Chapter 6. Conclusion and Policy Implications

The “emerging market phenomenon” of the late 1980s and early 1990s led many developing countries to initiate financial liberalization and open up their economy to allow foreign portfolio investment in their domestic stock markets. During this period, foreign portfolio investment was publicized as the most ideal form of capital inflow for the developing countries as it allowed them to access non-debt creating foreign capital which came without the constraints associated with foreign direct investment, commercial loans or aid. Mainstream views suggested that increased inflows of foreign capital would increase the allocative efficiency of capital and the rate of investment in a developing country. Moreover, during this period the IMF, through its Structural Adjustment Programmes, forced many developing countries to liberalize their financial markets and open up their financial sector for foreign investors.

Inflows of portfolio investment are seen to reflect investor confidence in the ambitious programs of free-market reform implemented in many countries. Inflows are also seen to be an important source of investment finance in capital-scarce economies (WIDER 1990). Perhaps what is most appealing about portfolio investment is that it seems to be free of the kinds of constraints on national policy sovereignty that have traditionally been associated with direct investment, commercial bank loans, or foreign aid flows.

As a result, a wave of financial liberalization swept across the developing countries during the late 1980s and early 1990s. Portfolio capital flow became a major source of foreign capital for developing countries and stock markets in these countries increasingly started to gain prominence in their financial system. India also joined the bandwagon in 1992 and allowed foreign portfolio investors to invest in its domestic stock markets. Since then, FPI has become the dominant form of private foreign investment in India. This study set out to investigate the impact of foreign portfolio investment on the economic development of India and in particular on Indian industry. The results of this study can be broadly divided into two categories.

1. Impact of Foreign Portfolio Investment on the domestic economy

First, this study observes that the perceived benefits of foreign portfolio investment have not been realized in India. From the results of this study it can be said that the mainstream argument that the entry of foreign portfolio investors will boost a country's stock market and consequently the economy, does not seem be working in India. The influx of FIIIs has indeed influenced the secondary market segment of the Indian stock market. But the supposed linkage effects with the
real economy have not worked in the way the mainstream model predicts. Instead there has been an increased uncertainty and skepticism about the stock market in this country. The following results of this study show why the influx of portfolio investment has not helped economic development in India.

Results:

1. The mainstream theory predicted that the influx of FPI would boost the domestic stock market and enhance the efficiency of the domestic financial system which, in turn, would lead to higher domestic saving. But empirical evidence shows that the entry of FIIs in the Indian stock market, was followed by a massive exodus of small savers from equity related instruments (shares and debentures + units of UTI). Investor surveys suggest that uncertainties and irregularities associated with stock markets are the main reasons behind the disenchantment of the small savers. Data also show that there has been a substitution away from equity related instruments towards safer instruments of savings like bank deposits, government papers and contractual savings during this period. This result suggests that the mainstream assertion that advent of FPI will boost up the domestic saving in equity related instruments, has not worked in this country. However, this result is not unexpected because in a relatively low income country like India, the need for secure incomes is likely to be the predominant concern among the small savers.

2. Withdrawal of household savers from the domestic stock market affected the primary market more than the secondary market. This happened because increased activities by the FIIs were able to compensate for the exodus of the household savers in the secondary market. But FII involvement in the primary market remained marginal in India and therefore the primary market could not recover from the large scale withdrawal of small investors. As a result, there was a sharp decline in the capital mobilized from the primary market during the period 1994-95 to 2000-2001. Only for a very brief period in 1999-2000, the primary market revived due to the boom in the Information Technology sector. But following the global crash of the technology stocks, the primary market slumped once again. The mainstream model suggested that a vibrant secondary market would also boost the primary market, which, in turn, would help the corporate sector to mobilize resource mobilization. However, the Indian experience shows that activities in the secondary segment of the stock market may not result in increased resource mobilization from the primary market.

3. A survey of literature on the financing pattern of developed and developing countries shows
that there are significant differences between the financing pattern of firms in developed and developing countries. Firms in developing countries tend to rely much more on external finance than their developed country counterparts. Also, the contribution of equity market, as a source of finance, is much higher in the developing country firms. Existing studies on the financing pattern of the Indian corporate sector confirm that firms in India followed the same financing pattern as the developing countries up to the early 1990s. This study empirically investigates the financing pattern of the Indian corporate sector for the period 1989 to 1998. Using a group of samples it has been found that the financing pattern of the corporate sector in India shows some broad similarity across the samples. The results show that

a. External finance is more important as a source of finance for Indian firms.

b. The importance of the capital market has declined as a source of finance after 1995. However, the capital market still contributes significantly in the financing of Indian firms.

c. The contribution of external equity has declined significantly after 1995.

d. External debt has remained an important source of finance for Indian firms. In fact, the importance of external debt has increased over the years.

These results highlight that equity related finance got a spurt in the early 1990s. The importance of equity as a source of finance peaked around 1994. After that resource mobilization of the Indian corporate sector shifted away from equity related financing towards financing using external debt. Private placements have also become a popular mode of resource mobilization among the Indian corporate sector. These observations reiterate the earlier finding that increased stock market activities in the secondary market have not resulted in easier resource mobilization for the Indian corporate sector.

4. Empirical evidence also shows that the performance of the Indian corporate sector has not been satisfactory in the decade of 1990s. Particularly during the second half of the decade, the performance declined even further. As far as the influence of stock markets on the corporate sector is concerned, this study shows that the massive growth of the stock market was not reflected in the performance of the corporate sector in India during the 1990s. It was suggested in the mainstream argument that the influx of FPI would help to develop a stock market based system, which, in turn, would lead to an increase in the level of efficiency of the corporate sector. If efficiency of the firms can be measured by any of the indicators such as profitability, return on capital employed, value addition or asset utilization ratios, the evidence presented in this study shows that on all these counts, there has been a steady
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decline in the performance of the corporate sector in India. In fact, corporate profitability reached an all time low during the late 1990s. Also, from the findings of this study, it appears that the market for corporate control has actually proved to be a drag on resources for the Indian firms. Moreover, it is observed that due to increased speculative activity in the domestic financial system, to make financial gains, many firms in the corporate sector have used a substantial portion of their resources in financial investments rather than using it to increase the productive capacity of the economy.

5. Investment pattern of the FIIs in the Indian stock market shows that the Pharmaceutical sector received very high proportion of foreign portfolio investment coming to India. Along with the Information Technology and Communication sector, the Pharmaceutical sector is one of the best performing sectors in the domestic stock market. It is generally presumed that the good performance of the Pharmaceutical sector during the 1990s and its high growth prospects are the main reasons behind the investor confidence shown towards this sector. However, empirical evidence presented in this study indicates that the optimism shown by the stock market is difficult to justify in terms of the present profitability and growth indicators of this sector. Also, this study shows that there are considerable doubts about the future growth prospects of the pharmaceutical sector in India. India’s commitment to the TRIPS agreement in WTO, requires that India should introduce a product-patents based regime by 2005. It is expected that there will be a complete structural overhaul of the Indian Pharmaceutical industry once the new patent regime is implemented. It is also expected that once the product-patent regime is introduced in India, multinational companies will enter the Indian Pharmaceutical sector. According to industry analysts, it is highly probable that the MNCs will try to enter the Indian market through acquiring existing companies. Based on this evidence, this study hypothesizes that there is a possibility that the high prices of the stocks of the pharmaceutical firms in India are not based on present performance or future growth prospects but in anticipation of takeover bids by the MNCs in near future. The results of this chapter show that the argument that stock markets reward efficiencies and high growth prospects may not be true in many cases. From this evidence it seems that for the Pharmaceutical sector in India, the stock market optimism does not stem from present performance or future growth prospects of this sector, but is a speculative move in anticipation of increases of share prices of the companies because of the possibility of M&A in near future.

These results suggest that the influx of FPI has not benefited the domestic economy. The impact
of foreign portfolio investment has largely been confined within the secondary market. The transmission mechanism by which secondary market activities help the real economy does not seem to be working in India.

These results are not surprising because unlike FDI, FPI does not have a one-to-one relationship with real investment. Portfolio investment is entirely concentrated in the secondary market and the beneficial effects of FPI are supposed to work only via the functioning of a stock market. Even at a theoretical level, the proposition that a vibrant stock market affects economic development is not beyond criticism. According to a vast body of literature, stock markets, under certain conditions, may actually inhibit economic development. Even in advanced countries with developed capital markets, stock markets are likely to do more harm than good to the real economy. One of the main reasons behind this deleterious role of stock markets emerges due to the dilemma posed by modern capital markets. Modern capital markets try to reconcile the social need for investment with the preference of individual investors for risk, return and liquidity. In this process, secondary markets open up prospects for speculation. Speculation leads to a situation where the players indulge in outguessing the market in foreseeing changes in short term financial ratios. This turns the secondary market in some kind of a casino where people speculate on other people's speculation (Keynes 1936). Also, Mishkin (1996) has argued that securities' markets are more prone to the problem of adverse selection, because asymmetries of information are particularly acute in these markets. Asymmetries of information make low quality firms more eager to issue securities, which exacerbates the problem of adverse selection in these markets.

The preponderance of distortionary speculative activities in stock markets and the existence of adverse selection problem ensure that the supposed positive contributions of stock markets (encouragement of savings and more efficient allocation of investible resources), hardly materialize in practice. Also, in a stock market based economy, individual investors, neither have the means nor the incentive to monitor and control corporate management. Market discipline is often exercised through hostile takeovers. Generally, it has been found that takeovers are disruptive and wasteful. More importantly, since markets try to value the enterprise largely on the basis of short-term financial performance, take-over threats create pressures and incentives for the management to think short-term. These negative features of stock markets like speculation, short termism and the turmoil of the take-over mechanism, can create a much more unfavourable impact on the third world countries with underdeveloped stock-markets, which are essentially less
efficient and less transparent than their developed country counterparts. Studies suggest that in developing countries, capital market development has generated more costs than benefits in recent years. These costs have included persistent misalignment of prices of financial assets, resulting in inefficiency in allocation of resources; sharply increased short-term volatility of asset prices, resulting in greater uncertainty; excessive borrowing to finance speculative asset purchases and consumption, resulting in unsustainable stocks of debt and reduced household savings.

Also as Rakshit (2002) points out, efficiency gains from short-term capital movements are crucially dependent on the absence of herd behaviour and moral hazard and on constant endeavor on the part of the investors in tracking changes in the economic fundamentals rather than in beating the gun by outguessing the psychology of the market. But according to Rakshit, it is increasingly becoming evident that short-term capital inflows do not operate under such ideal conditions. The telecommunication revolution has drastically decreased the time and cost of transferring funds from one market to the other in the recent years. The increasing ease of transferring funds between markets reduces the incentive for the investors to devote resources for assessing the health of enterprises and hence, leads to serious moral hazard problems. Here it is worth mentioning that the bailout packages adopted by the IMF to rescue the crisis ridden countries have actually exacerbated the moral hazard problem associated with foreign investment. This happens because the IMF bailout packages typically try to compensate foreign investors. This further encourages investors to undertake more risky ventures knowing that in the event of a crisis, they will be insulated from the potential losses.

Therefore, to sum up, according to the mainstream paradigm, the beneficial effects of FPI are crucially dependent upon the assumptions that well functioning stock markets promote economic development and that international portfolio investors are guided by economic fundamentals. The above discussion shows that both these assumptions are highly questionable on theoretical as well as on empirical grounds. In fact, recent empirical evidence from a number of cross-country studies, has pointed out that among various forms of foreign investments, foreign portfolio investment is the least effective in promoting domestic investment and growth. Recent empirical studies reveal that contribution of portfolio investment in domestic investment is lowest among different types of capital inflow. Table 1 summarizes the main findings of some of these studies.

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1 However, a wave of accounting frauds that have surfaced recently in the developed countries show that overdependence on short term financial indicators can create problems even in the markets which supposedly practice much better corporate governance and are more transparent than the developing country markets.

Table 1. Summary of Some Recent Studies on Capital Inflow

<table>
<thead>
<tr>
<th>Author</th>
<th>Time Period and Country Coverage</th>
<th>Conclusion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bosworth and Collins (1999)</td>
<td>1978-95 (for 58 developing countries)</td>
<td>Every dollar increase in capital flows was associated with an increase in domestic investment of about 50 cents (Above 80 cents for FDI, close to 10 cents for portfolio flows and 50 cents for loans).</td>
</tr>
<tr>
<td>World Bank (2001): Global Development Finance, 2001, chap3.</td>
<td>1972-98 (for 118 countries) This study uses the same methodology as Bosworth and Collins (1999) but uses a larger sample and longer time period.</td>
<td>Every dollar increase in capital flows was associated with about 80 cents increase in investment (close to 90 cents for long-term capital, 25 cents for short-term capital, above 80 cents for FDI, more than one dollar for bank lending and about 50 cents for portfolio flows).</td>
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2. Foreign Portfolio Investment and its Impact on the Macroeconomic Management of India

The second set of results show that the surge in foreign portfolio investment in the Indian economy has introduced some serious problems of macroeconomic management for the policymakers. Uncertainty and volatility associated with FPI have not only reduced the degrees of maneuverability available to the policymakers but have also forced them to take some measures which impose significant fiscal cost on the economy. This will be evident from the following observations:

1. As foreign portfolio investors earn their returns in rupees, any devaluation of the rupee can erode the earnings of foreign portfolio investors in dollar terms (assuming the devaluation is against dollar). Therefore, devaluation or even an expectation of devaluation of the rupee can create negative sentiments among portfolio investors. As is evident from the recent spate of financial crises across the world, any sharp depreciation of a domestic currency of a developing country has the potential to trigger a sudden capital flight from that country. On the other hand, the RBI also tries to avoid nominal appreciation of the rupee, because otherwise it could seriously affect the competitiveness of the country’s exports in the global market. Though officially the exchange rate of India is market determined, the dual threat of capital flight and exchange rate appreciation forces the RBI to closely monitor and intervene in the foreign exchange market, to maintain the value of rupee within a very narrow band. This compulsion not only limits the policy options available to the RBI, but it also forces the central bank to maintain high foreign exchange reserves so that it can intervene in the foreign exchange market effectively.
2. Secondly, faced with high capital inflows and the threat of appreciation of the domestic currency, the central bank has to absorb a very high percentage of the capital inflow to prevent the rupee from appreciating. This can affect the domestic economy in two ways. First, absorption of foreign asset increases the liquidity in the domestic economy. RBI partly neutralized the adverse impact of excess liquidity in the domestic money supply through sterilization. Sterilization is carried out through open market operations and changes in reserve requirements. However, sterilization is not costless as it imposes a quasi-fiscal cost on the economy. Secondly, to compensate the massive increase in Net Foreign Assets (NFA) and to have a check on the growth of reserve money, the RBI has to contract credit given to the domestic sector (government and commercial sector). This can increase the fiscal vulnerability of the government and can have serious repercussions for the domestic economy.

3. Data also show that taking advantage of the massive capital inflow and favourable external macroeconomic situation, the RBI has amassed huge amount of foreign exchange reserves since the late 1990s. Calculations done in this study suggest that the level of reserves accumulated by the RBI is much higher than level suggested by the recent literature on optimum reserves. It is apparent that RBI is building up such high levels of reserves as a possible defense against the risk of sudden and large withdrawal of portfolio capital. Accumulation of reserves is costly for the economy as building reserves essentially means swapping of high yielding domestic assets with low yielding foreign assets.

4. Finally, as India is competing with other emerging markets to attract FPI, to sustain the inflow of portfolio investment, the policymakers in India have to ensure that India is at least as attractive as an investment destination as other emerging markets. This compels the authorities to ensure that returns on portfolio investment are high and fiscal doles given to portfolio investors are at least as attractive as the other developing countries. This induces the policymakers to a situation where they have to ensure that the returns from the domestic stock markets are high. This study highlights the fact that faced with a stagnating stock market during the second half of the 1990s, the policymakers in India had to introduce various fiscal and other sops to the stock market buoyant and the portfolio investors happy. A compulsion to always take investor friendly policies can not only put serious burden on the government exchequer, but it also constrains the policy options of the authorities in a country. It is also noteworthy that often other extraneous events like political instability or strategic problems
can affect investor sentiments and it requires compensatory policy measures, like interest rate hike, from the government to maintain stability.

These observations support the arguments put forward by Grabel (1996) that reliance on foreign portfolio investment introduces mutually reinforcing problems of "compromised policy autonomy" and "increased risk potential" in a developing country. Grabel also points out that foreign portfolio investment is the riskiest form of foreign investment. Table 2 shows the constraints and risks associated with various forms of capital inflow and Table 3 shows how severely different types of capital flows can affect national policy autonomy and can increase the risk potential of a country.

Table 2. Types of Capital Inflow into Developing Countries: Sources and Constraints on National Policy Autonomy and Increased Risk Potential

<table>
<thead>
<tr>
<th>Type of Capital Inflow</th>
<th>Source of Constraints on National Policy Autonomy</th>
<th>Sources of Increased Risk Potential</th>
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<tbody>
<tr>
<td>Foreign Aid</td>
<td>Donors may influence domestic decision making through:</td>
<td>Donors may: withdraw aid or threat to do so</td>
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<tr>
<td></td>
<td>- aid conditionality</td>
<td></td>
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<tr>
<td></td>
<td>- threat of withdrawal</td>
<td></td>
</tr>
<tr>
<td>Commercial Loans</td>
<td>Creditors may influence domestic decision making through:</td>
<td>Creditors may: withdraw loans or threat to do so</td>
</tr>
<tr>
<td></td>
<td>- ex-ante conditionality</td>
<td>Global economic conditions may: increase debt service obligations</td>
</tr>
<tr>
<td></td>
<td>- threat of withdrawal</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- ex-post conditionality (e.g. Structural adjustment)</td>
<td></td>
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<tr>
<td>Direct Foreign Investment</td>
<td>Foreign owners may influence domestic decision making through:</td>
<td>Foreign owners may: withdraw or threat to do so</td>
</tr>
<tr>
<td></td>
<td>- control over natural resources, plant and equipment, technology and employment opportunities</td>
<td></td>
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<tr>
<td></td>
<td>- threat of withdrawal</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- use of foreign policy tools to protect the interests of owners</td>
<td></td>
</tr>
<tr>
<td>Portfolio Investment</td>
<td>Portfolio investors may influence domestic decision making through:</td>
<td>Portfolio investors may: withdraw very suddenly</td>
</tr>
<tr>
<td></td>
<td>- ex-ante and ex-post constraints on macroeconomic, exchange rate and social policies</td>
<td>- be prone to withdrawal</td>
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Table 3. Types of Capital Inflow into Developing Countries: Severity of Constraints on National Policy Autonomy and Increased Risk Potential

<table>
<thead>
<tr>
<th>Degree of Severity (Highest to Lowest)</th>
<th>Constraints on National Policy Autonomy</th>
<th>Increased Risk Potential</th>
</tr>
</thead>
<tbody>
<tr>
<td>Highest</td>
<td>Portfolio Investment</td>
<td>Portfolio Investment</td>
</tr>
<tr>
<td></td>
<td>Commercial Loans and Foreign Aid</td>
<td>Commercial Loans</td>
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<tr>
<td></td>
<td>Direct Foreign Investment</td>
<td>Foreign Aid and direct foreign investment</td>
</tr>
<tr>
<td>Lowest</td>
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</table>

Source: Table 2 and Table 3 are from Grabel (1996)
If we take into account the evidence from various cross-country empirical studies that suggests that FPI is one of the least beneficial forms of foreign investment and juxtapose it with the argument that it is also one of the most risky types of foreign investment, it is not surprising that the supposedly beneficial effects of foreign portfolio have not been realized in India.

In fact, it needs to be highlighted here that the findings of this study do not represent an isolated case where foreign portfolio investment has not been beneficial for a country. There is a growing consensus among economists that empirical results do not support the beneficial role of foreign portfolio investment. Rodrik comments:

"...persuasive evidence on the benefits of opening up to capital flows--especially of the portfolio and short-term kind--has yet to be provided"

Even some of the IMF economists, once the staunchest supporters of financial liberalization and foreign portfolio investment, are conceding that the so-called beneficial aspects of foreign portfolio investment have not been realized in practice. Michael Mussa, Economic Counselor and Director of Research, IMF, comments:

"Many empirical studies have confirmed the common-sense appraisal of the postwar experience with trade liberalization: open policies toward international trade are an important factor contributing to stronger economic growth. Similarly persuasive evidence is not available for liberal policies toward international capital flows, particularly for portfolio flows rather than direct investment flows. Indeed, the experience in recent financial crises could cause reasonable people to question whether liberal policies toward international capital flows are wise for all countries in all circumstances."

The lack of empirical support about the beneficial role of FPI should be viewed along with the fact that portfolio capital flows are highly volatile in nature. This is because more often than not, the expectations of the portfolio investors are based on extremely shaky informational base and can be subject to sharp changes without any underlying changes in the economic fundamentals of a country. This happens because portfolio capital flow, being entirely a market based device, is susceptible to a wide range of market failures. And as Stiglitz (1993,) has pointed out, market...

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failures in financial systems are quite common and pervasive in nature. The problem of market imperfection and asymmetric information amplifies the volatility resulting from sudden shifts in the pattern of portfolio flows. Coupled with this, herd behaviour and contagion are well documented features of financial markets where the portfolio investors operate. Together, these factors make FPI an inherently volatile form of capital flow. Instability of portfolio flows has the potential to adversely affect growth of a developing country. Increased volatility in the domestic stock markets may reduce household saving and hinder investment. Moreover, portfolio flows can hinder export promotion by exerting upward pressures on the exchange rate and also sustain an import-cum investment boom to overheat the economy. The East Asian crisis has shown that together with the volatility of FPI, the presence of a huge amount of international speculative capital has the potential to seriously disrupt a country's economy.

Given the risks associated with international speculative capital flows, the current reliance of many governments of developing countries, including India, on FPI, appears to be quite misplaced.

Policy Implications

To sum up, this study shows that the perceived benefits of FPI have not been realized in India. Empirical evidences do not show that FPI has helped the domestic economy in any significant way. On the other hand, FPI has considerably reduced the degrees of freedom available to the policymakers and has increased the risk potential of the Indian economy. Uncertainties associated with FPI are also imposing significant fiscal costs on the domestic economy. These results do not suggest that the supposed benefits of foreign portfolio investment have occurred in India.

These conclusions have some important policy implications for India. First, the uncertainties associated with FPI warrant that India should try to reduce its reliance on foreign portfolio investment. More emphasis should be given to attract foreign direct investment in India. FDI has some inherent advantages over FPI. Unlike FPI, FDI directly increases the productive capacity of the economy, brings with it new technology and is much less susceptible to short-term fluctuations. Though the FDI also has some disruptive potential, it is one of the more desirable modes of capital inflow to a developing country. In India, the FDI inflow is much less than desired level and the actual FDI inflow is only a fraction of the approved FDI inflow. The policymakers should take active steps to encourage FDI in India.

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Secondly, the East Asian crisis has shown that foreign exchange reserves can only provide a country some breathing space in the event of a speculative attack. However, foreign exchange reserves should not be relied upon as the only instrument to tackle speculative attack. The financial leverage available to the hedge funds can run down even huge foreign exchange reserves of a country. Also, as Chandrasekhar and Ghosh (2002) have pointed out, running down foreign exchange reserves to mitigate an external shock may amplify the negative sentiments of investors which, in turn, can lead to higher capital outflows. Therefore, it is important that along with maintaining high foreign exchange reserves, India continue to have restrictions on movements of capital. The Asian Crisis has shown that the countries with full capital account convertibility were the worst sufferers. Studies have also pointed out that with the constantly improving telecommunications technology, fund transfer between countries have become easier than ever before and, in absence of strict capital controls, it will increasingly become difficult for the policymakers to control capital inflow or outflow.

Thirdly, the idea of introducing full capital account convertibility in India should be shelved for the time being. In 1997, a committee for Capital Account Convertibility (CAC) headed by Tarapore recommended complete convertibility by 1999-2000. However, the Asian crisis forced the government to put CAC on hold. Currently, most economists, even the more pro-liberalization economists, are skeptical about the benefits of full capital account convertibility. No empirical studies (Rodrik 1998) have, so far, provided direct evidence of the beneficial role of capital account liberalization on the domestic economy. Stiglitz (2000c) comments: "Indeed it has become increasingly clear that there is not only no case for capital market liberalization, but there is a fairly compelling case against full liberalization". Also as Reinhart points out, once CAC is introduced, it is difficult to impose it again. When the countries which have been on convertibility for some time tried to combat capital outflows by re-introducing capital controls (Spain in 1992, Chile in 1991, and Brazil and Malaysia in 1994), the success of such controls in

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6 "Above all, technology has played a role. Revolutionary changes in information and communications technologies have transformed the financial services industry worldwide. Computer links enable investors to access information on asset prices at minimal cost on a real-time basis, while increased computer power enables them rapidly to calculate correlations among asset prices and between asset prices and other variables. Improvements in communications technologies enable investors to follow developments affecting foreign countries and companies much more efficiently. At the same time, new technologies make it increasingly difficult for governments to control either inward or outward international capital flows when they wish to do so. All this means that the liberalization of capital markets—and, with it, likely increases in the volume and the volatility of international capital flows—is an ongoing and, to some extent, irreversible process with far-reaching implications for the policies that governments will find it feasible and desirable to follow."- December 1998, Volume 35, Number 4, Capital Account Liberalization and the IMF, Barry Eichengreen and Michael Mussa

restricting capital outflows is temporary. As Panagariya (1998)\(^8\) says: "Having once been there, the residents and banks seem to be quickly able to devise channels that circumvent the controls. The bottom line is that convertibility is a one-way street." Therefore, unless the benefits of completely opening up of the capital account are unambiguously proved, policymakers should take utmost precaution to introduce CAC in India. It is a matter of concern that recently the RBI has announced a host of measures which indicate that the Indian central bank is deliberating towards a regime of full capital account convertibility in foreseeable future.

Fourthly, the Indian experience shows that in spite of a burgeoning stock market, the real economy did not benefit much from it. This evidence adds to the increasing skepticism about the beneficial role of capital market on a developing country's economic development. This prompts us to suggest that developing countries should reduce their dependence on stock-markets and give adequate recognition to the role of banks in economic development. Bank-based economic systems can insulate the industrial sector from the wild fluctuation of share-markets and can provide a source of more predictable finance. The presence of a large semi-organized sector (the small scale sector) is another reason why bank-based systems can be better suited to developing countries. It is very difficult, if not impossible, for the small-scale sector to approach the capital market for their financing needs. Banks remain the basic means of financing for this sector. Also, given the constraints faced by small entrepreneurs in this country, use of directed credit to promote strategic industrialization should be continued. Furthermore, specialized banks for industrial development and controls over credit allocation can play an important role in providing finance to new entrants.

But it should also be pointed out here that, if not regulated properly, bank-based systems can be problematic also. The banking sector in developing countries is typically highly oligopolistic in nature and protected from competition. The collusion between a few large banks and some big business houses can pre-empt the flow of credit to new or smaller firms. This calls for increased competition in the banking sector. However, competition policies should be designed to prevent monopoly power, rather than to allow completely free entry into the banking sector and unlimited price competition among banks - practices that have often led to financial instability in both developed and developing countries.

Another disturbing feature that has emerged in the Indian banking sector since the late 1990s is that now Indian banks are permitted to cross the firewall that has traditionally separated the

\(^8\) "Full convertibility: Must we have it?" Arvind Panagariya, The Economic Times, October 26, 1998
banking sector from the stock market. Banks are now allowed to invest in equities, provide advances against equity provided as collateral and offer guarantees to the broking community. This has led to significantly increased exposures of banks to the equity market and has made them vulnerable to stock market volatility. As a consequence, the fragility of Indian banking system has increased alarmingly in the recent years. Furthermore the nexus between banks and brokers also fuels speculation in the stock market as the extra liquidity provided by the banks encourages speculative investment and thereby increases stock market volatility, which in turn undermines the stability of the banks. As a stable and well functioning banking system is vital for industrial and economic development of India, it is of utmost importance that the firewall between the banking sector and the stock markets should be maintained so that the economy and industry can be protected from the speculative gyrations of the stock market.

Finally, as far as India is concerned, a worrying factor is the continuing withdrawal of the state from the financial sector. The spirit of deregulation has been a dominant theme in economic policy decisions during the last few years. It is often claimed that the problems of the Indian financial system are a result of excessive government intervention and regulation. According to this school of thought, financial liberalization will cure most of the ills of the Indian financial system. This excessive reliance on market forces can be quite harmful to the economy. As Stiglitz (1993, p. 2) points out,

".... financial markets are markedly different from other markets; ... market failures are likely to be more pervasive in those markets; and there exist forms of government intervention which will not only make those markets function better, but which will improve the overall performance of the economy".

Another area where this emphasis on financial liberalization and market-friendliness can have a serious impact is the social and infrastructural sector. Saving rates have been stagnating in India and according to this study, there is no tangible evidence of the much hyped positive impact of financial liberalization on the rate of savings. This stagnation of saving rates, coupled with the

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9 RBI's Monetary and Credit Policy Statement for the year 2001-2002, notes "The recent experience in equity markets, and its aftermath, have thrown up new challenges for the regulatory system as well as for the conduct of monetary policy. It has become evident that certain banks in the cooperative sector did not adhere to their prudential norms nor to the well-defined regulatory guidelines for asset-liability management nor even to the requirement of meeting their inter-bank payment obligations. Even though such behaviour was confined to a few relatively small banks, by national standards, in two or three locations, it caused losses to some correspondent banks in addition to severe problems for depositors. In the interest of financial stability, it is important to take measures to strengthen the regulatory framework for the cooperative sector by removing "dual" control by laying down clear-cut guidelines for their management structure and by enforcing further prudential standards in respect of access to uncollateralised funds and their lending against volatile assets."

10 For a detailed discussion see "Financial Liberalisation and Bank Fragility" by CP Chandrasekhar & Jayati Ghosh available at www.macroscan.net.
poor fiscal condition of the government, has ensured that less investible resources are available for investment in social and economic infrastructure. Given the fact that (a) the gestation period is very long in infrastructural investment, (b) the capital-output ratio is quite high in this sector, and (c) the ongoing political uncertainty and other factors discourage foreign investment, it is not very likely that foreign investment will come pouring in this sector. In the absence of adequate capital formation in the infrastructural sector, bottlenecks will quickly emerge, as they already have, with improvement in capacity utilization. This is bound to affect the industry. In a supply constrained economy like India, structural bottlenecks arise due to the poor performance of the infrastructural sector, especially, energy, telecommunication and transport sectors. Without adequate capital formation in these crucial areas, industrial stagnation is bound to occur.

Government spending in these sectors not only helps to remove the bottlenecks, but it also crowds in investment via linkage effects. Government spending can help the economy in other ways also. If, via the multiplier effect, government spending can affect the national income, then it is likely to boost the domestic saving rate. The aforementioned linkage effects of government spending will also induce private investment. This can have a positive feedback effect on the saving rates of the economy. If, in this way the savings of the economy can be increased, the increased savings can add to the investible resources of the economy.

However, the current reliance of many of the governments of developing countries, including India, on market mechanisms is marked by a concomitant withdrawal of the state. The total reliance is on financial liberalization to restore growth and stability by raising savings and improving overall economic efficiency. But this alternative has not yet delivered the results expected of it. This study finds that instead of lifting the level of domestic savings and investment, financial liberalization in general has rather increased financial instability. Financial activities have increased financial deepening, but without benefiting industry or commerce.

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