**Raining on India's parade**

*What India can learn from Brazil about controlling capital flows.*

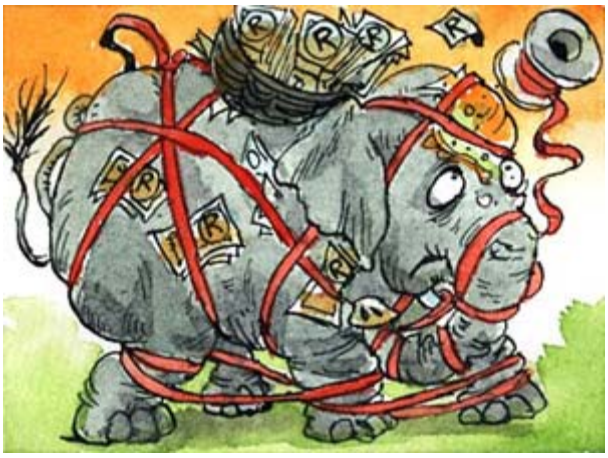

*Illustration by David Simonds*

In India, drought sometimes turns to deluge. This summer the country suffered its worst monsoon since 1972, which left half its rural districts parched, followed swiftly by floods that inundated two states. In recent years India's economic policymakers have confronted a similar phenomenon. A once-sheltered economy is now increasingly open to foreign capital, which rained down on the country in 2007, only to evaporate last year. The rains are now returning: foreigners have invested $13.8 billion in India's stockmarkets since April, having withdrawn $8.6 billion over the same period last year. The Sensex, India's most widely watched stockmarket index, has surged by almost 100% since its March lows. On October 27th the Reserve Bank of India (RBI) held its key policy rate at 4.75%, even though it is anxious about rising inflation. It is wary of attracting even more money from foreign investors, who are looking for high returns in a world of meagre yields.

India's discomfort (see article) is widely shared. Less than a year ago policymakers in emerging economies fretted about capital flight. Their currencies and reserves were falling as foreigners tried to raise cash by ditching whatever assets they could sell. Several governments queued up for emergency loans from the IMF or a currency swap with the Federal Reserve. Now they are worried about capital flowing in the opposite direction. On October 20th Brazil imposed a 2% tax on foreign purchases of equities and debt. Investors are now looking around to see who might follow suit.

Many emerging economies are reluctant to impose such controls. They fear such an infringement on economic freedoms will cast doubt on their commitment to market-friendly policies. Brazil seems almost apologetic about its taxes, which it insists are meant only to prevent excesses. India, by contrast, is less bashful about these things. It is proud of its "carefully calibrated" easing of capital restrictions over the past 18 years. It has no need to impose a tax on foreign investment in bonds, because such purchases are still banned beyond a fixed amount. Indian firms can raise money abroad, but the RBI sets limits on the amounts, rates and purposes of this borrowing. Foreign-direct investment (FDI) is welcomed enthusiastically, except in some industries, where it is spurned as an alien intrusion on the Indian way of life.

Having avoided the Asian financial crisis in the 1990s and escaped the worst effects of the most recent meltdown, India's cautious liberalisers feel they have won the argument this time around. It is hard to disagree. It is a pity emerging economies cannot enjoy a shortcut to prosperity by importing capital reliably from abroad; it is a pity they must rely so heavily on their own savings to finance their urgent investment needs; it is a pity, in short, that the

liberal case for the free movement of capital faltered. But falter it did. If the Asian financial crisis was not enough to give pause, eastern Europe's present travails should. Yet there are better and worse ways to impose capital controls to avoid inflating bubbles or becoming overdependent on foreign lenders—and India's are worse.

Keep it simple

For starters, they are needlessly complex, because India's policymakers like to retain as much room for manoeuvre as possible. They police capital flows by banning some trades, imposing quotas on others, lifting a price control here or tightening a registration requirement there. This makes life needlessly difficult for foreign investors. The rules are hard to interpret and changes are impossible to predict. One private-equity fund and its investors reckon this confusion and ambiguity cost them $8m in lawyers' fees. This accomplishes the policymakers' aim of deterring foreign capital, but not quite in the way they intended. By raising the cost of doing business, the regulatory thicket acts as an implicit tax on investing in India. Its policymakers could achieve the same effect through simple rules and explicit taxes. The $8m that is now spent on lawyers could be given to the Indian government instead.

Brazilian taxes are not the only way to put a price on inflows. Another, in a similar spirit, is to auction the right to borrow abroad. That would allow the RBI to set an overall cap on foreign fundraising, while letting borrowers themselves decide how much extra they are willing to pay for the privilege. Ministries which still impose an FDI ceiling on the industries they oversee should also abandon them. Few are justified. Why, for example, does India permit 100% FDI in the manufacture of hazardous chemicals and industrial explosives, but 74% in telecoms, 26% in insurance and none at all in supermarkets?

India must learn to live with foreign capital eventually, as its regulators freely admit. Some capital controls may help. But its current rules seem less like stepping stones to a more open future than relics of its shuttered past.

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