EXECUTIVE BOARD MEETING

SM/20/138
Supplement 8
Correction 1

September 28, 2020

To: Members of the Executive Board

From: The Secretary

Subject: **Independent Evaluation Office—IMF Advice on Capital Flows—IMF Advice on Capital Flows to the People's Republic of China and India**

Board Action:	The attached corrections to SM/20/138, Sup. 8 (8/20/20) have been provided by the IEO.
Factual Errors Not Affecting the Presentation of Staff's Analysis or Views	**Pages 1 and 2**
Questions:	Mr. Loungani, IEO (ext. 37043) Ms. Batini, IEO (ext. 35763)

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 ~~rose in excess of~~ exceeded US$2 trillion in 2009, and the fiscal situation was satisfactory.

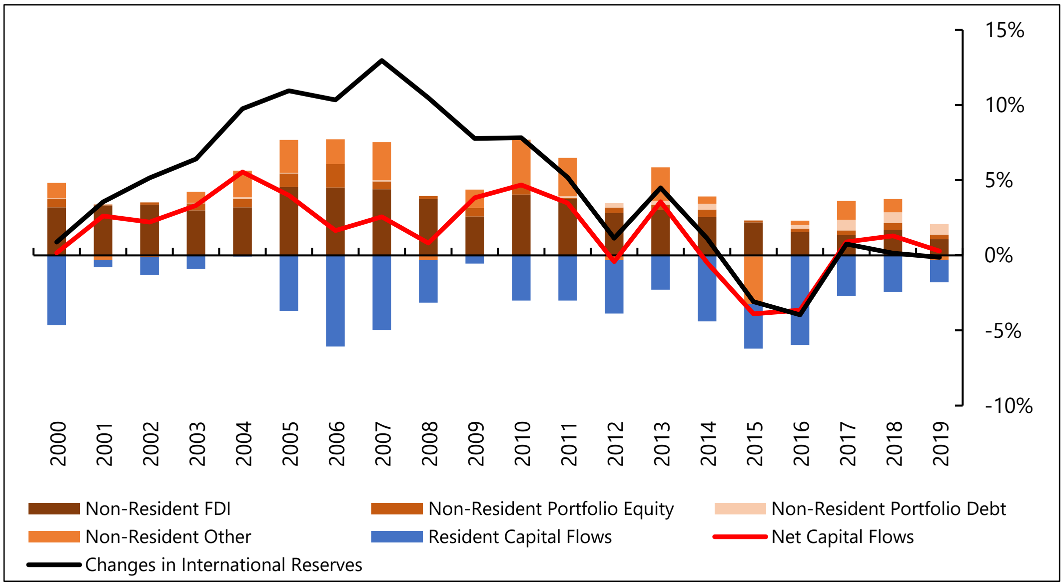
5. The country started a process of capital account liberalization from 2002 onward, actively pursuing inward foreign direct investment. Initially, China provided tax incentives for inward foreign direct investment, then permitted foreign strategic investors to take equity stakes in state-

[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.