

## Capital accounts LEX COLUMN.

7 November 2005

Financial Times

Whether they should open their capital account is one of the trickiest macroeconomic policy issues facing developing countries. Inflows of foreign capital boost growth. Rapid outflows, however, can precipitate a crisis, as Asia discovered in 1997/98.

That experience has prompted some governments to delay capital account liberalisation. But this stymies the development of healthy domestic financial systems. It also creates difficulties for economies, such as China, that receive substantial external inflows. They either face higher inflation as their domestic money supply expands, or the fiscal cost of "sterilising" that extra liquidity.

An International Monetary Fund paper, written by **Eswar Prasad**, head of its financial studies division, and Raghuram Rajan, chief economist, proposes securitising surplus foreign exchange reserves to solve these problems. Essentially, a country would decide the level of forex reserves it requires for prudential reasons. Fresh foreign capital inflows beyond that are then sold by the central bank to one or more privately managed mutual funds, which have issued shares to domestic investors. The funds then invest in foreign stocks and bonds.

The central bank thus removes the surplus reserves from its balance sheet without incurring conventional sterilisation costs. But it remains in control of how much capital leaves the country because it can decide the timing, and size of the funds it licenses. Many governments might therefore prefer this approach to a fully open capital account. Local investors, meanwhile, should benefit from broader investment opportunities and portfolio diversification. The new funds should also stimulate the development of domestic financial markets.

The risk is that some countries might regard this scheme as an acceptable halfway house and feel under less pressure to pursue full capital account liberalisation. In fact, it might provide breathing room for governments to undertake the financial reforms needed to achieve that goal.