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Control Mechanisms

Reversing the Flight of Capital

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OFFICIAL agencies have resigned themselves to the permanence of capital flight from the Indian economy. This export of wealth is conducted through bogus international trade and financial transactions. Today, this activity is increasingly seen as simply rational economic behaviour, since its purpose is often to evade taxation or inflation.

So government policy, as the current argument goes, should be to lower taxes and control inflation, to ensure such capital stays or returns. The government, it is felt, should not police the external account. But these very methods of sending money out of the country are employed to launder illegitimate profits. All such assets, whether of flight capital or other international crime, are managed by the highly sophisticated international private banking business. Merged with other transactions, all this money becomes indistinguishable.

If capital flight cannot be curbed, neither can any other sort of money laundering. Very large sums of money have entered India unlinked to any specific transactions, inviting speculation that this could be an important global centre for money laundering. At first, this money was treated as capital flows for the purpose of balance of payments accounting. Since it could not be linked to any particular investors, it was put in the statistical overflow basket of "other capital". Soon, "other capital" became the single largest item in the government's external capital account.

Other Capital

No comprehensive definition has ever been offered of this other capital — only varying partial descriptions, repeatedly modified. "Other capital" flows in 1994-95 sank unexpectedly from their peak level in the earlier year. But "private transfers" grew correspondingly. The RBI seems to have relocated some part of the other capital there. To this purpose, the annual report figures have been rewritten — but even for earlier years. Over the last three years, the figures for 1993 to 1998 have been repeatedly revised by more than a billion dollars. In some years, there are variations of over 50 per cent. Even in 1999, the figures for as long back as 1990 are marked "preliminary". This indicates that they will continue to be changed. Such laundered money can flow out even more quickly.

India's exports have reacted to the value of the rupee by growing when it appreciates, and falling when it depreciates. India doesn't export goods, it exports money — by under-invoicing exports or over-invoicing imports. Or imports it by reversing the operation, in order to deploy it in high profit speculative activities here. But such money can flow out as quickly. Now an excellent study by three American academics, Zdanowicz, Welch and Pak, has analysed every single India-United States import and export transaction for the years 1993, 1994 and 1995, to determine over-invoicing, under-invoicing and consequent capital flight. In the most recent year studied, 1995, capital flight to the United States is estimated as being up to $ 5.6 billion.

By extrapolation, it suggests that India witnessed a flight of capital of up to $ 46.1 billion on its total exports and imports to and from all countries of $ 75.1 billion in 1998-99 — or over half the value of India's international trade. How curious, then, that successive commerce ministers have applied themselves so diligently to dismantling any inspection of India's exports.

Selective Disclosure

Yet a simple monitoring of Indian export and import prices proposed by the authors would indicate such over-invoicing and under-invoicing, and could go a long way towards restricting such capital flight. Other countries take money laundering more seriously. The Australian Transaction Reports and Analysis Centre has identified all flows of capital to and from Australia, and whether they are connected to trade transactions with countries known to be significant trading partners, and whether to tax havens and centres of narcotics production. By this method, estimates of money laundering, including capital flight, have been developed. The same could be done in the case of India.

The fact that money flows to private Swiss banks are well known; but it is worth watching the the Channel Islands trusts which have developed the most sophisticated laws to protect their clients. Now this is sought to be changed by new legislation following the Edwards Report, which could permit much greater access to confidential information about Channel Islands account holders. It is very critical of Jersey's present law which limits cooperation with foreign governments to those cases which are offences in local law.

The Edwards report considers the curious case of BCCI's branch in the Isle of Man, which was wound up in 1991. One third of the individuals who lost money made no claim for compensation. This, he presumes, is because they wished to hide their identities because they were evading tax or other laws overseas. Now the Islands and Dependencies may open up and provide some information about their clients. But this may only be selective, and only to powerful states such as the US in hot pursuit of those identified as its enemies of the moment, such as Osama bin Laden, Mr Saddam Hussein or Colonel Gaddafi.

Chief Beneficiary

What the US wants are international economic bodies that it dominates. The US promotes the free convertibility of all currencies. The dollar is the global reserve currency, so the US has access to the world's savings. With the great increase in financial volatility, with every new international crisis, there is a further flight of capital to the dollar; and global financial liberalisation increases this trend. This is why the US encourages the international operations of private banks, especially American, with aggressive departments competing with the Swiss and Channel Islands' trusts for Third World clients.

The US is the biggest beneficiary of capital flight. But if we looked calmly to our own interests, there may well be a case for increased capital controls. Ms Karin Lissakers, the US executive director to the IMF, argued to the contrary before she took over her present responsibilities. And we could abandon our attempt to match the highest available returns for international flight capital. This only brings in volatile funds, which can as quickly exit. Trade and international transfers of funds could be closely monitored to detect and inhibit all money laundering. India could, were the government prepared to do so, institute cooperation with other jurisdictions to recover Indian wealth secreted abroad.