Chapter 1: Introduction

1.1 Introduction

The phenomenon of international financial flows dates back to the first wave of globalization. The first wave of globalization from around 1870 to 1913 was a period in which capital was free to move internationally. The interwar period with its economic instability, political disorder and rising nationalism witnessed a movement towards more irregular and diminished capital flows. After World War II, the Bretton-Woods system restricted international private capital mobility and national governments gave more priority to the achievement of domestic policy goals. In the early 1970s, the Bretton-Woods' dollar-gold standard was abandoned and international capital mobility surged. The 1970s witnessed a remarkable boom of capital flows to the emerging economies. The dramatic surge in international capital flows was triggered by the oil shock in 1973-1974, the growth of the Eurodollar market and the remarkable increase in bank lending during 1979-1981. The international financial flows have been further accelerated in the 2000s as a result of financial liberalization in many countries.

In theory, international financial flows are considered beneficial, as they result into accelerated economic growth through technology transfer, resource reallocation, greater financial deepening and efficient capital accumulation. At the same time, these financial flows make countries vulnerable to international financial crises, in the times of sudden reversals in international capital flows.
Financial openness brings greater volatility to domestic financial markets in developing countries, as financial systems are generally weak and economic policies lack credibility. Sudden and large reversals in short-term capital flows may lead to severe financial crises and sharp increases in unemployment and poverty, which have in some cases persisted beyond the short term.

As a result, there have been growing concerns about the negative effects of financial globalization on various macroeconomic variables and on the plight of the poorest people in the world. What is the impact of financial integration on poverty? Whether the poor do share the benefits of greater financial integration? If they are, then what is the share of their benefits? Or are the poor disproportionately hit by financial crises and economic downturns? How financial integration can be made beneficial for poor? These are some of the unresolved questions. Generally, a section of the poor remains untouched by the process of financial globalization and one sees a mixed kind of impact on them. Besides, the financial integration-poverty nexus is of a complex nature, which makes it difficult to study the effects of financial integration on poverty. Impact of financial integration on poverty also has certain country-specific aspects. Hence, analysing the actual impact of financial integration on poverty in a particular country, analysing and determining policy options to lift these people out of poverty are the most pressing issues and the most difficult tasks today.

1.2 Background
India’s financial integration, initiated in the early 1990s and financial sector reforms accompanying it were expected to enhance economic growth. And, there has been much hope that this accelerated economic growth would in turn bring more rapid poverty reduction.

‘Growth has been certainly accelerated, with GDP per capita rising at 4–5 per cent since 1991, up from barely 1 per cent in the 1960s and 1970s and 3 per cent in the 1980s. The trend rate of growth in India’s net domestic product per capita was 1.63 per cent during 1958–91 (with a robust standard error of 0.06 per cent) and 4.28 per cent (0.18 per cent) during 1992–2006. Similarly, the annual rate of growth of private consumption per capita from the NAS (Survey based on
National Accounts Statistics) rose from 1.21 per cent before 1991 to 3.13 per cent after.\(^1\)

Similarly, Per capita NNP at factor cost has increased from ₹ 14,157 in 1991-92 to ₹ 37,851 in 2011-12. In the post-reform period, Gross Domestic Capital Formation has been growing at the accelerated rate: 21.1% in 1991-92 and 38.5% in 2011-12. Accumulation of foreign exchange reserves in India have shown a steep rise from US $238.50 billion in 1991-92 to US $15061.30 billion in 2011-12. Foreign investment flows have been accelerating from US $267.44 billion in 2001-02 to US $1888 billion in 2011-12. Though not very impressively, employment in an organised sector has also increased from 36.76 million in 1991-92 to 38.83 million people in 2009-10.\(^2\)

Thus, the financial integration in India has contributed to higher foreign investment flows, accelerated growth, piling foreign exchange reserves. But, can one call this growth pro-poor? Has this financial integration-led growth served the welfare objective of poverty reduction?

According to the World Development Indicators, in 2009, 362 million people were below national poverty line in India; in 2011, this figure decreased to 273 million people. In terms of the international poverty line of USD 1.90 per day (measured at 2011 purchasing power parity exchange rates), there were 378.3 million poor people in India in a year 2009; this figure has decreased to 259.5 in 2011.

The NSSO data shows that, in the post-reform period, poverty is declining as headcount ratio has decreased from 38.9% in 1987-88 to 36 % in 1993-94, to 26.1% in 1999-2000, to 27.5 in 2004-05 and to 29.8 % in 2009-10\(^3\). However, poverty estimates differ from the committee to committee.

The major crux of financial integration-poverty nexus is that: this relationship is multidimensional, complex and mostly indirect or distant in nature. Financial integration may affect poverty directly or indirectly and positively or negatively. However, analysing net impact of financial integration on poverty reduction is a

\(^2\) Handbook of Statistics on Indian Economy; RBI.
\(^3\) The Head Count Ratios for the years 1987-88, 1993-94, 1999-2000 and 2004-05 are taken from the Planning commission’s Official estimates; i.e Lakadawala Committee estimates. The Head Cont Ratio for 2009-10 has been taken from the Tendulkar committee estimates. According to the Tendulkar committee report, both the estimates are not comparable. See Appendix 1.
difficult task. Besides, empirical research is inconclusive regarding the financial integration and poverty relationship.

1.3 Significance of The Study
It is over two decades since India has started the process of financial openness; it is the appropriate time to study its effect on the important policy objectives of growth and poverty eradication. Though post 1991, India's GDP was growing at the rate never seen before; it was a major criticism against India's growth story; that it is losing its human face; India's growth is exclusive in nature; the poor or backward section has remained untouched. If any policy is not contributing towards social welfare, then policy needs to be revised. Thus concerns for growth, labour and weaker section should be more explicitly taken into account in the current economic system in order for it to perform better. An attempt is made to analyze the impact of the policy of financial liberalization on poverty and to assess whether India's growth is pro-poor one or not.

In the spring session of April 2011 at the IMF, Mr. Dominique Strauss-Kahn, the Director, IMF; stated that, "..... ultimately, employment and equity are building blocks of economic stability and prosperity, of political stability and peace. It must be placed at the heart of the policy agenda." Thus, it is imperative to study whether financial openness achieves the said objectives and contributes to the social welfare. Financial openness affects the structure of the financial system, which in turn may have implications for financial stability, economic stability and social welfare. Monitoring financial openness is therefore important for regulators and central banks to analyze the policy of financial liberalization in India and to achieve the objective of social welfare. A study of impact of financial openess on poverty can prove helpful for future policy formulation.

The financial integration-poverty relationship is very much country specific and context-specific. The impact of financial integration on poverty depends upon many country specific factors like financial development, level of initial poverty level, existence and extent of inequalities, social expenditure, social security system in a particular country, etc. Thus the financial integration-poverty relationship specifically in India deserves a separate study with special reference to the economic conditions in India.
1.4 Objectives of The Study
The following are the objectives of the study-
1. To examine the policy developments on financial liberalization in India over the 20 years period (1991-2010);
2. To examine the extent of financial integration of the Indian economy;
3. To study the impact of financial integration on the macro variables;
4. To analyze the links between financial integration and poverty in India;
5. To study future challenges of financial integration in India;
6. To make policy suggestions on the basis of the above study.

1.5 Hypotheses of The Study
The study aims at testing following hypotheses-
• Financial integration has an impact on growth.
• Financial integration has an impact on poverty.

1.6 Research Methodology
• The present study will be based on secondary data.
• The data would be compiled from: Handbook of Statistics on Indian Economy (RBI), World Development Indicators (World Bank) and Planning Commission.
• Annual time series data on the variables like Gross Domestic Product, Per Capita Net National Product, Exports, Imports, Gross Domestic Capital Formation, Net Foreign Direct Investment Flows, Employment Ratio, Youth Literacy Rate, Consumer Price Index, M2, Head Count Ratio, Social Expenditure of the Central Government and States Governments, etc. will be compiled from the above mentioned sources.
• The annual data about the variables will be compiled for the period of 33 years from 1980 to 2013 and a time dummy on the basis of the degree of financial integration will be used to separate out the period of financial integration from the rest of the period.
• As Head Count Ratio, Youth Literacy Ratio and Employment Ratio are not available for the whole period under consideration (for the period of 33 years from 1980 to 2013), annual series will be compiled using Newton’s Divided
Difference Method, compounded annual growth rate formula or regression line, regression equation in the excel sheet.

- The data would be analyzed with the help of statistical methods like correlation analysis and regression analysis.
- The following softwares - SPSS (Statistical Package for the Social Sciences) and E-VIEWS (Econometric Views) will be used for the statistical analysis.

1.7 Limitations of The Study

- The study will be limited to the period 2001 to 2010.
- The present study aims at looking at the impact of financial integration on growth and poverty only.
- Only linear relationship between financial integration and poverty has been studied in the present study.
- Head Covint Ratio is the only available indicator of poverty in case of India. Hence it is the only measure that can be used to represent poverty. Some other comprehensive indicators of Poverty like Multidimensional Poverty Index should be explored and compiled for India on yearly basis.
- The methodology with which Head Count Ratio is measured is complex and controversial. The methodology to count the same has changed from time to time as per the recommendations of the committees set up for the task. Head Count Ratios measured on the basis of two methodologies suggested by two different committees are difficult to comparable.

1.8 Financial Openness – Concept, Meaning and Definitions

Financial integration, financial liberalization, capital account convertibility, financial globalization and financial openness are various concepts which are generally used interchangeably that one comes across in the literature on international finance. It is very important to highlight these concepts, as in principle, each one of these differs from others. Likewise in practice, all these concepts have a distinct impact on the macroeconomic variables and separate implications for the economy. If these concepts can be clearly identified and quantified, the implication of each could also be determined. Policy responses to different concepts would also be easier to define and justify.
In the beginning, the concept of **Financial Repression** is analyzed. It is the exact opposite of financial openness. This concept first originated in the works of Ronald I. McKinnon and Edward S. Shaw in 1973. According to Agenor and Montiel (1996), Financial Repression, is used to describe a developing country environment whereby “the financial system is repressed (kept small) by a series of government interventions that have the effect of keeping very low (and often at negative levels) interest rates that domestic banks can offer to savers.” Murat Ucer (1998) states that financial repression has been most commonly associated with the government fixing of interest rates and its adverse consequences on the financial sector as well as on the economy. Interest rate regulations, directed credit schemes and high reserve ratios are the most common forms of financial repression.

The main motive behind financial repression is to raise resources for the government, who lacks the resources but wishes to promote development. Through imposition of large liquidity and reserve requirements, government creates a captive demand for its own interest-bearing or non-interest bearing instruments, respectively, and uses it to finance its own priority spending. It puts a cap on interest rates, which creates excess credit demand, and directs credit to its own priority sectors. Financial repression creates problem because, repressing the monetary system fragments the domestic capital market with highly adverse consequences for the quality and quantity of real capital accumulation.

Financial repression affects the capital accumulation adversely. It forces potential investors to rely more on self-finance as the flow of loanable funds through the organized banking system is reduced. In the period of financial repression, interest rates on bank lending vary from class to class and from borrower to borrower. Financial repression impairs the process of self-finance too. Financial deepening becomes impossible as firms are illiquid and/or inflation is high and unstable.

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When economy moves away from financial repression that is, when the
government starts lowering the controls on the financial system, then it is called as **financial liberalization**. Earlier financial liberalization was restricted only to interest rate liberalization, elimination of directed credits and cutting down reserve requirements. But today the concept of financial liberalization has undergone a change. According to Murat Ucer (1998), other than interest rate liberalization and elimination of directed credits and high reserve requirements, financial liberalization involves a wide set of additional measures including the easing of portfolio restrictions on banks, changes in the ownership of banks, enhanced competition among banks, integration of domestic entities to international markets as well as changes in the monetary policy environment. Kaminsky and Schmukler (2003) have given the multidimensional definition of financial liberalization. According to them, 'financial liberalization consists of the deregulation of the foreign sector capital account, the domestic financial sector and the stock market sector viewed separately from the domestic financial sector'.

External sector reforms go hand in hand with financial sector reforms. External sector reforms include removing restrictions on exchange and payments system and establishing a freely functioning foreign exchange market. This helps to remove distortions those limit portfolio behaviour. Broadly, the external sector reforms involve two phases: removal of all restrictions on current payments and transfers, and capital account liberalization. The capital account liberalization, by enhancing country's integration with the rest of the world, ends the phase of financial repression.

By the term Financial Liberalization, Murat Ucer (1998) means all the measures, such as the autonomy of the Central Bank; completely free financial inflows and outflows i.e. full convertibility of the currency on current account as well as capital account; abolition of priority sector lending; market determined interest rates; no government control on banks; complete freedom of banks to pursue profits; de-nationalization of banks and full freedom for foreign ownership of banks; and so on. These measures are not necessarily presented or implemented as

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a package or in their maximum form. The sequence, form and strategy of presenting and implementing financial liberalization may differ from country to country and time to time.

Full financial liberalization implies that financial system, stock market and capital account of an economy are fully liberalized. According to Kaminsky and Schmukler (2003), full financial liberalization occurs when at least two of the three sectors i.e. the foreign sector capital account, the domestic financial sector, and the stock market sector viewed separately from the domestic financial sector, are fully liberalized and the third one is partially liberalized. A country is said to be partially liberalized when at least two sectors are partially liberalized.

A fully liberalized domestic financial system implies lack of controls on interest rates and the lack of credit controls. Deposits in foreign currencies are permitted. Foreign investors are also allowed to hold domestic equity without restrictions and capital, dividends and interest can be repatriated freely within two years of the initial investment.

The liberalization of the capital account implies relaxing the regulations on offshore borrowing by financial institutions and by non-financial corporations, on multiple exchange rate markets and on capital outflow controls. In a fully liberalized capital account regime, banks and corporations are allowed to borrow abroad freely. They may need to inform the authorities but permission is granted almost automatically. Reserve requirements might be in place but are lower than 10 per cent. Also, there are no special exchange rates for either the current account or the capital account transactions; there are no restrictions to capital outflows.

However, financial liberalization is different from monetary reforms and both these concepts have different meanings. Agenor and Montiel (1996) and Park (1991) have discussed these two concepts in detail, monetary reforms are defined as an increase in controlled interest rates to near-equilibrium levels, and the reform of the institutional set-up of monetary policy implementation, which primarily involves increased independence for the central bank and a switch from direct instruments of monetary policy. Whereas, financial liberalization is a much

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more ambitious set of reforms, directed at shift from direct controls on banking sector (e.g., interest rate controls, statutory liquidity ratios, directed credits,) to indirect controls (e.g. reserve requirements, public sector deposits, primary and secondary market sales of bills, foreign exchange swaps and outright sales and purchases). The main focus here is for the central banks to stimulate the growth of money markets and instruments with a view to enhancing market-orientedness of its policy environment.

Financial integration is the process through which a country’s financial markets become more closely integrated with the world financial markets. This requires the elimination of some or all restrictions on foreign financial institutions from some or all the countries. Countries may need to offer cross-border financial services in others, as well as there should be establishment of links between banking, equity and other types of financial markets. For the integration process to be successful, policies, rules and standards governing regulations, risk valuations, accounting and auditing have to be harmonized in all participating countries. This is crucial to guarantee transparency and comparability across financial sectors. Financial markets can become better integrated if information is shared across countries. Such integration can be strengthened further by harmonizing the rules that govern credit information and collateral registries, and by allowing for the sharing of information between countries. In addition, any policy that facilitates information sharing across countries or increases its efficiency at any level relevant to financial markets can help to promote cross-border trading of financial services.

Campbell R. Harvey (2012) defines ‘financial integration as a market in which there are no barriers to financial flows and the same risk asset commands the same expected return, irrespective of domicile’

The Farlex Financial Dictionary (2012) defines ‘financial integration as any market where capital may flow freely. For example, a country with uniform tax laws and regulation usually has an integrated financial market because there are no circumstances where one’s return will be reduced because of tax restrictions or different regulation. In other words, in an integrated financial market, investments of the same risk always have exactly the same expected return’.

10 Copyright © 2012, Campbell R. Harvey
Baele et. al. (2004) define **financial integration** as ‘freedom of participants in the financial markets of two countries to transact on markets in both countries, thereby causing returns on comparable assets in the two countries to be equalized through arbitrage’.12

**Financial markets** are **integrated** when the law of one price holds. The law of one price states that if assets have identical risks and returns, then they should be priced identically regardless of where they are transacted. Marco Pagano(2002) states that ‘assets generating identical cash flows command the same return, regardless of the domicile of the issuer and of the asset holder. When countries share a common legal and regulatory framework, identical assets may command same returns’.13

‘Integration of financial markets is a process of unifying markets and enabling convergence of risk-adjusted returns on the assets of similar maturity across the markets. The process of integration is facilitated by an unimpeded access of participants to various market segments. Financial markets all over the world have witnessed growing integration within as well as across boundaries, spurred by deregulation, globalization and advances in information technology’.14

‘The market for a given set of financial instruments and/or services is fully integrated if all potential market participants with the same relevant characteristics (1) face a single set of rules when they decide to deal with those financial instruments and/or services, (2) have equal access to a set of financial instruments and/or services, and (3) are treated equally when they are active in the market’.15

This definition of financial integration by Baele et al. (2004) does not consider the differences in the financial structures within regions. This definition also says that financial integration is concerned with the impact of existing hurdles on different areas and not about removing hurdles in the optimal allocation of capital, i.e. areas can be financially integrated if hurdles affect these areas symmetrically. Lastly,

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13 Pagano Marco. (2002) His talk; based on a report “Study to analyze, compare, and apply alternative indicators and monitoring methodologies to measure the evolution of capital market integration in the European Union” authored by himself, Klaus Adam, Tullio Japelli, Annamaria Menichini and Mario Adula. prepared by the Centre for Studies in Economics and Finance for the European Commission.

14 Report on Currency and Finance; 2005-2006; Reserve Bank of India.

financial integration also implies the same access to banks or trading, clearing and settlement of the transactions for both investors and firms regardless of their region of origin, i.e. there is no discrimination on the location of origin of the market participants.

Hong-Giang Le, (2000) has defined perfect financial integration, as 'the situation when the parity of real interest rates is guaranteed. To achieve this condition, the country's capital account must be open, and other barriers to achieve parity should not exist. In the real world, no country can achieve perfect financial integration, although most of them have already opened their capital accounts. The reasons vary across countries, but the consequence of less than perfect integration is common to all—domestic interest rates deviate vastly from the world rates'\footnote{ibid.}.

The RBI Report on Currency and Finance (2005-06) has given the dimensions of financial market integration. According to the report, 'financial market integration takes place in three dimensions, nationally, regionally and globally. Domestic financial market integration includes horizontal linkages of various segments, reflecting portfolio diversification by savers, investors and intermediaries. Under horizontal integration, market interest rates typically revolve around a basic reference rate, which is defined as the price of a short-term low risk financial instrument in a competitive and liquid market'\footnote{ibid.}.

'Global financial integration refers to the opening up of domestic markets and institutions to the free cross-border flow of capital and financial services by removing barriers such as capital controls and withholding taxes'\footnote{ibid.}. This implies removing restrictions on the movement of people, capital, technology and market participants across countries. Global financial integration can be enhanced through harmonisation of national standards and laws.

'Regional financial integration occurs due to ties between a given region and the major financial centre in that region'\footnote{ibid.}. Regional economic integration is easier to achieve due to ease of regional networking and the tendency of market makers to concentrate in certain geographical centres. Regional financial integration may

\footnote{Hong-Giang Le. (2000) "Financial openness and financial integration", Asia Pacific Press 2000; D100-4 3, Asia Pacific School of Economics and Management, WORKING PAPERS.}
\footnote{RBI. (2006), Report on Currency and Finance; 2005-2006; RBI.}
\footnote{ibid.}
\footnote{ibid.}
help to develop local financial markets through group pressure for strengthening institutions and upgrading local practices.

From an alternative perspective, financial market integration can be horizontal and vertical. The **horizontal financial integration** implies increasing inter-linkages among domestic financial market segments, while **vertical financial integration** implies increasing linkages between domestic markets and international/ regional financial markets.

There is a distinction between de jure financial integration and de facto financial integration.\(^{20}\) De jure financial integration is associated with policies on capital account liberalization, and de facto financial integration means actual capital flows.

According to E. S. Prasad n al. (2003), **financial globalization and financial integration**\(^{21}\) are two different concepts. Financial globalization refers to increasing global linkages created through cross-border financial flows. Thus financial globalization is an aggregate concept and refers to the process of enhancing financial linkages among all the countries. Financial integration refers to an individual country's linkages to international capital markets. These two concepts are closely related, as increasing financial integration leads to increasing financial globalization.

Hong-Giang Le (2000) defines 'the openness of a country's capital account' as the situation when capital can move freely across borders. Domestic firms can raise capital in both domestic and international markets, while domestic investors can invest wherever they want. However, the free movement of capital does not imply parity between domestic and world real interest rates. The difference may be attributed to asymmetric information problems, transaction costs, borrowing constraints, country risks, or government interventions and regulations in financial markets.\(^{22}\)

Capital account liberalization has to be implemented with greater caution, because financial markets and instruments are much more complicated in nature and the process of liberalization does not always guarantee full financial integration. Open


\(^{21}\) ibid.

\(^{22}\) Hong-Giang Le. (2000) "Financial openness and financial integration", Asia Pacific Press 2000; DI00-4 3, Asia Pacific School of Economics and Management, WORKING PAPERS.
economies may even face problems as capital account liberalization does not always guarantee financial integration. Thus, countries should pay attention to both openness and integration while liberalising capital accounts.

The Committee on Capital Account Convertibility (Tarapore committee I, 1997) defines Capital Account Convertibility (CAC) as ‘the freedom to convert the local financial assets into foreign financial assets and vice versa. It is associated with changes of ownership in foreign/domestic financial assets and liabilities and embodies the creation and liquidation of claims on, or by, the rest of the world. CAC can and does, coexist with restrictions other than on the external payments’ 23. The cross-country experience with capital account liberalization suggests that countries, including those which have an open capital account, do retain some regulations influencing inward and outward capital flows.

The mainstream view holds that capital account liberalization can be beneficial when countries move in tandem with a strong macroeconomic policy framework, sound financial system and markets, supported by prudential regulatory and supervisory policies.

The concepts of financial integration and financial openness are used interchangeably in the economic literature. As a result, ill-effects of financial openness are regarded as the costs of financial integration and it may be concluded that financial integration leads to welfare reduction. Therefore, a clear distinction should be made between these concepts. Thus, financial openness is the means, while financial integration is the goal. Country aims at greater financial integration with the policy of financial openness. Although financial openness is a necessary condition for financial integration, it is not a sufficient condition.

In practice, ‘financial openness is the situation where existing administrative and market-based restrictions on capital movement across borders have been removed. In some countries, it also includes the introduction of measures to attract foreign capital and reduce the discrimination against foreign financial institutions operating in domestic markets. Many countries have experienced a lot of problems after liberalising their capital accounts, which have prevented them from achieving the final goal of financial integration. This implies that financial openness does not guarantee immediate financial integration24. Thus, financial

23 Tarapore Committee I (1997) on Fuller Capital Account Convertibility.
24 ibid
openness is not a sufficient condition for financial integration. There is a need of certain other necessary conditions, in the presence of which financial openness leads to the financial integration. Absence of these conditions has caused troubles for those countries which were relatively open in terms of their capital accounts.

1.9 Economic Growth – Concept, Meaning and Definitions

Economic growth is a commonly used concept which is generally defined as ‘an increase in the capacity of an economy to produce goods and services, compared from one period of time to another. Economic growth can be measured in nominal terms, which include inflation, or in real terms, which are adjusted for inflation’.25

According to A. Maddison, ‘the raising of income levels is generally called economic growth in rich countries and in poor ones it is called economic development’.26

According to C. Kindleberger, ‘economic growth means more output. Growth may well involve not only more output derived from greater amounts of inputs but also greater efficiency, i.e. an increase in output per unit of input’.27

J. Friedman defines growth, ‘as an expansion of the system in one or more dimensions without a change in its structure’.28

Thus economic growth is related to a quantitative sustained increase in the country’s per capita output or income accompanied by expansion in its labour force, consumption, capital and volume of trade.29

Economic growth is the increase in the inflation-adjusted market value of the goods and services produced by an economy over time. GDP is commonly used as an indicator of the economic health of a country, as well as of a country’s standard of living. GDP is also used to compare the productivity of various countries, as the way of measuring GDP is uniform

25 www.investopedia.com/terms/e/economicgrowth.asp
from country to country. Gross domestic product (GDP) is the money value of all
the final goods and services produced within a country's borders in a given year.
Though GDP is usually calculated on an annual basis, it can be calculated on
a quarterly basis as well.
Gross Domestic Product can be calculated using the following formula:
\[ \text{GDP} = C + G + I + NX^{30} \]
where,
\[ C = \text{all private consumption, or consumer spending, in a nation's economy}, \]
\[ G = \text{the sum of government spending}, \]
\[ I = \text{the sum of all the country's investment, including businesses capital} \]
\[ \text{expenditures and} \]
\[ NX = \text{nation's total net exports, calculated as total exports minus total imports} \]
(NX = Exports - Imports).
Thus, GDP is a broad measurement of a nation's overall economic activity, which
includes all private and public consumption, government expenditure, investments
and exports minus imports that occur within a defined territory.
Growth is also calculated in real terms, i.e., inflation-adjusted terms. This is to
eliminate the distorting effect of inflation on the price of goods produced. The
Real Gross Domestic Product (GDP) is an inflation-adjusted measure: it reflects
the value of all goods and services produced in a given year, expressed at the
base-year prices. (It is also referred to as GDP at constant-prices or as inflation-
corrected GDP or constant dollar GDP.) Adjusting GDP for inflation from year to
year allows for the comparison of GDP across time, i.e. the comparison of current
GDP measurements with measurements from previous years or quarters. Thus
economic growth can be measured as a percentage change in the real GDP.
Conventionally, economic growth is measured as the per cent rate of increase in
per capita real gross domestic product, i.e. per cap real GDP, i.e. the ratio of Real
GDP to population. This measure facilitates the comparisons of growth or GDP
across time and across countries as this takes into account population differences
between countries and inflation i.e. changes in price levels.
GNP is also used as an indicator of growth. GNP is the money value of all the
final goods and services produced by the residents of the country within a year.
Gross National Product (GNP) is an economic statistic that includes GDP, plus

\[ \text{revised 19th edition.} \]
net income earned by the residents outside the country. Net income earned by the residents outside the country is calculated as the total income earned by the residents from overseas minus income earned within the domestic economy by overseas residents.

Gross National Product can be calculated using the following formula:

\[ \text{GNP} = \text{GDP} + \text{Net Factor Income from abroad} \]

where,

GDP = Gross Domestic Product

Net Factor Income from abroad is calculated by deducting the total income earned by the foreigners in the country from the total income earned by the residents of the country from abroad.

NNP is also used to measure growth. Net National Product (NNP) is an economic statistic that is calculated by deducting depreciation charges from the GNP. NNP measured at factor price is the actual national income generated in an economy within a given financial year.

Net National Product can be calculated using the following formula:

\[ \text{NNP} = \text{GNP} - \text{Depreciation} \]

where,

GNP = Gross National Product

Depreciation = Capital Consumption Allowance / Consumption of Fixed Capital as a result of its use in the production process or fall in the value of fixed capital due to wear and tear of a machine.

Thus, growth rates of Real Per Capita GDP, Real Per Capita GNP or Real Per Capita NNP are also used to indicate growth. Real Per Capita NNP measures the Net National Income i.e. national income adjusted for the depreciation of the capital. These measures when adjusted for the exchange rate differences i.e. based on the equality of the purchasing powers of the different currencies are the most suitable indicators for international comparisons. Thus, Real Per Cap NNP (measured at factor cost) based on the purchasing power parity can be considered as the suitable measure of growth. More specifically, \textit{Growth of Per Capita Net National Product measured at factor cost based on the purchasing power parity} is used to measure economic growth.

\[^{32}\text{ibid}\]
1.10 Poverty – Concept, Meaning and Definitions

Poverty has many dimensions. Poverty results from a combination of economic, political and environmental factors. Income is usually taken as a reliable proxy for determining the adequate level of consumption and poverty, as income is easier to consider and measure than most of the other dimensions. Thus income is commonly used as an indicator of poverty and particularly for the purposes of international comparisons of poverty. There are several definitions of poverty depending on the context of the situation and the views of the person giving the definition.

According to the United Nations, ‘fundamentally, poverty is a denial of choices and opportunities, a violation of human dignity. It means lack of basic capacity to participate effectively in society. It means not having enough to feed and clothe a family, not having a school or clinic to go to; not having the land on which to grow one’s food or a job to earn one’s living, not having access to credit. It means insecurity, powerlessness and exclusion of individuals, households and communities. It means susceptibility to violence, and it often implies living in marginal or fragile environments, without access to clean water or sanitation’.

According to the World Bank, ‘poverty is pronounced deprivation in well-being, and comprises many dimensions. It includes low incomes and the inability to acquire the basic goods and services necessary for survival with dignity. Poverty also encompasses low levels of health and education, poor access to clean water and sanitation, inadequate physical security, lack of voice, and insufficient capacity and opportunity to better one’s life’.

As pointed out by the Expert Group to review the methodology for Estimation of Poverty (Tendulkar Committee, 2009), the concept of poverty is associated with socially perceived deprivation with respect to basic human needs. ‘These basic human needs are usually listed in the material dimension as the need to be adequately nourished, the need to be decently clothed, the need to be reasonably sheltered, the need to escape avoidable diseases, the need to be (at least)

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33 UN Statement, June 1998 – signed by the heads of all UN agencies
minimally educated and the need to be mobile for purposes of social interaction and participation in economic activity'.

According to the committee, it is not possible to define poverty line on the basis of such a multidimensional and wide concept of poverty as it includes both material and non-material dimensions.

Generalized poverty can be straightforwardly defined as “a situation in which a major part of the population lives at or below income levels sufficient to meet their basic needs.”

The Copenhagen Declaration of The World Bank Organisation defines absolute poverty as, ‘a condition characterized by severe deprivation of basic human needs, including food, safe drinking water, sanitation facilities, health, shelter, education and information. It depends not only on income but also on access to social services’. The term 'absolute poverty' is sometimes synonymously referred to as 'extreme poverty.'

"The most commonly used way to measure poverty is based on incomes. A person is considered poor if his or her income level falls below some minimum level necessary to meet basic needs. This minimum level is usually called the "poverty line". What is necessary to satisfy basic needs varies across time and societies. Therefore, poverty lines vary in time and place, and each country uses lines which are appropriate to its level of development, societal norms and values.”

Poverty is computed on the basis of the number of individuals whose expenditure (or income) is below a conventional threshold, the poverty line. ‘Absolute poverty is defined in reference to a poverty line that has a fixed purchasing power determined so as to cover basic needs. The Absolute poverty line is determined with respect to the monetary value of a bundle of necessary goods and services,

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updated every year to take account of the variation in prices and bundle composition.38

*Relative poverty* is determined as a fixed proportion of the mean income of population. **Relative poverty line** is determined annually with respect to the population's average level of income.39

Internationally, the poor are defined as those individuals whose income (or expenditure) is less than 2 US dollars per day and extremely poor are defined as those individuals whose income (or expenditure) is less than 1 US dollar per day adjusted for Purchasing Power Parity (PPP) at 1985 constant prices. These poverty lines were originally introduced by Ravallion et.al. in 1991 and re-computed by Chen and Ravallion (2001) using 1993 as base year, and set to 2.16 and 1.08 US dollar per day. It should be noted that the use of PPP adjusted poverty lines facilitate the international comparisons of data on poverty.

National poverty lines defined on the basis of the monetary value of a country's specific bundle of goods, are also used to measure poverty. National poverty line is more accurate in describing the real extent of poverty within a country, but it is difficult to upgrade the poverty line over time and to compare such poverty lines internationally. As shown by Karshenas (2002), 'countries with higher GNP per capita tend to have higher poverty lines. Thus, on the other hand, the 1 and 2 USD/PPP lines are good proxies for national poverty lines in extremely poor and poor countries respectively'.

The existing all-India rural and urban poverty lines based on the per capita calorie norms of 2400 (rural) and 2100 (urban) were originally defined in terms of per capita total consumer expenditure (PCTE) at 1973-74 market prices and adjusted over time across states for changes in prices. The all-India poverty line so defined in 1973-74 was ₹ 49.63 for rural areas and ₹ 56.64 for urban areas.

The Expert Group (chaired by Dr. C. Rangarajan) computed the average requirements of calories, proteins and fats based on ICMR norms differentiated by age, gender and activity for all-India rural and urban regions to derive the normative levels of nourishment. Accordingly, the energy requirement works out to 2,155 kcal per person per day in rural areas and 2,090 kcal per person per day.

39 *ibid.*
in urban areas. For reasons elaborated in the text, the Expert Group (chaired by Dr. C. Rangarajan) views the Calorie norm not as a single number but as an average in a band of +/- 10 per cent of these values and with intakes even at the lower end still being adequate enough to not adversely affect health and work. Thus, monthly per capita consumption expenditure of ₹ 972 in rural areas and ₹ 1407 in urban areas are treated as the poverty line at the all India level in 2011-12.

1.11 Summary

To sum up,

As it is clear from the above discussion, financial liberalization, financial integration, financial openness, financial globalization and capital account convertibility are all different concepts having different implications thereof.

De jure financial integration, financial openness and capital account convertibility can be considered as similar to financial liberalization; whereas de facto financial integration can be considered as same as financial integration.

Financial liberalization can be considered as a process incorporating the liberalization of the capital and financial account and also elements such as less or different supervision and regulation of the banking sector and often liberalization of the foreign exchange rate regime. Financial liberalization means changes in laws and regulation, leading to greater financial integration.

Financial integration may be considered as the situation where country’s financial system is well integrated in the world financial system. For the integration process to be successful, policies, rules and standards governing regulations, risk valuations, accounting and auditing have to be harmonized in all participating countries. This is crucial to guarantee transparency and comparability across financial sectors.

Economic growth is related to a quantitative sustained increase in the country’s per capita output or income accompanied by expansion in its labour force, consumption, capital and volume of trade. Economic growth can be measured in nominal terms, which include inflation, or in real terms, which are adjusted for inflation. The indicator of growth is generally adjusted for the differences in price

level, differences in population growth, differences in the purchasing powers of the different currencies to make it comparable across time, nations, etc.

The discussion on the concept, measurement of poverty and poverty line also shows that poverty is a multidimensional concept having lots of measures and complexities in its measurement. Income level adjusted for the purchasing power parity is the most acceptable measure of poverty. It can be concluded that relative and absolute poverty are two separate concepts, with different meanings, measurement procedures, and theoretical links with globalization.

In the present study, Poverty will be considered as absolute poverty which is defined in reference to a poverty line that has a fixed purchasing power determined so as to cover basic needs. The state and degree of financial integration of India will be analyzed and its impact on poverty will be studied.