International Journal of Arts & Sciences,
CD-ROM. ISSN: 1944-6934 :: 07(03):355–368 (2014)

FINANCIAL LIBERALIZATION IN INDIA: THE RETURN OF AN OLD FAMILIAR GHOST- WASHINGTON CONSENSUS

Deepanshu Mohan

OP Jindal Global University

This research paper provides a macroeconomic commentary on India's current economic position which has highlighted structural weaknesses in its macroeconomic fundamentals. In the current state of *policy paralysis,* a *decline in the foreign direct investment* has considered Indian policymakers to move slowly and steadily towards Fuller Capital Account Convertibility (FCAC) -a rudimentary feature of the *Washington Consensusi* of the 1980s. India, in the past has acted boldly refuting IMF's stand on FCAC and other Washington Consensus type policies by exercising certain capital controls to maintain a system of partial capital account convertibility. This was one of the main reasons why India unlike the rest of the world did not enter into a state of deep recession post the US financial meltdown. The option of FCAC being considered by the policy makers to drive more investment into the economy poses a lot of pertinent questions like- Is this necessary? If yes, then how *feasible* and *sustainable* would an investment driven growth achieved through FCAC be for any one sector. My paper looks to analyse this aspect limiting our analysis to the case of India.

In times of global financial uncertainty, will the concept of FCAC or deregulating callously to boost foreign investment within certain sectors actually be feasible for India's growing economy in the future? This is the main research question I aim to answer through the analysis done in the paper. The paper starts by giving an introduction to the concepts of capital controls, full capital account convertibility (FCAC); providing then, a lucid picture of India's current plight in terms of the existing capital controls and the state of its macroeconomic indicators (GDP growth rates, savings rate, investment position, BOP deficit etc.). The claim on the presence of structural weaknesses in the Indian economy which should act as a deterrent on moving towards FCAC are substantiated by the analysis put forth in the paper (also drawn upon from the works of C.P. Chandrasekhar and Jayati Ghosh). At the same time, it also highlights similar studies done on other emerging market economies to draw similar conclusions from the capital account crisis faced by South East Asian economies in the past after resorting to FCAC.

Keywords: Capital mobility, Capital controls, Fiscal consolidation, Current account deficit, Macroeconomic indicators.

Introduction

The importance of capital controls in the form of capital account regulations (CARs) are critical in ensuring sustainable growth of the economy, particularly in the case of emerging market economies which are more vulnerable to capital account crisis due to the sudden stop of capital flows. What history aptly teaches us is that most of the recent crises (post the Bretton Woods era) have been caused due to this sudden stop problem. IMF's old view of propagating capital account liberalization for developing

economies to improve their growth rates has been attacked by economic historians and economists from all corners.

In recent times, the IMF, however, has changed its position on promoting full capital account liberalization. In the 1970s the International Monetary Fund became an advocate of capital account liberalization, and in 1997 it tried to change its Articles of Agreement to include capital account convertibility among its mandates. In contrast, in December 2012 the IMF embraced a new "institutional view" on this issue. While it remains wedded to eventual financial liberalization, it now acknowledges that free movement of capital rests on a weak intellectual foundation.

The case of India is of critical importance here as Indian economic policy thinkers have always boldly refuted the IMF's earlier stance on complete capital account liberalization. However, over a period of time this opinion from the Indian economic policy thinkers has undergone a deep metamorphosis. In current times, inward foreign investment to India has seen a decline. This has pushed for a swelling need for relaxing the existing capital controls to drive more foreign investment into India. Our paper provides a macroeconomic commentary trying to evaluate the issues involved as a result of moving towards full capital account convertibility.

Capital account liberalization per se is often considered to be the most difficult and, invariably, the last stage of financial market opening in emerging economies. There is a vast literature on the benefits and costs of financial market opening. Majority emphasis on economic growth, financial market stability, and reserve holdings for self-insurance in emerging markets as a first step towards assessing the rationale of currency internationalization in East Asia's emerging economies.

With regards to increasing economic growth, the standard argument states that financial globalization leads to capital flows from advanced economies with low rates of return on capital to emerging and developing economies with higher returns, thereby complementing limited domestic savings and lowering the cost of capital to augment domestic investment in the latter.

Certain types of capital inflows, such as foreign direct investment (FDI), bring with them new technologies and help to improve the managerial and organizational capacity of the host countries. The existing literature presents little robust evidence on the growth benefit of financial opening. Kose et al (2006) argue that there are certain threshold conditions that must be met by emerging economies in order to reap the growth benefits from financial market opening such as developed financial markets, high quality of institutions and governance, and trade integration. Economists like Doni Rodrik, Barry Eichengreen et al have written extensively, on the repercussions from prematurely opening of the capital account in the absence of certain supporting/regulatory conditions, which tend to make emerging economies more vulnerable to external shocks, such as sudden stops of capital inflows.

Table 1 : Foreign Direct Investment (Net)

Year	**Foreign Direct Investment net (Current US$)**
2005	-4628652265
2006	-5992285935
2007	-8201628957
2008	-24149749829
2009	-19485789182
2010	-11013000000
2011	-17354000000

Source: World Bank Database

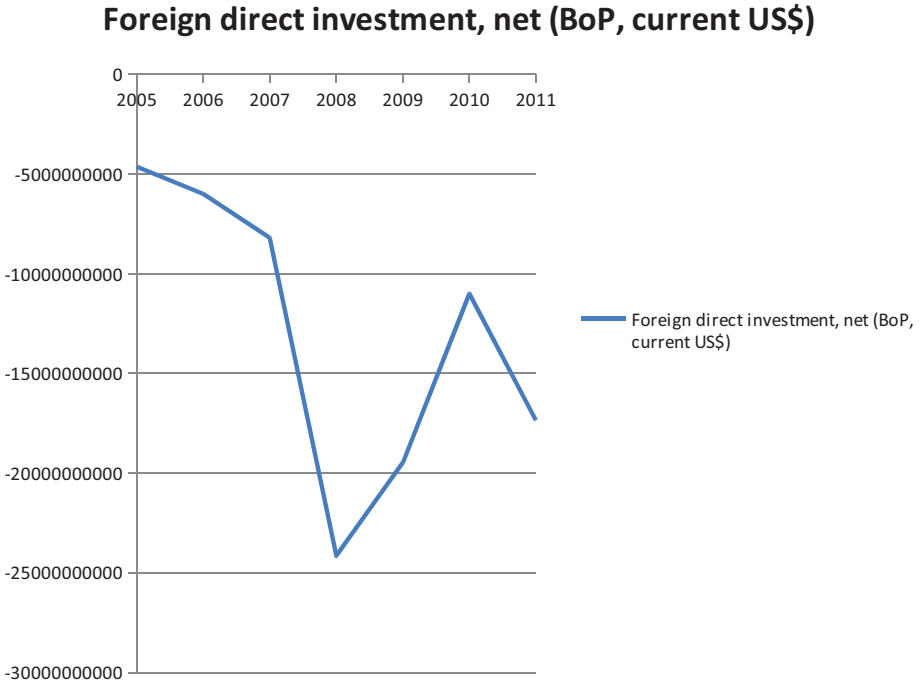
Table 1 and Figure 1 illustrate the rapid decline seen in the net FDI drawn by India from the rest of the world. This has been attributed to a number of factors but primarily the effect of the global economic slowdown post the US financial crisis in 2007 has had a gradual but definite impact in the declining FDI level. The other critical factor points at the failure of the Indian state in ensuring a conducive investment

and business environment within the country where India is currently ranked 134, as per the 2013 Ease of Doing Business report of the World Bank.

Lack of an effective and speedy decision making process, lots of pending bills in the parliament, high corruption level and a pessimistic business sentiment at the national level have resulted in what can be called as a state of policy paralysis for the Indian government.

In the paper, I look at trends in some of the critical macroeconomic indicators, the stability across which is pertinent to even consider the option of moving towards a fuller capital account convertibility system to draw more investment into India. These indicators include trends in GDP growth rate, balance of payment balances, fiscal indicators (capital receipts, capital expenditure, revenue receipts, revenue expenditure), Current account deficit to GDP, Non-performing assets (proxied by looking at aggregate liabilities) and inflation rate (consumer prices).

Figure 1



IMF's new view on capital controls:1

In the 1970, it was the International Monetary Fund (IMF) who supported the argument of capital account liberalization and accordingly changed its mandates in 1977. The same institute advised emerging economies and developing countries to open up their capita accounts. Even to India, IMF suggested to go

[1] 'Capital Controls' include any measure taken by a government, central bank or other regulatory body to limit the flow of foreign capital in and out of the domestic economy. This includes taxes, tariffs, outright legislation and volume restrictions, as well as market-based forces. Capital controls can affect many asset classes such as equities, bonds and foreign exchange trades. Tight capital controls are most often found in developing economies, where the capital reserves are lower and more susceptible to volatility.

for current account convertibility in 1997 and gradually go for the capital account liberalization along with South Korea and Malaysia.

In contrast, in Dec 2012 IMF supporting a new 'institutional view' on capital account liberalization and the management of capital flows. IMF recognizes the risk attached with the capital flows, especially under certain unhealthy/abnormal global market situations, it suggests regulating the capital flows under such circumstances to avoid its adverse impact on the entire economy. The IMF makes it very clear that before any nation reaches a certain threshold of financial and economic development, it should not opt for the capital liberalization option.

This new view of IMF is completely in contrast with its other international commitments, such as in trade and investment treaties that does not allow any cross-border finance regulation. Liberalization of country's capital account was IMF's long term goal but the IMF agrees to this that it's a gradual process and cannot be implemented before any economy matures to a certain level. This view holds specifically for the emerging economies and developing countries.

Along with the view, the IMF now recommends that nation can do it with the help of "Capital Flow Management Measures (CFMs)" and "Capital Account Regulations (CARs)" along with the best macroeconomic policy options; counter-cyclical monetary and fiscal policies with adequate foreign exchange reserves and all.

However, this view has been criticized on being too narrow regarding the use of CFMs or CARs is concern. It has not taken into account the multilateral aspects of regulating cross-border finances. Considering this new view of the IMF on capital controls, if we try seek the help of the available literature on rational for capital controls, then we get to read major work done by the Nicolas E. Magud, Carmen M. Rein hart and Kenneth S. Rogoff. In Feb 2011, Rogoff Magud and Hart pointed out at the "Four Fears" of complete capital mobility.

Fear of Appreciation- with the capital inflows upward pressure on the exchange rate of the country's currency increases, making domestic manufactures, traders less competitive in global market. Though foreign exchange reserves accumulation take place at sufficient level, after a certain point, sterilization of such reserves become more difficult.

1. Fear of 'Hot Money'- Which is rightly associated with the fear of inevitable outflows. This has actually started happening in India.2

2. Fear of large inflow- which might just create dislocation in the financial system. Foreign funds can create asset price bubble; encourage excessive risk involving cash-rich domestic enterprises.

3. Fear of loss of monetary autonomy- Along with floating exchange rates, if policy makers are planning to make capital more mobile, then they will have to surrender the monetary autonomy.

The recent financial crisis (2008) had again thus, intensified the debate on capital controls. Before the new view of the IMF on capital controls and right after the financial crisis in 2008, sufficient literature has come up, arguing pro and against of the capital controls.

A paper by Eswar S. Prasad, from National Bureau of Economic Research, Cambridge, said that the capital account in India is quite open and reversing is not a viable option at this point. Moreover, the remaining controls are rapidly becoming ineffective. He said that emerging economies have to adapt the rising financial globalization and capital controls are getting less effective there because of the sophistication of international investors. Huge amount of money is flowing across the borders taking some or the other channels for the evasion of these controls. Hence, emerging economies like China and India are handling these new realities of financial globalization, wherein capital controls are losing their potency as a policy instrument. According to him, managing the existing financial integration into

[2] Refer to Ila Patnaik and Ajay shah, 'Why India choked when Lehman broke', (Jan 2010), working paper 2010-63, NIPFP, New Delhi.

international capital markets and aligning domestic macroeconomic policies in such a manner that maximizes the indirect benefits and reduces the risks is the key challenge in front of India's policy makers.

Another paper titled, 'Why India choked when Lehman broke', written by Ajay Shah and Ila Patnaik, in Jan 2010, was sort of raising the question like, despite of having enough capital controls, why did Indian money market experience stress immediately after the bankruptcy of Lehman Brothers? Why did operating procedures of monetary policy break down? Why was there a huge borrowing from the RBI? These events were really unexpected with the given set up of capital controls. In the paper, they produced enough evidences to show that many Indian firms (financial and non-financial) had been using the global money market before the crisis, avoiding India's capital controls by locating global money market operations in offshore subsidiaries. When the global money market collapsed after the failure of Lehman, these firms were suddenly short of dollar liquidity. They borrowed in the rupee money market, converted rupees to USD, to meet obligations abroad.

India's Structural Weaknesses

The problem of imbalances seen in India's balance of payments highlighted in the high rising current account deficit (CAD), falling capital inflows level has resulted in a structural weakness for the Indian economy. Cumulatively there had been a huge excess of capital inflow into India when compared to its current account financing needs, partly reflected in the significant increase in India's foreign exchange reserves. This enhanced access to foreign finance over the two decades (1990s,2000s) as a result of the expansion of global liquidity and liberalization of rules regarding capital inflows led to a complacent view on what is an acceptable CAD, with 3% of GDP seen as quite normal and easily financed. The problem here is that a "normal" and acceptable CAD is defined by what would be considered a "normal" and perennial level of capital inflow. The government had in the past considered such normal inflows to be around 2.5% of GDP. But an unusual surge after 2005 has induced an element of complacency. As a result inadequate attention has been paid to the structural weaknesses in the current account, with non-oil imports rising, driven not just by the Indian elite's obsession with gold but also by a range of non-essential manufactured goods.

This implies that any adverse shock in the form of a rise in oil prices with or without an accompanying deceleration in export growth can sharply widen the deficit (to as much as 6.7% of GDP in the last quarter of 2012, for example) resulting in a high degree of volatility in the CAD in recent quarters3.

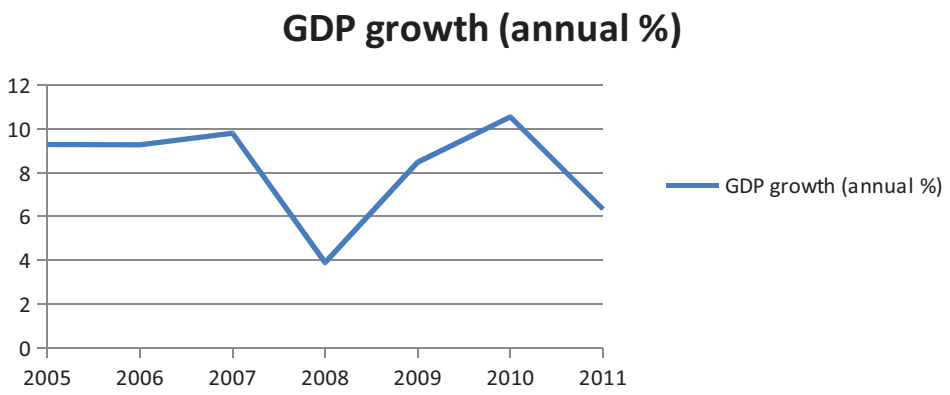
In absolute terms, the CAD has widened from around $9-12 billion per quarter to $15-20 billion a quarter (C.P. Chandrasekhar, 2012). Simultaneously, capital inflows have steadied and even declined (as evident from the Figure 3). This has meant that capital inflows are now just about adequate to finance the CAD, with reserves falling when the deficit is particularly high. This does draw attention to the structural deficit on the current account, leading to greater pressure on the currency.

The impact of weak fundamentals and speculation on the rupee's value is all the greater because of the uncertainty created by the substantial deceleration in GDP growth from more than 8% to 5% or even lower. High growth matters also because it provides the basis for expectations of increases in corporate earnings that support investments in the secondary market for equity, even when price-earnings ratios are already high4. A significant share of such investment comes from foreign institutional investors, so any slackening in secondary market investments, even if not directly of relevance for physical capital formation, also aggravates BoP vulnerability

[3] "Macroeconomic Vulnerability and the Rupee's Decline" (EPW) C.P. Chandrasekhar (pg 6)

[4] "Macroeconomic Vulnerability and the Rupee's Decline" (EPW) C.P. Chandrasekhar (pg 6)

Figure: 2



Source: World Bank Database

It needs to be noted that the high growth of the 2005-07 period was surprising to say the least (evident from the above figure no 2). This is because a number of factors should have made slow growth the long-term tendency under liberalization. To start with, the declared objectives of neo-liberal fiscal reform are a lenient tax regime (aimed at incentivizing private savings and investment) and a substantially curtailed fiscal deficit. With revenues at any level of GDP lower than they could have been and the deficit target set low with respect to GDP, expenditure must necessarily be lower than it would be in a proactive fiscal regime5. While the deficit target was not realized in the 1990s, the government has been assiduously working to achieve it over the last few years.

The result must necessarily be a lower level of expenditure than would have otherwise been the case. In an accumulation regime that depended substantially on the stimulus provided by public expenditure this must have restrained growth significantly. The implication of that structural weakness is that India's accumulated foreign exchange reserves of around $280 billion are less significant than they seem, because they are in the nature of borrowed reserves, with associated servicing commitments and the right to exit in the future6. While these capital inflows may be financing current account deficits, they do constitute a source of vulnerability. So are the reserves themselves, as they can deplete if foreign investors choose to sell and exit the country.

Apparently we are declining on FCAC.

India has moved slowly and steadily towards the FCAC. India's capital account transactions have been partially open with some major restrictions still in practice. The first major policy initiative to move towards FCAC was projected in the third report presented by the Tarapore committee on the FCAC in 2006. The committee's first and second report on the same issue of moving towards a more open capital account did not translate into any tangible actions where in the second report, the committee suggested three phases viz. 1997-98, 1998-99 and 1999-2000 for adopting the fuller capital account convertibility of rupee, and targeted certain desirable rate of major macroeconomic indicators and labeled them as pre-requisites for achieving the FCAC. This was to fulfil the basic threshold criteria before economy moves to the higher level.

Some of the experiences of the emerging economies (EMEs) helped the Committee to focus on some of the macroeconomic indicators of the economy; the East Asian crisis in Thailand in June 1996, later

[5] Ibid 1 (pg 10)

[6] Ibid 2 (pg 3)

dispersed to Malaysia, Indonesia, S. Korea and the Philippies were due to major macroeconomic factors identified as mismatch in savings and investments along with current account deficit issue, overvalued currency and so on. Brazil was suffering from both fiscal and balance of payment weaknesses and was affected in the aftermath of the East Asian Crisis in early 1998. Unhealthy fiscal situation in 1998 Russia had to introduce a series of emergency measures, including re-intensification of capital controls, as it faced serious foreign exchange crisis. Argentina's inability to reduce its public and external debts caused a recession during 1998-2001. Almost similar thing happened in Turkey in 1993-94.

According to the Tarapore Committee, the FCAC is a process and therefore, it suggested to open up gradually the capital outflows by individuals, corporates, banks and non-banks, and took the stance that such liberalization would result in an increase in net inflows, provided that the macroeconomic situation is stable. On this basis, the Committee submitted, practically its third report in 2006 and suggested a gradual five year time span up for FCAC up to 2010-11. Accordingly the Reserve Bank of India also moved very cautiously over this issue.

The rationale for the FCAC given by the Committee was,

- To ensure the complete financial mobility in the country.
- To efficiently distribute the international capital among the players in the Indian markets.
- Such allocation of foreign funds will equalize the capital return rates not only across the borders, but also escalates production levels.
- Committee also hoped that it will also bring about a fair income distribution in India.
- Given the huge investment needs of the country and that domestic savings alone will not be adequate to meet this aim, inflows of foreign capital become imperative.

Here, I want to draw attention to the given prerequisites for achieving FCAC, the targeted figures for the same variables and the actual condition of the given pre-requisites in year 2000, 2006 and 2010-11 which are given in the following table, (table 2)

Table 2

Prerequisites for achieving FCAC by 2000			Actuals of prerequisites in 2000-01	Actuals in 2006-07	Actual in 2010-11
1.	Gross Fiscal Deficit to GDP ratio	3.5%	9.5%	5.37%	4.79%
2.	Inflation rate	3-5%	7.2%	6.6%	9.6%
3.	Gross NPA	5%	20.4%	6.8%	6.3%
4.	Avg.effective CRR	3%	8.5%	5.00%	6.00%
5.	Debt servicing ratio	20%	16.6	4.7%	4.3%
6.	Current Account Deficit				

Source: Planning Commission Data

The above table shows that we have failed to achieve most of the targets here. So rather than discussing the *discriminatory tax treaties* and *different tax regimes* for individuals who are non-resident Indians (NRI) and other non-residents in a progressively capital account regime, or keeping aside the strengthening goal of the banking sector and revisiting the goal of monetary policy for achieving the FCAC, in my paper *(the first section)* I have concentrated more on India's fiscal situation at present as fiscal consolidation remains a key pre-requisite for moving to fuller convertibility and the external imbalances in India.

The *second section* argues more on the changed, new view of the IMF on capital controls referring to some of the available literatures on capital controls after the recent global financial crisis in 2008.

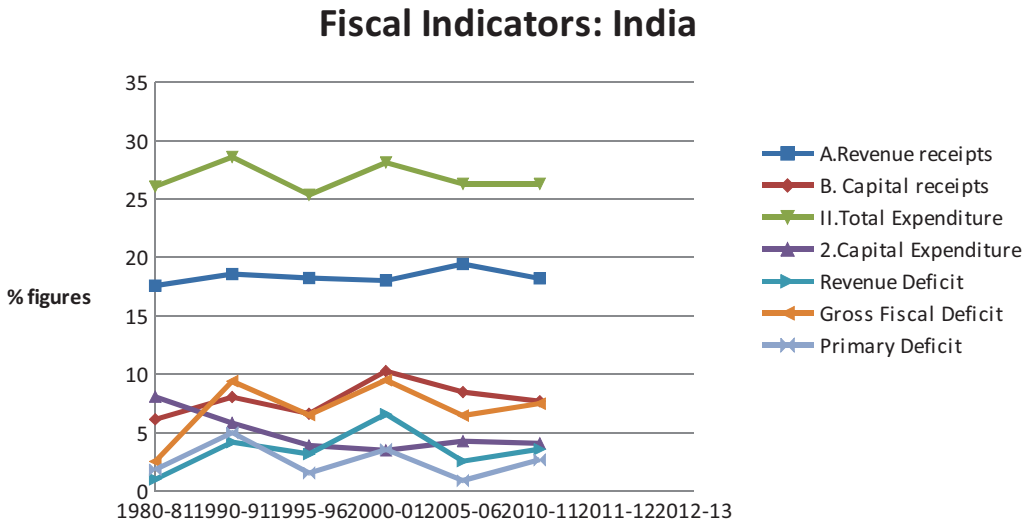
Let us look at the fiscal situation of India first during the last three decades;

Table 3

	1980-81	1990-91	1995-96	2000-01	2005-06	2010-11
I.Total Receipts(includes non-debt cap.receipts and loans)	23.74	26.61	24.89	28.29	27.94	26.6
A.Revenue receipts	17.58	18.57	18.25	18.02	19.44	18.2
1. Tax receipts	13.59	15.37	14.67	14.53	15.86	14.71
2. Non-tax revenue	3.99	3.19	3.58	3.49	3.58	3.65
B. Capital receipts	6.15	8.05	6.64	10.27	8.49	7.70
II.Total Expenditure	26.07	28.59	25.35	28.12	26.29	26.29
1.Revenue Expenditure	17.97	22.76	21.43	10.35	22.01	22.20
2.Capital Expenditure	8.08	5.84	3.92	3.50	4.28	4.09
Revenue Deficit	1.02	4.19	3.18	6.60	2.57	3.6
Gross Fiscal Deficit	2.55	9.41	6.52	9.51	6.48	4.79
Primary Deficit	1.86	5.02	1.56	3.57	0.91	2.7
Liabilities						
Center	41.1	55.2	50.9	55.6	51.7	50.3
State	18.4	22.5	20.9	28.3	29.9	24.6
Central loans to state	11.7	13.0	10.7	13.3	4.2	2.0
Outstanding liabilities	47.8	64.8	61.1	70.6	77.4	72.9

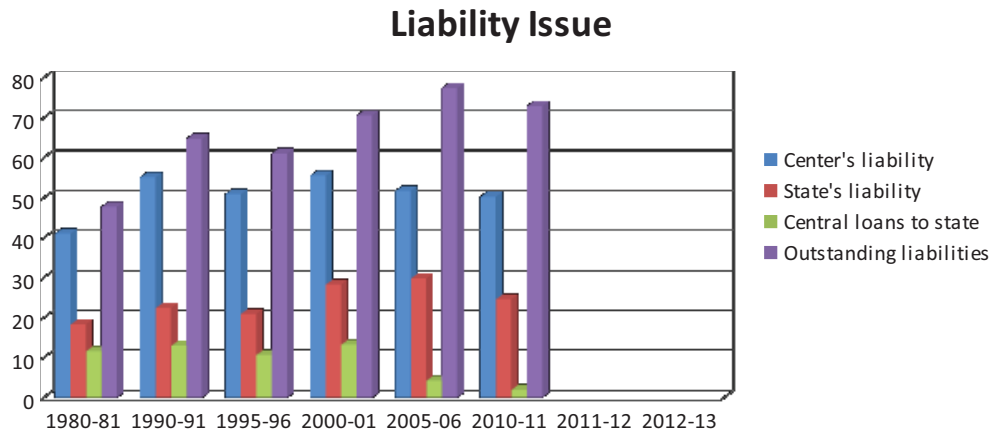
Source: Indian Planning Commission data

Figure: 3



Source: Planning Commission Data

Figure: 4



Source: Planning Commission Data

Observations from the above table:

- The fiscal data in the above table and graphs is from 1980 onwards till 2012, which clearly shows that the revenue receipts have always been falling short of the total expenditure till date. Out of the total expenditure, major chunk is going into the revenue expenditure rather than having more of capital expenditure. This is creating a recurring fiscal imbalance. Fiscal imbalance is not completely bad as such as long as the govt. expenditures are utilized properly and govt. gets desirable rate of return on them. If this is not happening then this excess spending is a real cause of concern.

- Total govt. liability and its outstanding liability figures are actually making us raise our eyebrows with a serious concern in our heart.

Now let's have a look at trends in the macroeconomic balances in the country:

Table 4

	2004-05	2006-07	2009-10	2010-11	2011-12	2012-13
1.Rate of GDP growth	7.60	9.60	8.59	8.39	6.21	4.96
2.GDCF % of GDP	32.45	35.88	36.30	36.98	35.00	35.40
3.GDS % of GDP	32.41	34.61	33.81	34.02	30.81	31.80
i) Household ii) Savings	23.55	23.16	25.38	22.79	22.33	22.80
iii) Household financial savings	10.12	11.28	12.94	10.00	8.02	12.70
iv) Pvt.sector savings	6.55	7.89	8.24	7.85	7.18	7.80
v) Public sector savings	4.0	2.41	0.18	2.6	1.30	1.10
vi) Govt.Admin.	-2.32	-1.04	-3.15	-1.63	-2.01	-
4.Savings-investment gap	-0.04	-1.27	-2.49	-2.96	-4.19	-3.60
5.Fiscal Deficit % of GDP	7.2	5.4	9.6	6.86	8.07	8.40

Source: Central Statistics office (CSO)

Indian economy lowered the GDP estimate for year 2011-12 from 6.4% to 6.2%. This was due to the greater concern of sharp decline in the domestic savings from 34.2% in 2010-11 to 30.81% in year 2011-12. To a substantial measure this is due to decline in the public sector savings (from 2.6% to 1.3 % in year

2011-12) and also due to worrisome decline in the household sector's financial savings (from 10% in 2010-11 to 8.02% in 2011-12). These factors clearly point out the poor state of finances. Persistent large revenue deficit is the cause of low public sector savings and the large and recurring fiscal deficit is creating a poor investment climate in the economy. Inflationary pressure and inability of the financial sector to generate inflation adjusted returns has been the reasons for households to save in gold and real estate.

Lot has been studied on savings and investment relationship. The 1980 Feldstein Horioka (FH) study of the relationship between domestic saving rates and domestic investment, reasoned that if domestic savings were added to a world saving pool and domestic investment competed for funds in that same saving pool, then there would be no correlation between nation's savings rate and its rate of investment. Whereas the statistical evidence showed that on the contrary, the long-term saving and investment rates of the individual industrialized countries in the OECD are highly correlated. Then the question arises here is that can it be possible in case of all Asian countries? Can this above exercise of bringing the domestic savings into a common pool and then availing it for the investment opportunities? In that case we all will need to open up our markets completely and which is precisely what we are trying to understand here.

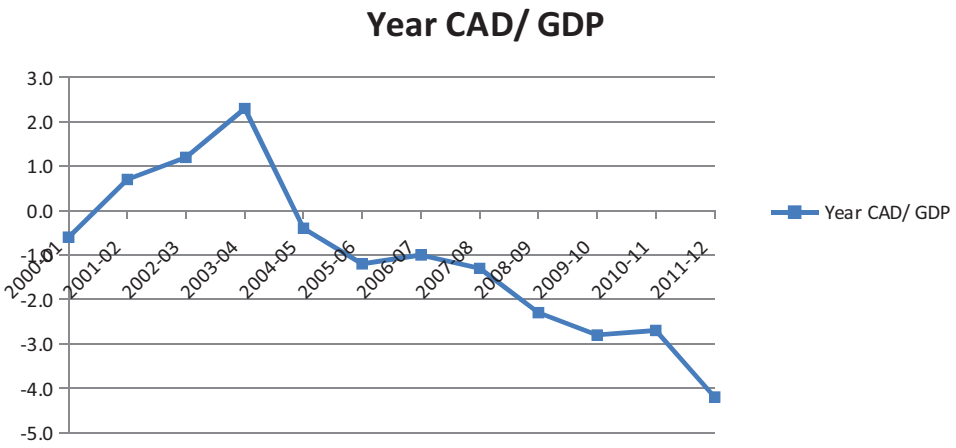
An external sector data table would complete this story in the following manner;

Table 5

Year	Trade		Invisibles			Current Account			Capital Account		Import Cover of Reserves (in months)
	Exports/ GDP	Imports/ GDP	Net/ GDP	Payments/ GDP	Receipts/ GDP	CAD/ GDP	Current Receipts/ Current Payments	Current Receipts/ GDP	Foreign Investment/ Exports	Foreign Investment/ GDP	
2000-01	9.9	12.6	2.1	4.9	7.0	-0.6	96.4	16.9	14.9	1.5	8.8
2001-02	9.4	11.8	3.1	4.6	7.7	0.7	103.8	16.9	18.2	1.7	11.5
2002-03	10.6	12.7	3.4	4.9	8.3	1.2	106.6	18.8	11.2	1.2	14.2
2003-04	11.0	13.3	4.6	4.3	8.9	2.3	112.8	19.9	23.7	2.6	16.9
2004-05	12.1	16.9	4.4	5.5	9.9	-0.4	98.0	21.9	18.0	2.2	14.3
2005-06	13.0	19.4	5.2	5.9	11.1	-1.2	94.8	24.0	20.3	2.6	11.6
2006-07	13.6	20.1	5.5	6.6	12.1	-1.0	96.0	25.6	23.1	3.1	12.5
2007-08	13.4	20.8	6.1	5.9	12.0	-1.3	95.0	25.4	37.3	5.0	14.4
2008-09	15.4	25.2	7.5	6.2	13.7	-2.3	92.6	29.1	14.8	2.3	9.8
2009-10	13.4	22.1	5.9	6.1	12.0	-2.8	89.9	25.4	35.9	4.8	11.1
2010-11	14.9	22.6	5.0	6.7	11.8	-2.7	90.6	26.6	22.9	3.4	9.6
2011-12	16.8	27.0	6.0	5.8	11.9	-4.2	87.0	28.6	16.3	2.7	7.1

Source: RBI database

Figure:5



Source: RBI database

Here the external sector (table 5, Fig. 5) also gives us a picture of imbalances, which is another area of concern. Diverse experience across the globe shows that excessive current account deficit (CAD) tends to make economy vulnerable to external debt or currency crisis which brings in its wake financial instability and substantial output and welfare losses. In India, unrelenting expansion of fiscal deficit in the late 1980s spilled over to CAD that culminated in Balance of Payments (BoP) crisis of 1991, a situation very close to debt default.

Theoretically, sustainability of CAD refers to the ability of a nation to finance its current account gap on an ongoing basis by normal capital flows. Thus, the level of CAD that could be financed on a continuous basis without resulting in any pressure on the economy is termed as the sustainable level.

Looking at the literature on this one can draw some answers from what Martin Feldstein and Philippe Bacchetta did in their work, commenting on the consistent current account deficit. Their argument was, *'an increase in the merchandise trade deficit means loss of exports and substitution of imports for domestic production, consistent merchandise trade deficit in that case can cause dislocation involved in changing the pattern of production in the long run.* They also said that, because of capital income taxes, *a persistent capital outflow diverts domestic savings to investment abroad that has a low rate of return to the originating nation. Each govt. therefore, has an incentive to seek a capital inflow and to resist the outflow of its own capital.*

The link between fiscal deficit and growth, saving and investment rates, inflation and current account deficits have also been examined in many studies. The relationship between fiscal deficit and interest rate and the existence of crowding out are important considerations in determining the advisability of deficit-financed expansionary fiscal policies. Authors like Sunderarajan and Thakur (1980); Pradhan *et. al*., (1990); and Parker (1995) had earlier examined the issue of crowding out in the Indian context. C. Rangarajan and D.K. Srivastava have worked on the implication of fiscal deficit and govt.debt on growth and stabilisation.

The RBI has in fact eased a number of controls, both on inflows and outflows. For instance, although capital outflows by individuals are in principle still restricted, each individual is allowed to take up to $200,000 of capital out of India each year, a generous ceiling by any standards.7 The restrictions on outflows by Indian corporates are even weaker. As for inflows, FDI inflows into certain sectors such as retail and banking are restricted, and foreign investors are not allowed to participate in the government debt market. These restrictions are gradually being lifted.

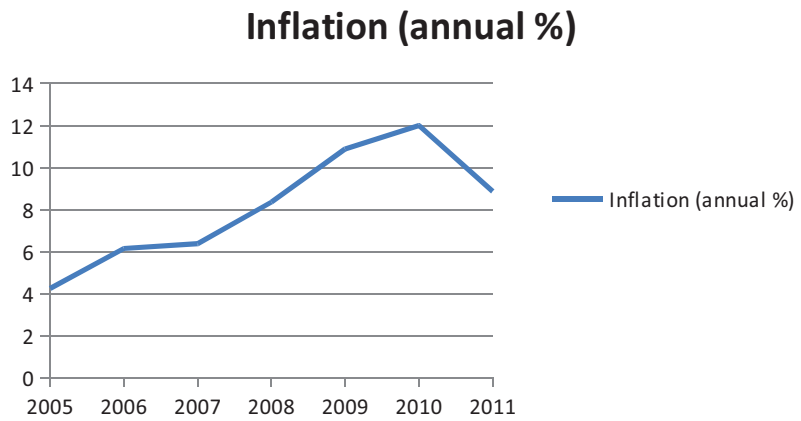
Equity market investments are permitted by registered foreign institutional investors (although there are limits on their ownership shares in certain types of Indian firms), and those who do not wish to register can invest only indirectly through an instrument called participatory notes, which are tightly regulated by the government.

Table 6 Inflation- consumer price (%)

Year	Inflation Rate- consumer prices (%)
2005	4.24
2006	6.14
2007	6.36
2008	8.35
2009	10.87
2010	11.99
2011	8.85

Source: World Bank Database

Figure: 6



Source: World Bank Database

Persistence of Inflation

Unlike the CAD, the persistence of inflation, as measured by the consumer price index (CPI), in a period of slowing growth is more difficult to explain. Though it does seem to more in control now than a few years back but multiple factors like administered price increases, demand and supply imbalances, imported inflation aggravated by rupee depreciation, and speculation have combined to keep high inflation going. An element common to them is that many of them are the outcomes of economic reform.

India's vulnerability to the effects of changes in international prices has increased with trade liberalization. Increased concentration due to the dilution of anti-trust measures and reduced regulation tend to encourage a profit driven escalation in the prices of certain manufactured goods, as exemplified by pharmaceuticals (C.P.Chandrasekhar, 2013). Imbalances between demand and supply of primary products are accentuated by the government's reluctance to release more food through the public distribution system at below poverty line (BPL) prices7. The effort to reduce subsidies has resulted in a continuous

[7] "Macroeconomic Vulnerability and the Rupee's Decline" (EPW) C.P. Chandrasekhar (Pg 3)

increase in the prices of commodities such as petroleum and fertilizers that are administered. The list is long and almost endless. The processes of liberalization and deregulation are creating a high inflation economy.

Blast from the Past: Lessons from the East Asian Crisis

In 1996, five Asian economies (South Korea, Indonesia, Malaysia, Thailand, and the Philippines) received net private capital inflows amounting to $93.0 billion. One year later (in 1997), they experienced an estimated outflow of $12.1 billion (IIF 1998), a turnaround in a single year of $105 billion, amounting to more than 10 percent of the combined GDP of these economies. Consequently, three of these economies (Indonesia, Thailand, and South Korea) were mired in a severe economic crisis, the magnitude of which would have seemed inconceivable even to the most knowledgeable and insightful observers of the region. If the recent evidence teaches us anything, it is that there is a compelling case for maintaining controls or taxes on short-term borrowing. The three countries hardest hit by the Asian financial crisis—Indonesia, Thailand, and Korea—were the three in the region with the largest short-term obligations (in relation to reserves or exports). Admittedly, we know too little about what kinds of controls work best in these circumstances. The evidence on the effectiveness of controls on short-term borrowing is patchy, even in the relatively clean and well-studied case of Chile (Edwards 1998).

Since the late 1960s, the Singapore government has provided special regulatory and tax treatment for foreign commercial banks to promote offshore foreign currency deposits. Singapore also eliminated all barriers to bona fide capital account transactions and raised the institutional environment to international best practices. Such policy reforms have contributed to the establishment of the Asian dollar market (ADM) along the lines of the eurodollar market. (Chow (2008)).

At this stage, few East Asian emerging economies, excluding the five latecomers of ASEAN, are suffering from a lack of domestic saving. For more than a decade since the 1997–98 crisis, they have been exporting capital by running sizeable amounts of current account surpluses. Their concern has been the lack of investment demand. And the current trend is not likely to be reversed any time soon.

The 1997–98 financial turmoil has also served as a catalyst for a regional movement towards the construction of a region-wide defence system against future crises, as well as financial market and monetary integration. This movement has culminated in the institutionalisation of two regional initiatives: the Chiang Mai Initiative (CMI)9 and the Asian Bond Market Development Initiative (ABMI).

The ABMI, launched in 2003, was designed to diversify East Asia's bank-based financial system and to create broad and liquid regional bond markets by integrating the domestic markets of individual countries. Park and Wyplosz (2008) argue that one of the preconditions for the construction of efficient Asian bond markets is domestic financial deregulation and market opening. The market liberalization and opening would increase the supply of investment grade local currency bonds and allow domestic investors to invest in foreign bonds and foreign borrowers to issue bonds denominated in different currencies in East Asia's domestic bond markets. Such market developments would then facilitate cross-border investment in bonds, thereby bringing about deeper integration of regional domestic bond markets.

Concluding Remarks

Y.V. Reddy in his book on Global Crisis Recession and Uneven Recovery in 2011 suggested a comprehensive review of the scope and intensity of controls. He suggested monitoring of capital account transactions particularly by large intermediaries, corporates should help in undertaking corrective actions. Opening up of the capital account does not necessarily result in large amount of capital inflows, according to Y.V. Reddy, in case if India is hoping for it.

So, if we ask today that, in times of greater global financial uncertainty does the concept of FCAC or deregulating callously to boost foreign investment within certain sectors actually feasible for India's growing economy in the future? The answer to this would be a clear No. To promote full capital account convertibility or absolute capital account liberalization, in India will only add to its existing financial woes. The claim on the presence of structural weaknesses in the Indian economy which should act as a deterrent on moving towards FCAC are substantiated by the analysis put forth in the paper (also drawn upon from the works of C.P. Chandrasekhar and Jayati Ghosh). At the same time, clear evidence can be gathered by looking at failure of other emerging market economies that have pre-maturely opened up their capital account to draw more rapid foreign investment .The nightmarish experience faced by the South East Asian economies should be fresh in the memory of the Indian policy makers who have advocated for FCAC in recent times. Against the failure of achieving the given targets of the prerequisites, for getting the FCAC in place in India by 2013, IMF's new view on capital controls in Dec 2012 has indeed put us in a dilemma.

---

[i]The Washington Consensus refers to a set of broadly free market economic ideas, supported by prominent economists and international organizations, such as the IMF, the World Bank, the EU and the US. Essentially, the Washington consensus advocated, free trade, floating exchange rates, free markets and macroeconomic stability. The ten principles originally stated by John Williamson in 1989, includes ten sets of relatively specific policy recommendations (http://www.economicshelp.org/blog/7387/economics/washington-consensus-definition-and-criticism/)

Bibliography/References

1. C.P. Chandrasekhar, September 21, 2013, "Macroeconomic Vulnerabilityand the Rupee's Decline", Economic and Political Weekly, vol xlviii no 38.
2. Dani Rodrik, Feb 1998, 'WHO NEEDS CAPITAL-ACCOUNT CONVERTIBILITY?', Harvard University
3. Eswar S. Prasad, (Jan 2009), ' Some New Perspective on India's Approach to Capital Account Liberalization' National Bureau of Economic Research, Cambridge
4. Ila Patnaik, Ajay Shah, (2010), ' Why India Choked When Lehman Broke', Working Paper 2010-63 NIPFP-
5. John Williamson, (May 2006), ' Why Capital Account Convertibility in India is Premature', Vol- XLI No. 19, EPW
6. Kevin P. Gallagher, Jose Antonio Ocampo, (March 2013), 'IMF's New View on Capital Control', Vol.XLVIII No. 12, EPW
7. Martin Feldstein, Philippe Bacchetta, (1991), ' National Saving and International Investment', National Bureau of Economic Research, University of Chicago Press.
8. Nicola E. Magud, Carmen M. Reinhart, Kenneth S. Rogoff, (2011), 'Capital Controls: Myth and Reality- A Portfolio Balance Approach', National Bureau of Economic Research, Cambridge
9. Rakesh Mohan, (June 2007), ' Capital Account Liberalization and Conduct of Monetary Policy- The Indian Experience', presented paper in International Monetary Seminar on Globalization
10. Tarapore Committee, (2006), 'Report on the Committee on the FCAC', Reserve Bank of India.
11. Y.V. Reddy, (2011), Global Crisis Recession and Uneven Recover, Orient BlackSwan.
12. Yung Chul Park and Kwanho Shin, "Internationalization of currency in East Asia: implications for regional monetary and financial cooperation".