The Dollar Drain

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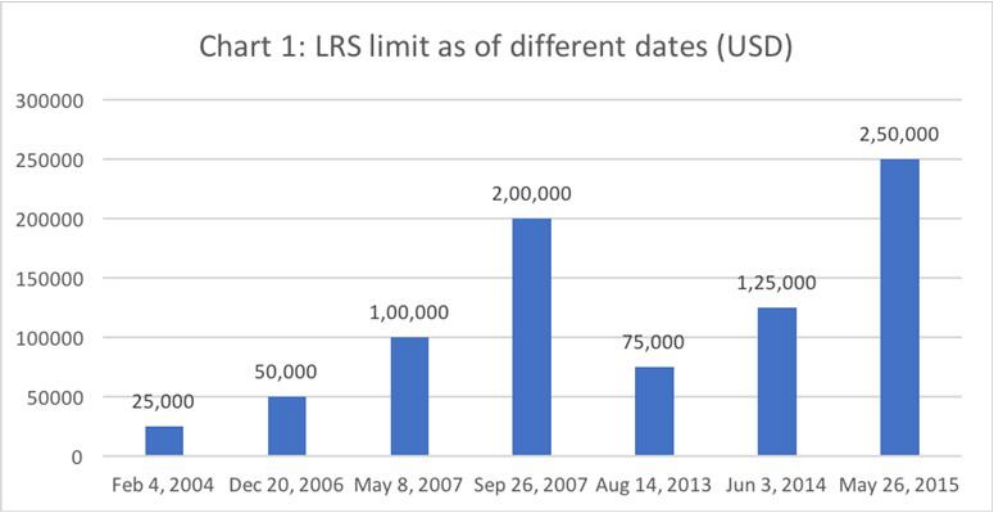
In the many debt, currency and financial crises that have affected Latin American countries, one factor often seen as responsible, was the flight of resident capital abroad, facilitated by liberalised capital account and exchange rate regimes. India had, however, been insulated from this for long because capital account liberalisation came late and was focused on liberalising inflows of foreign capital. However, this need not remain true any longer, because of the liberalised regime for foreign exchange access to resident Indians.

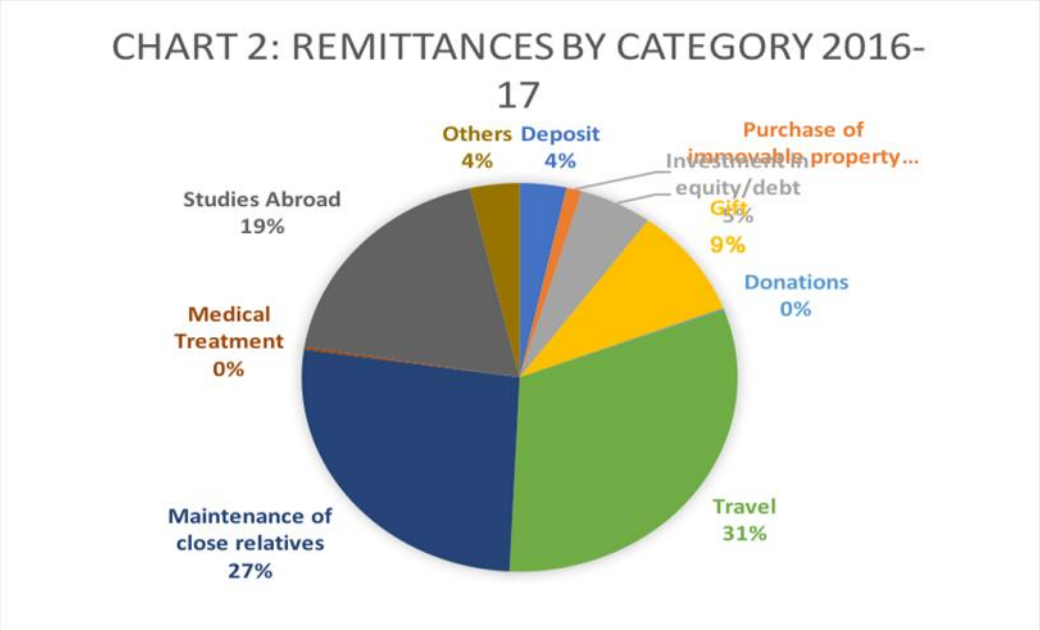
In February 2004 the government announced a new *Liberalised Remittance Scheme* (LRS) for Indian residents, marking a small but significant push in the direction of full rupee convertibility. Under the Scheme, resident individuals were permitted to convert rupees into foreign exchange to finance legitimate current and capital account transactions, including acquisition of immovable property or shares or debt instruments outside India, without prior approval of the Reserve Bank. They were also permitted for this purpose to open, maintain and hold foreign currency accounts with banks outside India for carrying out transactions permitted under the Scheme.



The scheme seems to have been motivated by the need to increase demand for foreign exchange in the country, to exhaust a part of the large flows of foreign capital that were finding their way to India. But when the scheme was launched, the ceiling on transfer for capital account purposes was set at $25,000 per person per calendar year.

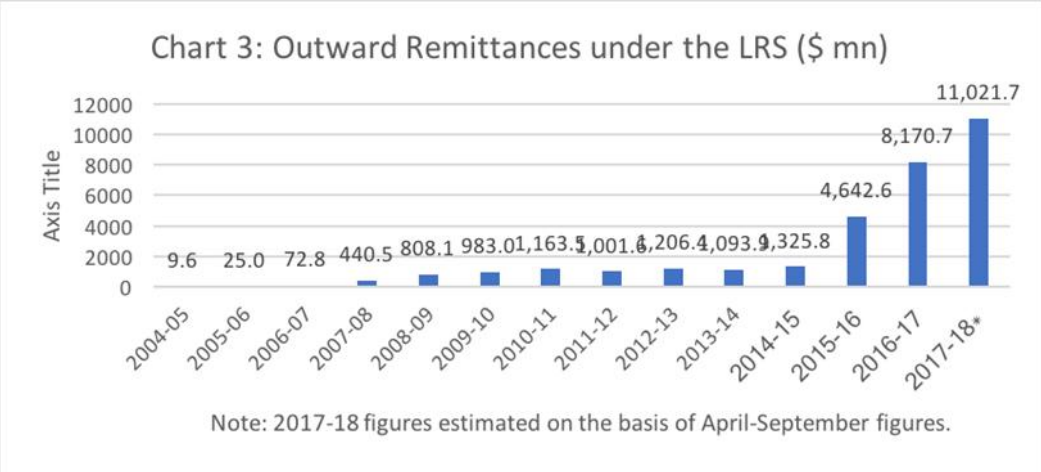
Finding the flow inadequate for its purposes the government hiked the ceiling to US $ 50,000 in December 2006 (per year) and further to US $ 1,00,000 (per year) in May 2007. At that point, remittances towards gift and donation by a resident individual as well as investment in overseas companies were subsumed under the scheme and included in the ceiling. This too proved insufficient and the ceiling was raised just four months later in September 2007 to $200,000 per person per year. Fearing, at the time of the "taper tantrum" of autumn 2013, that this route to transfer money could be a means of capital flight, the ceiling was drastically cut to $75,000 in August that year, only to be raised to $125,000 in June 2014 and $250,000 in May 2016 (Chart 1). This implies that a family of four would be permitted to transfer a total sum of a million dollars a year under different heads.

In recent years, well-to-do Indians, exploiting the benefits of this liberalisation, have been taking or sending foreign exchange abroad for various current or capital account transactions. In 2016-17, for example, Indian residents invested $444 million in equity abroad, gifted another $750 million, transferred $2170 million for the maintenance of close relatives abroad and spent $1,536 million on financing educational expenses abroad and and$2,568 million on travel (Chart 2). In sum, what is termed "outward remittances by resident Indians" by the Reserve Bank of India totalled $11.02 billion in 2016-17.



That might seem small relative to the magnitude of India's trade and of capital inflows into the country. But it is a figure that is rising. Estimated at $9.6 million in 2004-05, the figure jumped to $440.5 million in 20007-08 and $1,163.5 in 2010-11, around which level it hovered till 2014-15. But since then it has risen sharply to $4,642.6 million in 2015-16, $8,170.7 million in 2016-17 and a projected$11,021.7 in 2017-18 (Chart 3).

The policy changes that allowed this spurt in legal forms of capital outflow were in turn triggered by the liberalisation of capital inflows. Interestingly, 2003-04 was the year since when India began receiving large foreign (fixed and portfolio) capital inflows, consequent to capital account liberalization since the 1990s. Aggregate inflows rose from a historical peak of $29.8 billion dollars in 2006-07 to $62.1 billion dollars in 2007-08, and has since remained far in excess of India's current account financing requirements. Along with this surge in capital inflows, foreign currency assets with the Reserve Bank of India rose sharply, because the surge forced the central bank to buy up the surplus foreign exchange entering the country, to prevent appreciation of the currency, since that would erode the competitiveness of India's exports. But in time the RBI was burdened with large foreign assets on its balance sheet, making it difficult to continue with the policy. The liberalisation of foreign exchange access for resident Indians was seen as one way of absorbing the large foreign exchange inflows.



However, there has been a shift in the main heads under which foreign exchange has been remitted out of the country. The four heads under which remittance outflows had increased the most between 2006-07 and 2010-11 were: investment in equity/debt (from $21 million to $266 million); gifts to close relatives (from $7

million to $243 million); maintenance of close relatives (from negligible amounts to $255 million); and purchase of immovable property (from $9 million to $66 million). More recently, remittances have increased under the heads of travel, from $15.9 million in 2013-14 to $2,568 million in 2016-17, studies abroad, from $159.3 million in 2013-14 to $1.536.4 million in 2016-17, and maintenance of close relatives, from $173.9 million in 2013-14 to $2,169.5 million in 2016-17. However, these variations in the heads under which expenditure of foreign exchange by residents occurs may only reflect the ease with which the transfers may be supported with the documentation that authorised dealers need to ask for. What the overall numbers reveal is a sudden increase in transfer of funds abroad.

Despite this spike, these remittances under the LRS are small relative to either capital inflows into the country or remittances to India by Indians working abroad. But the rising Indian appetite to transfer money abroad could reflect capital flight encouraged by policy. This could prove to be a problem if economic uncertainty increases. Even if a tenth of the top one per cent of Indians enter the category of households that can mobilise the equivalent of $250,000 a year, the sum involved would be around $300 billion. That is by no means small, even relative to India's $400 billion reserve of foreign currency assets, since much of that reserve is built with capital that has the right to exit the country.

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