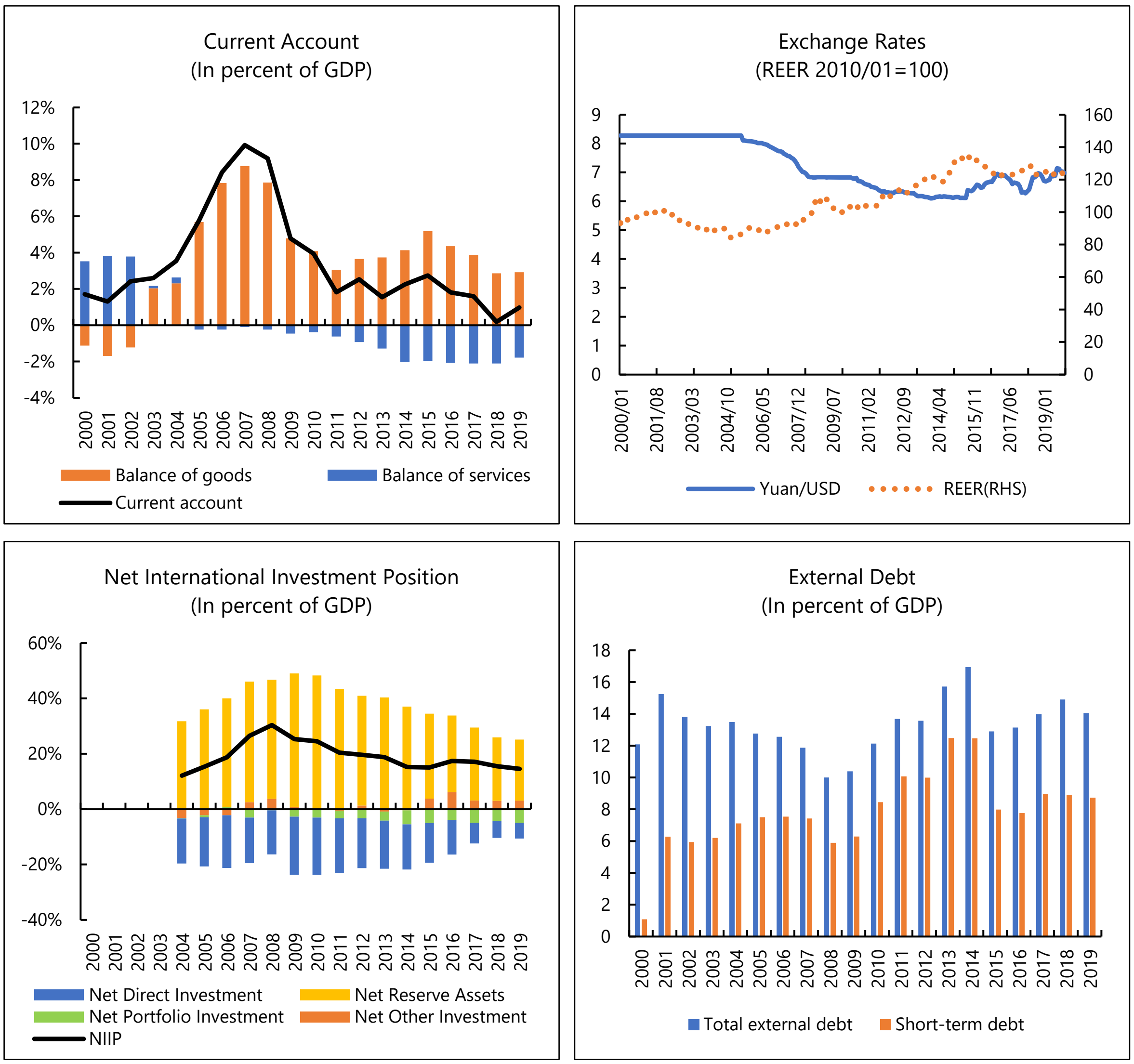
14. By 2011, the global environment had improved sufficiently that the staff advised China that the monetary stimulus should be withdrawn and that the fiscal position "should return to broad budget balance in the next one or two years." Capital account liberalization again became a staple of IMF advice, although caution about pace and sequencing remained important. For instance, the IMF's First Deputy Managing Director Lipton advocated "a gradual and careful opening of China's external capital account" in the press conference following the Article IV consultation discussions in 2013 (Lipton, 2013). That year, the IMF and the PBC also organized a conference to discuss lessons from international experience on capital flow management, at which IMF staff members noted that "while unequivocally beneficial overall, capital account liberalization has also been littered with dozens of accidents and crises" (Rodlauer, 2013).

15. Tension between the Fund and China over the valuation of the exchange rate eased during this period as the current account surplus dropped quite sharply and the exchange rate was allowed to move more flexibly (Figure 2). The 2012 Article IV Report stated that the authorities were facilitating a gradual increase in the international use of the renminbi, which was assessed to be only moderately undervalued. By 2015, with the renminbi's imminent inclusion in the SDR, the staff judged the renminbi to be no longer undervalued.

16. The Fund's adoption of the Institutional View on the Liberalization and Management of Capital Flows (IV) (IMF, 2012a) did not bring about much change in staff advice as country teams for China had already been sympathetic to the use of temporary capital account measures in the face of the significant volatility in cross-border flows. In 2009–13, when China experienced large

capital inflows, the authorities tolerated outflow "leakages," while keeping formal restrictions on outflows. The IMF staff generally supported these measures. In 2015, when concerns pivoted to capital outflows, the staff again supported the authorities' moves to reinforce existing capital account controls and to impose some additional measures (Mohan, 2019).

Figure 2. China: External Balance Indicators, 2000–2019



Sources: IMF, International Financial Statistics; April 2020 *WEO* database; and IEO staff calculations.

17. The analytic focus of the Fund staff in the period leading up to and following the global financial crisis was largely on China's current account balance, and on how exchange rate and other policies could affect internal and external imbalances. Through 2015, capital flows received less direct attention in staff reports and background papers, especially compared to the extensive attention devoted to current account and exchange rate valuation issues. Attention to capital

account issues has grown in more recent years. For instance, the Selected Issues papers for the 2016 and 2017 Article IV consultations contained chapters on the outlook for net capital outflows and the strategy for capital account liberalization, respectively.

Inward and outward spillovers: advice and analysis

18. The Chinese authorities were keen from the start of the global financial crisis that the IMF analyze the spillovers from the crisis and the effects of unconventional monetary policies (UMP) adopted by the major advanced economies. The staff was responsive to these concerns, with staff reports often relaying views from the authorities on the impact of the volatile "external environment," and potential spillovers from UMP.[3]

19. That said, while the authorities were apprehensive about large spillovers, IMF analysis based on the Fund's large-scale macro models tended to conclude that the spillovers from UMP to China would be quite small. IMF country teams also felt that the influence of UMP on China could be managed through China's capital account and macroprudential measures, as well as further exchange rate flexibility, and would be buffered by China's sizable foreign exchange reserves.

20. The staff has also analyzed the effects of developments and policy choices in China on other countries and the global outlook. The 2011 Spillover Report investigated the possibility that barriers to portfolio investment in China deflected such investment to other emerging markets, but concluded that "while this is plausible, the evidence is ambiguous" (IMF, 2011). The 2016 Selected Issues paper analyzed impacts on other countries from a rebalancing of demand in China from investment to consumption, as well as financial spillovers from China, noting that the effects through trade channels were still small, on average, for most countries but were rising as the Chinese economy grew in size and international integration, and that financial spillovers could be larger and more disruptive.

21. The staff has also looked at the possible impact on other countries, and on China itself, from the BRI. The BRI is not primarily a capital account policy but BRI-related outflows constitute an important source of external funding for many of the recipient countries. In 2018, the Fund prepared a set of comprehensive background papers on the BRI for a conference co-hosted with the PBC (IMF, 2018). After noting the benefits of the BRI for the recipient countries, staff analysis raised concerns that large-scale government-only projects could generate negative impacts if costly projects failed to produce sufficient investment returns, since BRI-participating countries

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[3] For instance, the 2008 Article IV staff report noted the authorities' concern that "the dramatic easing of U.S. monetary policy had greatly complicated monetary management in the rest of the world, especially in China, which has had to deal with the resulting rise in liquidity." The 2013 Article IV report mentioned the authorities' view that FX interventions had been reintroduced because of "an anomaly triggered partly due to the unconventional monetary policies in advanced economies."

could be burdened with elevated debt and debt servicing needs, with little contribution to jobs and growth.

C. Views of the Authorities

Policy advice and analytic work

22. Overall, the Chinese authorities have greatly valued their engagement with the IMF over the past decade. As noted by Mohan (2019), Article IV missions were regarded as substantive and fruitful policy discussions, with representation at the highest levels on both sides. The resident representative and other senior IMF staff sometimes provided advice outside the Article IV cycle to senior Chinese officials on various economic policy issues. The Fund's adoption of the Integrated Surveillance Decision in 2012 (IMF, 2012b), the flexibility shown by IMF staff during the global financial crisis, the renminbi's inclusion in the SDR basket, the efforts of the resident representative office, and the substantive technical assistance provided all helped build a strong relationship. The joint economic conferences started by the IMF and the PBC in 2013—with active participation by IMF technical staff, Chinese central bank and finance ministry technocrats, and policy experts and academics from several countries—were regarded as a useful innovation.

23. Interviews conducted for this evaluation highlighted a general concern similar to that picked up in IEO (2019) as well as two additional concerns pertaining to how the IV had worked during key episodes over this period. The general concern was that the staff's advice was often too broad-brush and did not fully account for China's special circumstances (for instance not fully appreciating the unique features of China's quantitative credit guidance and allocation system) (Mohan, 2019). This was echoed in the sentiments of some officials who felt that the staff tended to rely on cross-country analysis of capital account dynamics without enough attention to the specifics of China's capital markets and policy frameworks.

24. The two concerns pertaining to the operation of the IV related to: (i) staff reluctance to take a view on the possible "collateral benefits" of capital account liberalization; and (ii) staff advice during the stressful period in 2015. In both cases, some officials—while expressing support for the IV in general—had doubts about how well the framework had worked in these particular episodes.

25. As noted earlier, from 2010 to 2015, China embarked on a number of measures to ease restrictions on cross-border capital flows. These steps were framed around achieving certain external objectives—promoting the international use of the renminbi, enabling the currency's accession to the SDR basket, and inclusion of Chinese capital markets in global equity and bond indices. This approach provided a useful organizing framework for the opening up of, and reforms to, China's capital markets, while also helping to overcome domestic resistance to such measures. The Fund staff was reasonably supportive of the authorities' goal of capital account liberalization, while repeatedly and consistently emphasizing the risks of premature liberalization and the importance of adequately preparing the ground through other reforms.

26. A few key senior officials felt that the Fund could have been more supportive of the broader objectives at play. These officials pointed out the important "collateral benefits" of capital account opening—including the development of domestic capital markets, more competition for the domestic banking system, opportunities for Chinese investors to diversify their portfolios, improved public and corporate governance, and incentives to improve regulatory and supervisory frameworks in the financial sector. These officials felt that Fund staff took a narrow approach constrained by the IV that getting the sequencing of reforms right was more important than opportunistically pushing forward much-needed reforms even if this entailed some risks. Other officials felt that the Fund staff had been right in emphasizing the importance of getting the sequence right and stressing the risks of premature capital account liberalization.

27. The second episode pertains to the period immediately after mid-2015 when, in the face of depreciation pressures and a surge in net capital outflows, the authorities tightened capital controls through a variety of administrative measures and stricter enforcement of existing controls. Chinese officials felt that, during this difficult period, the staff was reasonably supportive of the measures taken to cope with the surge in capital outflows. However, these officials felt that the IV, while giving the staff room to approve capital flow management measures (CFMs) in such exceptional circumstances, nevertheless constrained the staff in a different way: rather than providing a broad approval of measures taken by the authorities, each of these measures needed to be justified to the staff and checked internally within the Fund on a case-by-case basis rather than being seen as components of an overall strategy. This view was echoed by some staff members, who thought the Fund could have taken a different approach of providing broad guidance and support to the authorities rather than having to evaluate and pass judgment on each proposed measure using the complex criteria embedded in the IV.

28. Some officials also felt that it was counterproductive for the Fund to emphasize exchange rate flexibility at such a time and that the IV provided only limited and grudging support for capital flow management measures, even in such exceptional and perilous circumstances as the ones that China then faced. As a reflection of the Fund's approach, one official pointed to the wording in the 2018 Staff Report that: "capital flow management measures, including the 'macroprudential framework for managing cross-border flows,' should not be used to actively manage the capital flow cycle and substitute for exchange rate flexibility in line with the IMF's Institutional View on capital flows."[4]

29. During 2015–16, the authorities undertook aggressive measures to intervene in foreign exchange markets, both onshore and offshore, in order to support the currency. They also introduced a "countercyclical adjustment factor," intended as a signal to markets that the PBC would intervene to prevent rapid currency depreciation. The Fund took issue with this approach, arguing that it would only hurt the PBC's credibility with market participants and make it harder

[4] In the 2018 Article IV Staff Report, the authorities reportedly agreed that CFMs should not substitute for exchange rate adjustment in the context of the staff's call for reforms that would support the removal of CFMs.

to eventually transition to a more market-determined exchange rate. Some officials felt that the Fund was not sufficiently sensitive to the need to reduce speculative activity that was not tethered to macroeconomic fundamentals.

30. In arguing against heavy foreign exchange intervention and the accumulation of large reserve balances, the staff had maintained that China's reserve cushion was adequate. For example, the Staff Report for the 2015 Article IV consultation noted that "Given China's progress and plans with capital account liberalization…further accumulation is unnecessary from a reserve adequacy perspective." The loss of about US$1 trillion of foreign exchange reserves (about 25 percent of the peak stock of US$4 trillion) between mid-2014 and late 2016 in the face of turbulent conditions, according to some officials, indicated that the Fund was being too sanguine about the level of reserves that even a large emerging market economy needs to protect itself from capital flow volatility.

Inward and outward spillovers

31. The authorities appreciated the efforts made by the Fund staff to draw attention to and analyze spillovers from UMP, including through the launch of the Spillover Reports. Nevertheless, they felt that the Fund's work tended to downplay the magnitude of spillovers affecting China and other EMs, and the challenges posed to EM policymakers. For instance, in commenting on the 2011 Spillover Report, Chinese authorities noted that it did not fully capture the effects of "external shocks" for EMs and for China: UMP "not only fueled inflation pressures but also constrained the options regarding policy mix, as well as the timing, path, and pace of the monetary policy normalization in emerging market economies." Similarly, it was felt that during the period 2014–15, when the Fund was pushing for greater exchange rate appreciation, the staff did not give adequate heed to the authorities' concerns about the spillover effects of the policies of the major advanced economies' central banks and the risks of capital flow reversals (Mohan, 2019).

32. While the authorities pushed back against the concerns about the outward spillovers from BRI, emphasizing the "substantial benefits" to recipient countries through greater integration, improvement in infrastructure, and increased trade, they have nevertheless been responsive to the point made by the IMF, as well as others, that rapid build-up in debt in some borrowing countries could provide problematic in some instances. For instance, they have taken steps to take account of debt sustainability concerns for BRI participating countries.

D. Assessment

33. The Fund staff deserves considerable credit for a wide-ranging and generally successful engagement with China. The Fund's support for the policy responses by authorities in the face of capital flow volatility was important in helping China and the global economy better weather a challenging decade. That said, the required focus at the Fund on current account issues and the value of the exchange rate meant that capital flow issues received less attention until capital

outflows had become a major concern. Indeed, some IMF staff members themselves expressed the view that, in retrospect, earlier and deeper analysis of the structure and drivers of capital flows could have better guided the Fund's advice on external sector issues.

34. The concerns raised by some authorities about the operation of the IV deserve consideration. The first issue was about the collateral benefits of capital account liberalization. The view embedded in the IV, supported by empirical evidence in the academic literature and research done at the Fund, is that well-developed and well-regulated domestic financial markets and a flexible exchange rate regime can improve the benefit-risk tradeoffs associated with capital account liberalization (Montiel, 2020). Thus, on the one hand, the Fund staff stuck to traditional prescriptions about sequencing that had analytical and practical merit and were consistent with the IV. On the other hand, the staff did not take full heed of the institutional constraints on market-oriented reformers in China and the need to use windows of opportunity to push forward reforms even if the sequencing violated those prescriptions by trying to undertake multiple reforms simultaneously. The diverse set of views even among Chinese officials on this issue reflects its complexity, and it is difficult in the end to fault the staff for its caution. Nevertheless, it merits discussion within the Fund whether reaping the benefits of capital account liberalization, which the IV states as a goal, does not also involve taking some considered risks on occasion.

35. The reaction by Chinese officials to the Fund's advice on outflows during the 2015 episode also merits consideration by the Fund. Though the staff supported the measures taken, it is disconcerting that the application of the IV proved to be a cumbersome exercise at a time when Chinese officials would have appreciated a nimbler response by the staff in providing support. It is worth considering how, in the face of near-crisis conditions of heavy outflows and depreciation pressures, the Fund could provide more prompt support to measures taken by authorities within the framework of the IV.

36. Chinese officials also objected to the staff's insistence on the need for exchange rate flexibility in the midst of the 2015 crisis.[5] A careful reading of Fund reports suggests that the staff did strive to provide a balanced perspective, but evidently not to the satisfaction of the authorities. Nonetheless, there was certainly merit to the staff's position that a more transparent exchange rate framework, rather than one with arbitrary one-sided intervention mechanisms, would enhance credibility and stability.

37. Better modeling and analysis of financial spillovers remains a work in progress, at the Fund and elsewhere. It is important for the Fund to take note of the concerns of Chinese officials that the impact of advanced country policies on China and other EMs is generally underestimated by the Fund. By the same token, it is encouraging to note that the staff is starting to do more work on the spillovers from developments and policies in China itself and

[5] The 2015 Article IV Report urged the authorities to gradually move to a fully floating exchange rate regime within two to three years—a call that was repeated in 2016 though with more emphasis on ensuring smooth adjustment, through foreign exchange intervention when needed.

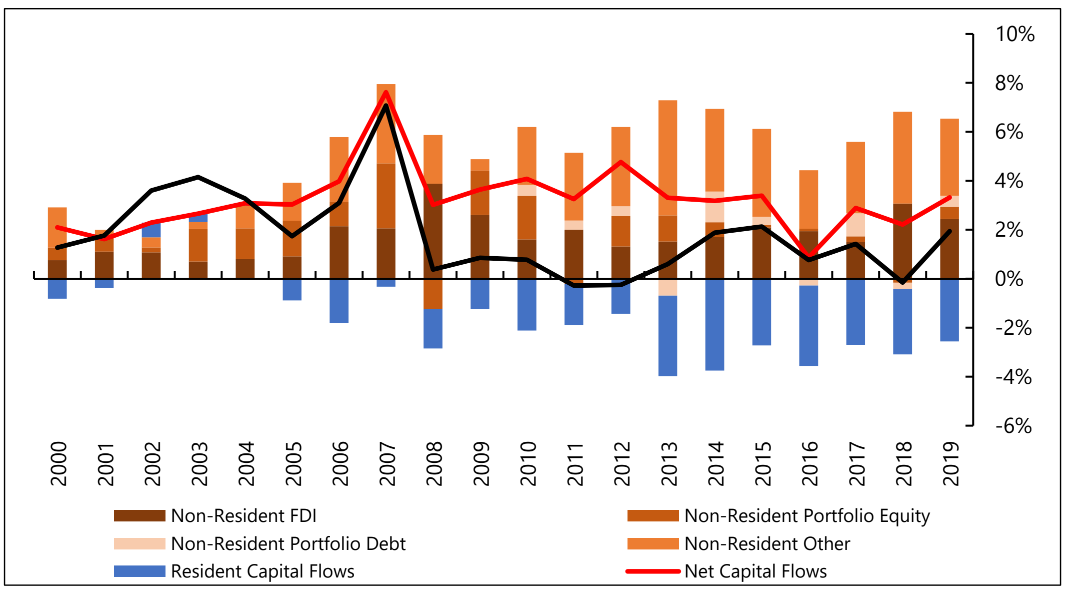
has brought attention to some of the risks as well as benefits and risks of BRI for countries receiving sizable capital inflows.

III. INDIA[6]

A. Economic Developments Since the Global Financial Crisis

38. India enjoyed strong performance in the years prior to the global financial crisis, with annual GDP growth exceeding 8.5 percent in the five years preceding 2008, inflation rates stable in the 5–6 percent range, and the fiscal deficit coming down to about 3.5 percent of GDP in 2007–08. Over this period, India also increased its financial integration with the rest of the world. A cautious capital account liberalization proceeded over the period from 2000 to 2008, resulting in a sustained rise in non-resident inflows and raising foreign exchange reserves three-fold to more than US$300 billion by mid-2008 (Figures 3 and 4).

Figure 3. India: Net Capital Flows, 2000–2019
(In percent of GDP)



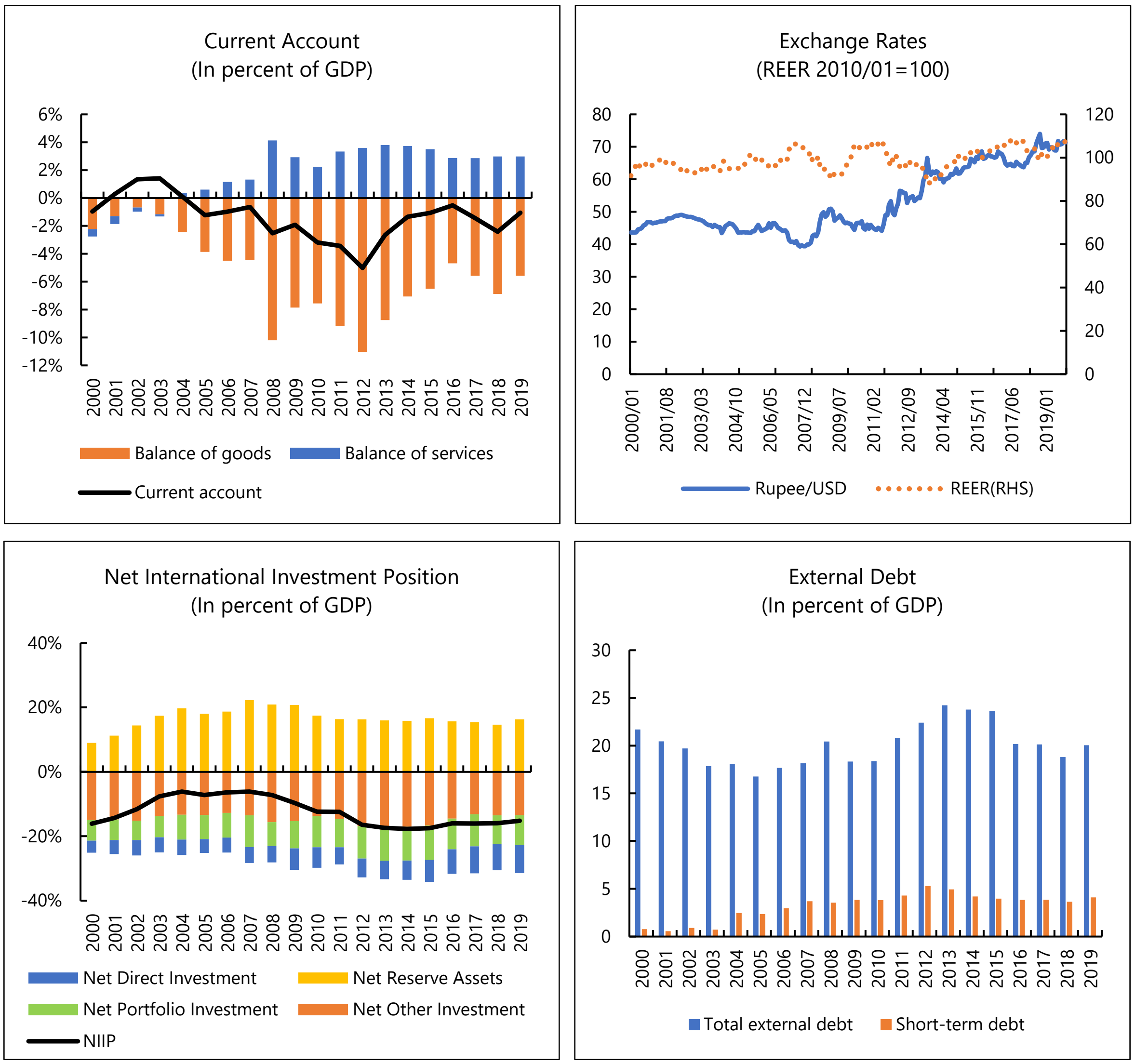
Sources: Institute of International Finance; April 2020 *WEO* database.

39. The global financial crisis had a significant economic impact on India, with a sudden drop in capital inflows after the Lehman crisis broke in September 2008. After reaching unprecedented levels of more than US$100 billion in 2007–08, non-resident capital inflows fell to less than US$10 billion in 2008–09. While foreign direct investment flows exhibited resilience, portfolio

[6] Prepared by Ila Patnaik.

flows reversed sharply and access to external commercial borrowing and trade credits tightened significantly.

Figure 4. India: External Balance Indicators, 2000–2019



Sources: IMF, International Financial Statistics; April 2020 *WEO* database; Federal Reserve Bank of St. Louis; and IEO staff calculations.

40. In response, monetary policy was loosened considerably, and a significant fiscal stimulus was provided. Large-scale foreign exchange market intervention helped to compensate for net capital outflows, along with liquidity management measures to restore stability in domestic money markets. Through these measures, the impact on the economy was contained: GDP growth fell from 9 percent in 2007–08 to just under 7 percent in 2008–09.

41. With the resumption of capital flows after 2009, the nominal and real exchange rates appreciated, accompanied by widening trade and current account deficits. However, departing from past policy, the Reserve Bank of India (RBI) did not intervene over this period to try to contain possible overshooting of the exchange rate. This hands-off approach was accompanied by the loosening of restrictions on foreign portfolio investment in the domestic government securities and corporate debt markets. Debt portfolio inflows to India rose to nearly 2 percent of GDP in 2012 and the early part of 2013. The inflows added to the upward pressure on the exchange rate.

42. India came under significant market pressure in the summer of 2013 after the "taper tantrum." The considerable widening of the current account deficit that had occurred in the preceding years contributed to making India a member of the "fragile five" in the eyes of international investors. Net portfolio inflows declined from US$30 billion in 2012 to US$7 billion in 2013—though predominantly in the recently opened domestic debt markets. The rupee depreciated by 15 percent in just three months, as the RBI struggled to convince markets that the outflow from India was not in line with the fundamentals of the Indian economy and was caused mainly by an exogenous and temporary shock.

43. These developments required a sharp turnaround from the hands-off approach, to the deployment of a broad array of policy measures to contain the crisis. The response involved monetary policy tightening (both through the policy rate and through direct controls) as well as changes to a number of current account and capital account measures, primarily restrictions on gold imports and lending against gold, direct dollar sales to oil companies, a reduction in limits on cross-border outflows for individuals, restrictions on outward foreign direct investment (FDI), and subsidized foreign exchange swaps to attract inflows from non-resident Indians.[7] Over time, fiscal policy was tightened, FDI flows were further liberalized, and foreign exchange intervention was reintroduced. These measures together helped to restore confidence, increase capital inflows, and reduce exchange rate volatility.

44. In 2015, following the double-digit inflation in previous years, the monetary policy framework was amended, and in 2016 a flexible inflation targeting framework was formally adopted with the establishment of a monetary policy committee, in line with a long-standing IMF recommendation. Since the adoption of this new framework, inflation has been contained within the target range of 4 percent ±2 percent (Mohan, 2019). Proactive rather than reactive foreign exchange intervention to smooth rupee movements, to be assessed over a full capital inflow-outflow cycle, remains part of the framework.

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[7] To encourage banks to attract more U.S. dollars into India, RBI introduced a U.S. dollar–rupee swap window for fresh dollar funds. It also allowed banks to borrow additional foreign currency funds from overseas and swap them into rupees at a concessional rate of 1 percent below market. These swap schemes encouraged banks to take dollar deposits as they reduced currency risk.

45. In her budget speech for FY2019–20, the Finance Minister proposed that since India's sovereign external debt-to-GDP ratio is among the lowest globally, the government would start raising part of its borrowing in external markets in external currencies (Sitharaman, 2019).[8] She proposed measures to further ease restrictions on foreign participation in government and corporate bond markets, and stated that certain specified categories of government securities would be opened up fully for non-resident investors and that the current limit of 9 percent for foreign participation in corporate bonds would be raised to 15 percent.

46. As the COVID-19 pandemic hit India, portfolio inflows ebbed in March 2020, with the reduction in net capital flows in that month alone comparable to the reduction that occurred over four months during the "taper tantrum" of 2013. Thus far, the policy response this time has differed from that in 2013 as the shock has been perceived as a shock to the global economy, not one specific to India or a small number of emerging markets. The government's focus has been to bolster the domestic economy through a fiscal stimulus package of 3.5 percent of GDP, together with cuts in policy interest rates and some quantitative easing in the form of purchases of government bonds. The exchange rate was allowed to depreciate, declining by just under 3 percent between mid-March and mid-June 2020, with intervention in foreign exchange markets in March and April to the tune of US$10–20 billion a month according to market estimates. The government relaxed controls on foreign portfolio investment but took no action to limit capital outflows. [9]

B. Engagement with the IMF

47. The staple Fund advice to India before the global financial crisis was to move towards greater exchange rate flexibility and to sequence further opening of the capital account for both inflows and outflows. On financial sector liberalization, the advice was to develop the corporate debt market, including opening to foreign institutional portfolio investment, and to develop derivatives markets (Mohan, 2019).

48. During the global financial crisis, the IMF broadly supported the substantial monetary and fiscal stimulus measures taken, particularly the monetary accommodation; in fact, the 2008 Article IV Report advocated greater easing of monetary policy than was undertaken at that time. With the robust recovery in 2009, the staff recommended the withdrawal of both monetary and fiscal stimulus by 2010. The Indian authorities were slower to tighten the policy stance, starting with gradual monetary tightening in mid-2010, while fiscal consolidation was delayed still further.

[8] These steps were announced against the backdrop of a crisis in the country's non-bank financial companies, which some observers attribute to declining growth while others fault, at least in part, lax regulation of past capital flows in sectors such as real estate.

[9] The limit for foreign portfolio investment in corporate bonds was increased to 15 percent of the outstanding stock for FY 2020/21 and the restriction on non-resident investment in specified securities issued by the central government was removed.

49. The period from 2009–13 saw a convergence in views between the authorities and the Fund staff on proceeding with capital account liberalization and on the policy toolkit to deal with capital flow volatility. When capital inflows surged again in 2009, the staff recommended that the rupee should be allowed to adjust freely. It argued that the downside risks for bank and corporates were limited because the rupee appeared "broadly in line with its equilibrium level." Though the authorities remained concerned about excessive volatility and overshooting, as they had been in the past, over the coming years they showed greater willingness to allow market determination of the value of the rupee. For its part, the Fund staff showed greater openness to the use of capital flow measures and foreign exchange intervention should these be needed to manage capital flow volatility, although as last resort tools. This was signaled in the 2010 Article IV Report, in the context of rising capital inflows and the possibility of a further surge, in advance of the Fund's 2012 adoption of the IV. The IMF staff saw intervention and reserve accumulation as well as some tightening of existing capital account restrictions as a possible response, with the introduction of new controls a last resort.

50. The Fund staff also suggested moving ahead with capital account liberalization. The 2012 and 2013 Article IV Reports recommended easing restrictions on external commercial borrowing by domestic corporates, although the advice switched from recommending foreign currency denominated borrowing in the earlier report to rupee denominated borrowing in the later one. The IMF also advocated liberalizing FDI further, developing the onshore FX futures and forward markets, and initiating steps aimed at facilitating the inclusion of Indian bonds in global indices. As noted, the authorities did take steps to liberalize the capital account over this period,

51. The significant impact of the "taper tantrum" in summer 2013 took both the authorities and the staff by surprise; the 2013 Staff Report had listed external risks to India but fallout from announcement of a U.S. Fed exit from unconventional monetary policies was not one of them.[10] As the authorities mobilized to respond, officials had hoped that an early statement of Fund support for the various measures they were undertaking might be of some help in calming markets (Mohan, 2019). While this was discussed within the Fund, and there was considerable sympathy for the measures taken—including many of the capital account measures—the IMF did not in the end make a public statement until the 2014 Article IV Report. This report praised in particular the success of the FX swaps made available to oil marketing companies, which had limited exchange rate volatility by removing a significant source of FX demand from the market. The Fund did note that the initial communication by the authorities to market participants of the policy intent and composition of the measures could have been better. During her visit to the RBI in March 2015, the IMF Managing Director praised the actions taken by the Indian authorities (Lagarde, 2015).

52. For the 2015 Article IV consultation, the country team prepared a study to assess the effectiveness of major policy actions taken by emerging markets after the 2013 taper episode,

[10] The 2013 Article IV consultation was concluded in spring that year, a few months before the taper tantrum.

focusing on India and how its experience compared with others'. It found that in India the immediate liquidity tightening measures had triggered negative bond and equity market reactions in the short run but had helped to support the exchange rate; restrictions of capital outflows seemed not to have helped either the bond yield or the exchange rate in the short run. However, the same study found that over a two-year period EMs with a comprehensive package of policy actions including fiscal adjustment (such as in India) had seen the largest improvements in fundamentals, and that during later bouts of market volatility they were relatively less affected than other EMs.

53. Since 2015, IMF advice to India has returned to the pre-GFC policy lines of cautiously opening up capital account and financial markets further and introducing greater exchange rate flexibility, with disruptive movements smoothed through foreign exchange intervention or via liquidity provision through swaps.[11] The Article IV Reports of 2015–17 continued to emphasize liberalizing non-debt creating capital inflows. The reports noted that while traditionally India's capital account had been dominated by portfolio equity and FDI flows, in recent years debt flows in the form of non-resident Indian deposits and unhedged foreign currency borrowing by Indian corporates had become more dominant. Given the volatility of portfolio flows, the staff advised on attracting more stable sources of capital flows. In particular, it advised that India's restrictions on FDI in construction and insurance should be reduced. The reports repeated the Fund's cautious stance on further liberalization of external commercial borrowings. The 2018 Article IV Report acknowledged the steps taken to liberalize FDI flows including easing of some regulatory and administrative burdens.

C. Views of the Authorities

54. Current and former Indian officials who were interviewed for this evaluation were generally satisfied with the overall engagement with IMF country teams and resident representatives over the past decade. The Article IV consultation was regarded as a useful consistency check of the country's macroeconomic policies by an independent agency. Nonetheless, there was a sense that financial sector knowledge among Fund economists was still not deep enough to bring value added to discussions on market developments, though Financial Sector Assessment Program teams and financial experts were better prepared.

55. The IMF's endorsement of India's actions at the height of the global financial crisis was appreciated and regarded as useful, as was the call—once recovery took hold—for withdrawal of the stimulus (though the authorities' response was delayed, particularly the fiscal adjustment). In contrast, many officials felt that the IMF had not acted in a timely manner during the "taper tantrum" in 2013. Its endorsement of actions taken by the Indian authorities could have come

[11] The RBI intervention was based on broader objectives including enhancing growth, reducing inflation, limiting volatility and building precautionary buffers. In 2015, rebuilding external buffers was a priority. Gross foreign exchange reserves continued to rise thereafter with the authorities engaged in proactive smoothing of capital flows over the cycle.

earlier, with some officials pointing to what they perceived as a contrast to IMF support for China during its stressful times in 2015. It was noted that the IMF's 2013 pilot external sector report and the external balance assessment had concluded that India's current account and the value of the rupee were broadly consistent with medium-term fundamentals. Hence it should have been easy for the Fund to have made the argument that markets were driving the rupee away from fundamentals (IMF, 2013).

56. Several observations from the interviews pertaining to the operation of the IV are notable. While there was appreciation for the IV as providing a framework for advice on dealing with capital flow volatility, certain aspects of it were not considered satisfactory, notably the primacy given to exchange rate adjustment. There was also a spectrum of opinions on the value of the IV as a guide to long-run capital account liberalization, with some interviewees strongly of the view that it emphasized caution about liberalization far more than was warranted, relative to the possible benefits.

57. There was satisfaction among Indian officials that the wider policy toolkit used by India over the years to manage the capital account had become more palatable to the IMF and that the value of using capital account restrictions under certain conditions had been acknowledged in the IV. Nonetheless, the primacy accorded by the IV to exchange rate adjustments in dealing with capital flow volatility has been a fairly constant source of disagreement between staff and the authorities. Indian officials made the following points:

- First, the authorities felt that the Fund's continued calls for further exchange rate flexibility seemed unwarranted, particularly because the Fund did not have a good basis for judging the impact on corporate balance sheets. After all, the rupee had significantly moved in both directions over the past decade (e.g., a more than 10 percent real appreciation in 2007 and a nearly 25 percent depreciation in 2008—comparable to movements in other currencies such as the Canadian dollar in those years). A few officials felt that it was the rupee's excessive appreciation during mid-2009 to 2012 in the absence of intervention that set India up for trouble during the "taper tantrum."

- Second, while the IMF staff advocated that "further rupee flexibility would be the most effective way to address the 'trinity,'"[12] the authorities preferred to consider it as part of a toolkit of "all possible options" for maintaining stability, including FX intervention and capital account restrictions (2008 Article IV Report).[13]

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[12] The staff further noted that the "stated policy of a managed but market-determined exchange rate with no target patch, and intervention only to curb short-term volatility remains appropriate."

[13] Subir Gokarn, former RBI Deputy Governor and IMF Executive Director, was fond of saying—drawing on a basketball analogy—that the IMF kept recommending man-to-man defense whereas the Indian authorities preferred zone defense.

- Third, some officials were of the view that exchange rate flexibility sometimes exacerbated market swings and related boom-bust risks rather than equilibrating them. For instance, analysis by former RBI governor Raghuram Rajan found that countries that had allowed the real exchange rate to appreciate the most in the years preceding the taper tantrum also saw the greatest adverse impact on financial conditions during the taper tantrum (Rajan, 2014).

58. Officials expressed a range of views about Fund advice on the pace and sequencing of capital account liberalization. Some senior officials, particularly those formerly at the Ministry of Finance, felt that the Fund staff had been excessively cautious in its advice, and that this tendency had become more prominent after the adoption of the IV. In this view, the system of administrative controls in place in India to keep foreign capital out was cumbersome and not very transparent. While it may have helped to preserve financial stability and fostered greater transparency and the rule of law, it imposed a large cost by hindering the development of liquid domestic markets and putting a lid on economic growth. The Fund staff was thought to be captive to the "RBI view" of looking at capital account measures solely through the lens of financial stability. Other officials felt the Fund's caution was justified given the risks of crises from premature liberalization.

59. Indian authorities generally welcomed the efforts made by the Fund staff to take seriously the concerns about spillovers from advanced economy policies on EMs. The analysis in the Spillover Reports and the efforts made by the country teams to apply these findings to the case of India were appreciated. At the same time, it was felt that these efforts continued to underestimate the magnitude of these effects and to overplay the extent to which the spillovers were due to EMs' own shortcomings. These points were made explicitly by former RBI governor Rajan in a series of speeches and papers (Rajan, 2014). He noted political economy limits on EM policymakers' room for maneuver and called for advanced economies to do more to alter their own policies to avoid causing spillovers, while seeing "merit in assigning the IMF or a similar institution the responsibility of assessing the spillover effects of major central banks' policies—much as the World Trade Organization does with trade rules."

D. Assessment

60. Engagement with the IMF is valued by the Indian authorities and the Article IV consultation provides a valuable annual assessment of India's macroeconomic framework. Greater depth of expertise in financial sector issues and market dynamics among country teams would help the IMF make a greater contribution to the policy dialogue within India.

61. On capital flow issues, the Fund's adoption of the IV seen as a welcome sign of the institution catching up with practices on the ground, including in India, to deal with capital flow volatility. Some of the concerns raised by Indian authorities are worth the Fund's attention as it reflects on the experience with the IV.

62. Understanding the extent to which exchange rate adjustments can be a sufficient instrument in the face of volatility should be high on the Fund's research agenda. The concern that such adjustments can amplify shocks deserves attention, but without ruling out the possibility that countries are indeed sometimes trying to avoid needed macroeconomic adjustments.

63. The view of some officials that the Fund staff is now excessively cautious in its advice on capital account liberalization should also be taken seriously. The possibility that continuing pervasive controls exert a high toll on growth should be given weight. Moreover, overcoming the inertia to carry out reforms of the domestic financial sector and spur market development might sometimes require some liberalization in advance. The staff's concern about the risks from opening up the capital account more rapidly was partly influenced by the findings of the 2012 Financial Sector Assessment Program update, which stressed the vulnerabilities of public sector banks and risks of capital outflows. Regardless of one's view on this issue, however, it seems clear that the Fund could provide a service through marshaling cross-country evidence on the costs of capital account measures, and particularly the longer-term impacts of keeping controls in place. The Fund could also carry out research so as to be able to provide more detailed advice on the effectiveness and impacts of different types of controls on both growth and financial stability: are there "win-win" capital account measures that help financial stability without hurting growth?

64. The IV framework does not appear to have been of much value in facilitating a nimble IMF response when India faced outflow pressures in 2013. If timely Fund support for capital account measures taken by countries in near-crisis situations was one of the goals of the IV, it does not seem to have been accomplished in this instance.

IV. CONCLUSIONS

65. There are some common messages to be drawn from the China and India cases about how the Fund could provide better advice and improve the traction that advice has with country authorities, especially in large countries where the institution has limited direct leverage.

66. The Fund's approach of providing advice based on extensive analysis of cross-country experiences, adjusted to reflect country-specific circumstances, remains in principle the best way of engaging with authorities. But for large countries like China and India—and particularly so in the former case—the Fund has to work harder to convince the authorities that they are not *sui generis* and that some of the lessons of cross-country experience do apply to them as well. In both countries, authorities seem to feel that the Fund staff's advice on matters related to capital flows and exchange rates does not pay sufficient heed to their countries' specific circumstances and institutional framework. In China, the use of an annual conference with the Central Bank to share cross-country experience in an open way—with experts and technocrats present—appears to have been a fruitful way to proceed; the 2013 conference on how to deal with capital flow volatility seems to have been very useful. The Fund should also be active in analysis of the

changing structure and drivers of capital flows to these countries before capital account management becomes more complicated.

67. While there was support overall for the IV as a step forward, it is noteworthy that some officials in both countries felt that the Fund could be somewhat bolder in its support of capital account liberalization. It would be useful for the Fund to reflect on this viewpoint and assess evidence for the direct and collateral benefits of liberalization to be set against the likely risks (particularly when there are substantial domestic financial sector vulnerabilities that need to be addressed).

68. When the countries were faced with mini-crises and capital outflows, the IV does not appear to have proved particularly useful in ensuring timely support. China's capital account measures received much quicker public support, however, surely reflecting Fund concerns about the greater systemic effects of a downturn there than in India.

69. Officials in both countries continue to feel that the Fund downplays the challenges created for them by spillovers from developments and policies in advanced economies. In the case of China, a new twist is that outward spillovers from China are themselves a source of attention from the Fund staff. It is encouraging that the staff is willing to deliver clear messages about potential effects of Chinese policies, but evenhandedness demands that such messages be delivered to all source countries, advanced or emerging, when they are needed.

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