Concluding remarks

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After the Government of India undertook various measures under the rubric of financial liberalization, we have witnessed rapid stock market development in India in the last 15 years. This has resulted in a rapid increase in the stock market valuation, where we have seen the Sensex crossing 14,000 points in a very short span of time. However, this development has not affected the level of real investment in the economy in any significant manner. This we have seen in our preceding analysis of the interaction of the stock market and the real economy, where the rapid increase in the stock market valuation did not stimulate investment in any perceptible manner (as had been propounded by the Tobin's 'q' theory of investment) in the context of India. On the other hand, a rising stream of profits over the years serves as an indicator for the firms to undertake more investment.

The accumulation of reserves by the RBI due to the surge in capital inflows, especially in the recent past, has not been costless to the economy. The yield on RBI's foreign exchange reserves held in the form of short-term US or EU government securities, is significantly less than that on foreign capital invested in India. This implies reduction of the country's GNP on account of holding foreign exchange reserves in excess of what is required for management of the external account. Following the analysis Rakshit (2006)[59], if we take the yield differential to be 6 per cent and excess foreign exchange reserves to be US

[59] The current foreign exchange (forex) reserves are over US$ 200 billion. It is generally believed that forex of about US$ 50 billion is adequate to act as a cushion against external economic vulnerabilities. Thus, under the present circumstances, the excess forex reserves are US$ 150 billion.

$ 150 billion, the income loss on this account comes to US $ 9 billion, about 1 per cent of the country's net national product.

The accumulation of reserves also affects the fiscal health of the economy. In order to keep the money supply at the targeted level, RBI had to undertake sterilization of reserves on a massive scale, balancing its purchase of foreign currency with sale of government securities. The cumulative sale of government securities had been so large that the RBI holding of government securities became too small to conduct open market operations on the required scale. Hence a new financial instrument called the market stabilization bond (MSB) had to be introduced for sterilization of accretions to the reserves. Issue of MSB like that of ordinary government securities adds to the public debt, but their proceeds cannot be used by the government for financing its expenditure. The RBI has been forced to switch from high yielding Government of India bonds to low yielding foreign exchange reserves. This causes a fall in RBI profits and hence in government revenue.

It is true that higher stock prices provide firms with a potentially cheap source of finance, so firms are expected to react by issuing equity. Economic theory, however leaves open the question of whether business fixed investment will respond to such a bubble. On the one hand, according to the *active financing mechanism*, firms may use the price-earnings ratio as a measure of the cost of capital so that a stock price bubble will lower the discount rate applied to future cash flows and stimulate investment. On the other hand, the *inactive financing mechanism* suggests that firms might view stock prices as unreasonably high and though they issue shares, they put the proceeds into cash and securities, rather than fixed investment.

Despite short booms in stock markets across the developing countries, especially in the emerging economies like India in the recent past, there was little mobilization of new capital or capital for new ventures. In fact, small investors show a tendency to withdraw from markets because of allegations of manipulation and fraud, and erstwhile areas of long-term investments supported by state intervention tend to disappear. While financial liberalization did encourage new kinds of financial savings, total domestic savings did not increase in any perceptible sense.

With the onset of financial crises in the developing countries across the globe, there is now increasing (though sometimes grudging) acceptance of the view that financial liberalization increases financial fragility. It is also seen as not really improving the growth prospects of developing countries (except indirectly by triggering short-term, credit-financed consumption and housing booms), whereas it works to depress growth and even induce contraction when the accompanying financial fragility leads to a crisis, as evident in Latin America. Recently, it appeared that even the IMF, which has assiduously promoted financial liberalization in developing countries, had come round to the view that such liberalization increased fragility.[60]

[60] An IMF Working Paper, by Graciela Kaminsky of George Washington University and Sergio Schmukler of the World Bank (2003), authorized for distribution in February 2003 by the IMF's Chief Economist and Research Director Kenneth Rogoff, declares that findings in the "crisis literature" suggest that "booms and busts in financial markets are at the core of currency crises and that these large cycles are triggered by financial deregulation", even though some of "the finance literature tend to support the claim that deregulation is beneficial, with liberalization reducing the cost of capital."

In spite of the evidence of impact of financial flows, especially short term portfolio flows there are still some who emphasize strengthening the domestic financial system and enforcing prudential regulation as a way to retain the benefits of capital flows without suffering from the adverse effects of volatility. The rationale provided from such quarters is that one can still make free capital flows safe for the world if appropriate antidote to crisis is in place (Rodrik 1998).

Following the Asian crisis of the late 1990's, there has been a renewed interest in the role of capital controls in developing countries within both policy and academic circles. The reasons for this interest are not hard to find. Even strong proponents of CAL have acknowledged that many countries that avoided the worst effects of recent financial crises were also those that used capital controls, including China, India, Malaysia and Chile. Consequently, prominent mainstream economists and even the IMF have relaxed their insistence that immediate CAL is the best policy for all countries in all circumstances (IMF, 2000; Fischer, 2002; Eichengreen, 2002). Adding momentum to the discussion over the last several years, a number of highly respected economists have actively argued in favor of capital controls (e.g., Bhagwati, 1998; Stiglitz, 2002; Krugman, 1998; Rodrik, 1998).

With the evidence of not so beneficial results of financial liberalization in the context of India, it is quite apparent that the policies of the government in the future should aim at controlling capital flows and reducing the fragility they can result in. It is possible for the government to keep out the specific forms of capital, such as short term borrowing, that render countries more crisis-prone, with measures such as a 'Tobin tax' on foreign exchange transactions (Eichengreen, et al, 1995).

Davidson (1997) argued that "a 'grains of sand' small Tobin tax might slow down the speculative fever when 'grains of sand' small exchange rate changes are expected. When dealing with small differentials in exchange rates, however, one is likely to be discussing the question of arbitrage rather than speculation. Accordingly, the Tobin tax is more likely to be a constraint on arbitrage flows rather than speculative flows."

Moreover, while some have positively assessed the efficacy of limited, market-based controls in managing the structure and effects of capital flows, others have been skeptical. While Jomo (2002) claims that the shift away from such controls, in countries like Chile is a sufficient indication of the fact that they are not sustainable, Rodrik (1998) has argued: "The evidence on the effectiveness of controls on short-term borrowing is patchy, even in the relatively clean and well-studied case of Chile."

Though such measures can reduce and have reduced excessive volatility in some contexts, the focus on post-liberalization control over capital flows is partially contradictory, especially in countries capable of attracting financial flows. In such contexts, liberalization is adopted in the first instance to attract flows whose presence does affect domestic policy space and autonomy adversely. All financial investors need an exit option, when making investments in particular countries. While there could be some control on inflows in terms of sources (no hedge funds, for example) and maturities (not less than a year without penalties), and some requirements with regard to length of stay and activities may be prescribed, the broad thrust in favour of greater flows appears irresistible.

Once such flows occur, policy space is limited for a number of reasons. To start with, the presence of foreign financial investors inevitably introduces a deflationary bias in fiscal policy, independent of the circumstances with regard to supply-side constraints and demand deficiency. Financial interests are against deficit-financed spending by the state for a number of reasons. Firstly, deficit financing is seen to increase the liquidity overhang in the system, and therefore as being potentially inflationary. Inflation is anathema to finance since it erodes the real value of financial assets. Second, since government spending is "autonomous" in character, the use of debt to finance such autonomous spending is seen as introducing into financial markets an arbitrary player not driven by the profit motive, whose activities can render interest rate differentials that determine financial profits more unpredictable. Finally, if deficit spending leads to a substantial build-up of the state's debt and interest burden, it may intervene in financial markets to lower interest rates with implications for financial returns. Financial interests wanting to guard against that possibility thus tend to oppose deficit spending. Given the consequent dislike of expansionary fiscal policy on the part of financial investors, countries seeking to attract financial flows or satisfy existing financial investors are forced to adopt a deflationary fiscal stance, which limits the policy option on the part of the governments in the developing countries.

Further, if a country is successful in attracting financial flows, the consequent tendency for its currency to appreciate, forces the central bank to intervene in currency markets to purchase foreign currency and prevent excessive appreciation. The consequent build-up of foreign currency assets, while initially sterilized through sale of domestic assets, especially government securities, soon reduces the monetary policy flexibility of the central bank. Governments in Asia, especially India, faced with these conditions are increasingly resorting to trade and capital account liberalization to expend foreign currency and reduce the compulsion on the central bank to keep building foreign reserves. That is, if financial liberalisation is successful, in the first instance, in attracting capital flows, it inevitably triggers further liberalization, including of capital outflows, leading to an increase in financial fragility.

Traditionally, development theory had emphasized the role of investment that expands capital stock. It argued that given production conditions, a rise in the rate of real capital formation that leads to an acceleration of the rate of physical accumulation, is at the core of the development process. Associated with any trajectory of growth predicated on a certain rate of investment is, of course, a composition or allocation of investment needed to realize that rate of growth given a certain access to foreign exchange.

However, the Keynesian theory showed that the lack of adequate finance cannot be the constraint on investment and growth and it appeared that the role of financial sector in mobilizing and channelizing savings was secondary and inevitably fulfilled. Joan Robinson aptly remarked: "Where enterprise leads, finance follows".

Therefore, the issue of financing development is a question of mobilising or creating real resources. Finance in the sense of money or financial assets came in when there arose obstacles to deficit-financed spending. This is so because if real constraints to growth were not overcome it would result in inflationary situations. In this framework, the financial sector is seen as adjusting to the requirements of the real sector. However, in economies with substantial private assets and where private agents are assigned an important role in investment decision-making, if the financial sector is left unregulated, market signals would determine the allocation of investible resources and therefore the demand for and the allocation of savings intermediated by financial enterprises. This could result in the problems conventionally associated with a situation where private rather than overall social returns determine the allocation of savings and investment.

The state therefore must not merely play the role of investment coordinator, but use the financial system as a means to direct investment to sectors and technologies at scales of production it considers appropriate. Equity investments, directed credit and differential interest rates are important instruments of any state-led or state-influenced development trajectory. Although financial policies may not help directly to increase the rate of savings and ensure that the available *ex ante* savings are invested, they can be used to influence the pattern of investment. Such a framework is crucial because in a large number of developing countries development occurs in a mixed economy framework where private initiative and investment are significant. In others, the transition is ensuring a growing role for private agents. This implies that independent of whether the government adopts a strategy of growth based on the home market or one of protecting and building the home market while targeting the world market in mercantilist fashion, it would have to play a major role in channelizing large volumes of cheap finance to the selected units and using the leverage provided by this activity to coordinate and influence investment decisions across the economy.

Post-liberalization changes in the institutional structure of the financial system in the developing countries do benefit foreign financial firms substantially. Liberalization allows for a process of segment-wise and systemic consolidation of the financial system, with the emergence of larger financial units and a growing role for foreign firms in the domestic financial market. It also allows for a greater role for foreign institutional investors in local equity and debt markets, a substantial increase in speculative activities and often a wave of capital inflow that renders exchange rate and monetary management extremely difficult. When the going is good, these investors are able to earn much higher rates of return, which far exceeds the exchange rate risk characterizing many of the developing economies. Further, when exchange rates do tend to fluctuate, the new options for trading in currency markets generated by liberalization, offers an additional channel of profit. And above all, the risks to be borne in these markets are doubly insured against. First, there is the near certainty of intervention by developed country governments and the Bretton Woods institutions that ensure that there are orderly workouts in times of crisis.[61] Second, financial liberalization offers opportunities not just to hedge against risk but to transfer and socialize those risks through securitization measures that generate new assets that help transfer credit risk and other financial risks by banks and NBFIs. These gains registered by international

[61] The most recent, even if unsuccessful, effort of the IMF to ensure such orderly workouts, is the promotion of the Sovereign Debt Restructuring Mechanism (SDRM).

financial institutions, particularly those from the United States are merely inflated versions of the gains that the institutions have derived from liberalization in their own home countries.

A financial crisis is more likely to occur when the economy is experiencing deflation because firms find that the real burden of indebtedness is increasing while there is no increase in the real value of their assets. The resulting decline in a firm's net worth increases adverse selection and moral hazard problems, making it more likely for a financial crisis to occur and the financial markets could no longer be able to allocate funds to firms with productive investment opportunities.

So it is imperative for the Government of India to take cognisance of the fact that the huge amount of foreign investment that is flowing into the Indian economy is not able to stimulate investment. The increase in the stock prices that we are witnessing at present, though it may induce firms to issue new shares, the proceeds of such issues either would be put into cash or into securities rather than generating investment. It should be noted that a firm that builds up large stock of cash for future investment opportunities is often considered a cash cow; a prime target for takeovers.

The Argentine crisis has underscored the crucial need for capital controls as no currency regime can provide stability under conditions of freely flowing capital. The Argentine crisis is but the latest in a string of financial meltdowns over the years that have vividly brought home the perils of free capital flow regimes and the consequent need for controls on the volatile financial flows traversing the international capital markets. The Government of India must remember that India escaped the 'contagion effect' of the East Asian crisis in 1997, mainly because of the fact that capital controls were in place. So there is no need for India to move to a regime of complete CAL. Instead we should continue a policy with regard to capital account that is in tune with our development goals. Such a cautious policy has had relative success in insulating the Indian economy from the excesses of the international financial markets which led to the crises of some of its neighbours in 1997.