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Entwicklungsfinanzierung im Umbruch – Entwicklungsstaaten im Aufbruch?

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Financial Liberalisation and Fragility in Developing Countries: The Indian Experience[1]

For quite some time now, and especially since the financial crisis in East Asia in 1997, the view has gained ground that developing countries opting for financial liberalisation are prone to fragility and periodic crisis (Eichengreen 2003). This was most often attributed to the fact that financial integration tends to expose these countries to new forms of vulnerability. In particular, the herd instinct characteristic of imperfect financial markets, the competitive thrust for speculative gains on funds garnered from profit-hungry investors, and the moral hazard generated by an implicit guarantee from the State that the financial system would be bailed-out in periods of crisis, all result in excessive exposure of developed country financial institutions in particular developing countries. The corollary of this was that supply-side factors were likely to result in high volatility in financial flows to developing countries, with a surge in such flows followed in all likelihood by a sudden collapse of such flows.

Typically, internationally accessed capital went to sustain an 'investment boom' in stock and real estate markets, raising rates of return on such investments and fuelling the thrust to obtain quick profits through arbitrage. The resulting speculative bubble substantially increased financial fragility. The point is that, it is no longer possible, with completely unbridled capital flows, for a country to control the amount of capital inflow or outflow, and both movements can create undesirable consequences. This makes developing countries that have substantially liberalised their financial markets prone to periodic crisis.

Interestingly, this view is being challenged by advocates of financial reform, based on the performance of the so-called 'emerging markets' during the financial crisis that erupted in the developed world in 2008. They are seen to have been insulated from the worst effects of the crisis because of strong and well regulated financial markets. Among the countries whose experience has warranted this optimism is India, which is the focus of this paper. This is not because developing countries, like India, reduced their integration with the global financial system after 1997. Rather, financial liberalisation and integration have increased substantially over the decade and a half since then. And, even though in the immediate aftermath of the East Asian financial crisis, capital flows, especially debt flows, to developing countries slowed, things have changed substantially since then.

In fact, cross-border flows of capital have seen a robust revival in recent years. Although, the crisis of 2008 resulted in the first instance in a significant exit of capital from developing countries, because financial investors from the developed countries booked profits and exited to cover losses or meet commitments at home, capital flows to emerging markets quickly revived, leading to a strengthening of currencies in many of these countries.

Because of this experience, two factors became the focus of attention immediately after the 2008 crisis. Firstly, despite financial liberalisation and financial integration, the exposure of financial firms in developing countries to the speculative instruments and toxic assets that later turned worthless was extremely low. The danger on this front was that developed country financial firms that were exposed to these assets at home but also had a significant presence in the emerging markets could turn insolvent, resulting in an unusual form of exposure to the crisis. Secondly, having crossed the hump resulting from an initial exit of capital, emerging market countries did not face a collapse of reserves and a depreciation of their currencies, but seemed to register a strengthening of their balance of payments position, an increase in foreign exchange reserves and an appreciation of their currencies. This was a far cry from the experience with the currency crisis in East Asia in 1997.

When analysed with reference to India, these results are often viewed as the consequences of a 'prudent' yet extensive programme of global economic integration and domestic deregulation that involves substantial financial liberalisation[2], but includes capital controls and limited convertibility of the currency for capital account transactions. Such prudence is also seen to have ensured that India remained unaffected by the contagion unleashed by the East Asian financial crisis in 1997.

This argument sidesteps three facts. The first is that India had experimented with a process of external liberalisation, especially trade liberalisation, during the 1980s, that resulted in a widening of its trade and current account deficits, a sharp increase in external commercial borrowing from private markets and a balance of payments crisis in 1991 (Chandrasekhar/Ghosh 2004; Patnaik/Chandrasekhar 1998). Financial liberalisation was partly an outcome of the specific process of adjustment chosen in response to that crisis. Second, India had been on the verge of substantially liberalising its capital account and rendering the rupee fully convertible, when the East Asian crisis aborted the process. The road map for convertibility was drawn up by an officially appointed Committee, under the chairmanship of former Reserve Bank of India deputy governor S.S. Tarapore, and prudence on this score was the result of the lessons driven home by the 1997 crisis regarding the dangers of adopting that route. Third, even while avoiding full capital account convertibility, India has pushed ahead rapidly in terms of financial liberalisation and has, in small steps, substantially opened its capital account.

The point to note here is that the basic tendency in economic policy since the early 1990s has been towards liberalisation of regulations that influence the structure of the financial sector. This applies to capital account convertibility as well. There has been a continuous process of liberalisation of transactions on the capital account, as the 2006 report of the Committee on Fuller Capital Account Convertibility (FCAC) noted (Reserve Bank of India 2006). The strategy has been to allow convertibility in various forms, subject to ceilings which have been continuously raised.

While a consequence of these developments has been an increase in capital flows into the country since the early 1990s, the effects of these relaxations have varied in different periods. In the period between 1993 and 2003, there was a positive but moderate increase in the average volume of capital inflows. However, since 2003 there has been a veritable surge (Table 1). The perception of India as an 'emerging economic power' in the global system derives whatever strength it has from developments during the five years after 2003 when India, like other emerging markets, was the target of a surge in capital flows from the centres of international finance (Mohan 2008).

Table 1: Capital Flows Into and Out Of India ($ million)

	Inflow	Outflow	Net
2001–2002	47,108	36,535	10,573
2003–2003	46,368	35,528	10,840
2003–2004	75,885	59,149	16,736
2004–2005	98,539	70,517	28,022
2005–2006	144,376	118,906	25,470
2006–2007	233,291	188,088	45,203
2007–2008	438,357	331,772	106,585
2008–2009	313,632	306,864	6,768
2009–2010	345,674	292,277	53,397

Source: Reserve Bank of India (2001–2010)

Recent developments also point to a qualitative change in India's relationship with the world system. Till the late 1990s, India relied on capital flows to cover a deficit in foreign exchange needed to finance its current transactions, because foreign exchange earned through exports or received as remittances fell substantially short of payments for imports, interest and dividends. More recently, however, capital inflows are forcing India to export capital, not just because accumulated foreign exchange reserves need to be invested, but because it is seeking alternative ways of absorbing the excess capital that flows into the country. Evidence from the Reserve Bank of India on different aspects of India's external payments point to such a transition.

The most-touted and much-discussed aspect of India's external payments is the sharp increase in the rate of accretion of foreign exchange reserves. India's foreign exchange reserves rose by a huge $110.5 billion during the financial year 2007–2008 to touch $309.7 billion as on March 31, 2008. The increase occurred because of a large increase in the inflow of foreign capital. Being adequate to finance around 15 months of imports, these reserves were clearly excessive when assessed relative to India's import requirements. More so because *net* receipts from exports of software and other business services and remittances from Indians working abroad were financing much of India's merchandise trade deficit. Viewed in terms of the need to finance current transactions, which had in the past influenced policies regarding foreign exchange use and allocation, India was now foreign exchange rich and could afford to relax controls on the use of foreign exchange. In fact, the difficulties involved in managing the excess inflow of foreign exchange required either restrictions on new inflows or measures to increase foreign exchange use by residents. The government has clearly opted for the latter.

Not surprisingly, the pace of reserve accumulation has been accompanied by evidence that Indian firms are being allowed to exploit the opportunity offered by the 'invasion currency' that India's reserves provide to make cross-border investments under liberalised rules regarding capital outflows from the country. Figures on India's international investment position indicate that direct investment abroad by firms resident in India, which stood at $10.03 billion at the end of March 2005, rose sharply to $67.6 billion by the end of March 2009 and $82 billion at the end of March 2010. The acceleration in capital outflows in the form of direct investments from India to foreign countries has been sustained, as suggested by the anecdotal evidence on the acquisition spree embarked upon by Indian firms in areas as diverse as information technology, steel and aluminium.

Does this suggest that, by using the invasion currency that India has accumulated, the country (or at least its set of elite firms) is heading towards sharing in the spoils of global dominance? The difficulty with this argument is that it fails to take account of the kind of liabilities that India is accumulating in order to finance its still incipient global expansion. Unlike China, which earns a significant share of its reserves by exporting more than it imports, India either borrows or depends on foreign portfolio and direct investors to accumulate reserves. China currently records trade and current account surpluses of around $250 billion in a year. In contrast to this, India incurred a trade deficit of around $120 billion and a current account deficit of close to $38.5 billion in 2009–2010. Its surplus foreign exchange is not earned, but reflects a liability.[3] However, given its small size, financing the current account deficit with capital inflows is not yet a problem. The problem in fact has turned out to be exactly the opposite: capital inflows have been too large given the size of the current account deficit.

Net capital inflows peaked at $106.6 billion in 2007–2008, when the current account deficit was just $15.7 billion. The major items accounting for these inflows were foreign direct investment (15.9 billion), portfolio investments ($27.4 billion), external commercial borrowings ($22.6 billion) and short term credit ($15.9 billion). To accommodate these and other flows of smaller magnitude, without leading to a substantial appreciation of the rupee, the central bank had to purchase dollars and substantially increase its reserve holdings.

The core issue is that the reserves are not principally a reflection of the country's ability to earn foreign exchange. The acceleration in the pace of reserve accumulation in India is not due to India's prowess but to investor and lender confidence in the country. Nevertheless, the more that such confidence results in capital flows in excess of India's current account financing needs, the greater is the possibility that such confidence can erode.

1. Signs of fragility

Another reason why investor confidence can diminish is the evidence that capital flows are financing a speculative bubble in both stock and real estate markets. As has been true of many other emerging markets, large capital inflows into India through the FII route have resulted in an unprecedented rate of asset price inflation in India's stock markets and substantially increased volatility. Having averaged $1776 million a year from 1993–1994 to 1998–1997, net FII investment dipped to an average of $295 million during 1997–1999, influenced no doubt by the Southeast Asian crisis. The average rose again to $1829 million during the period 1999–2002 only to fall to $377 million in 2002–2003. The surge began immediately thereafter and has yet to come to an end. Inflows averaged $9800 million a year in the period 2003–2006, slumped in 2006–2007 and are estimated at $20,328 million during 2007–2008. Going by data from the Securities and Exchange Board of India, while cumulative net FII flows into India since the liberalisation of rules governing such flows in the early 1990s till end-March 2003 amounted to $15,635 million, the *increment* in cumulative value between that date and the end of March 2008 was $57,860 million.

2. Financial flows and fiscal contraction

Growing FII presence is disconcerting not just because such flows are in the nature of 'hot money' which renders the external sector fragile, but because the effort to attract such flows and manage any surge in such flows that may occur has a number of macroeconomic implications. Most importantly, inasmuch as financial liberalisation leads to financial growth and deepening and increases the presence and role of financial agents in the economy, it forces the state to adopt a deflationary stance to appease financial interests. Those interests are against deficit-financed spending by the state, for a number of reasons. First, deficit-financed spending is seen to increase the liquidity overhang in the system, and therefore to be 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 more unpredictable interest rate differentials that determine financial profits. Third, 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 tend to oppose deficit spending. Finally, the use of deficit spending to support autonomous expenditures by the state amounts to an implicit legitimisation of an interventionist state, and therefore, a de-legitimisation of the market. Since global finance seeks to de-legitimise the state and legitimise the market, it strongly opposes deficit-financed, autonomous state spending (Patnaik 2005).

Efforts to curb the deficit inevitably involve a contraction of public expenditure, especially expenditure on capital formation, which adversely affects growth and employment; leads to a curtailment of social sector expenditures that sets back the battle against deprivation; impacts adversely on food and other subsidies that benefit the poor; and sets off a scramble to privatise profit-earning public assets, which render the self-imposed fiscal strait-jacket self-perpetuating. All the more so since the finance-induced pressure to limit deficit spending is institutionalised through legislation like the Fiscal Responsibility and Budget Management Act passed in 2004 which constitutionally binds the state to do away with revenue deficits[4] and limit fiscal deficits to low, pre-specified levels.

3. Implications of curbing the monetised deficit

The fiscal fall-out of Foreign Institutional Investor (FII)[5] inflows and its effects are aggravated by the perception that accompanies the financial reform, namely that macroeconomic regulation should rely on monetary policy pursued by an 'independent' central bank rather than on fiscal policy. The immediate consequence of this perception is the tendency to follow the IMF principle that even the limited deficits that occur should not be 'monetised'. In keeping with this perception, fiscal reform involved a sharp reduction of the 'monetised deficit' of the government, or that part which was earlier financed through the issue of short-term, *ad hoc* Treasury Bills to the Reserve Bank of India, and its subsequent elimination.[6] Until the early 1990s, a considerable part of the deficit in the government's budget was financed with borrowing from the central bank against *ad hoc* Treasury Bills issued by the government. The interest rate on such borrowing was much lower than the interest rate on borrowing from the open market. The reduction of such borrowing from the central bank to zero resulted in a sharp rise in the average interest rate on government borrowing.

It is relevant to note here that for many years the decision to eliminate the practice of monetising the deficit hardly affected the fiscal situation. Fiscal deficits remained high, though they were financed by high-interest, open-market borrowing. The only result was that the interest burden of the government shot up, reducing its maneuverability with regard to capital and non-interest current expenditures. As a result, the Central Government's revenue expenditures rose relative to GDP, even when non-interest expenditures (including those on subsidies) fell, and the fiscal deficit continued to rise.[7]

An obvious lesson from that experience is that if the government had not frittered away resources in the name of stimulating private initiative, if it had instead continued with earlier levels of monetizing the deficit and also dropped its obsession with controlling the total fiscal deficit, especially at the turn of the decade when food and foreign reserves were more than adequate, the 1990s would in all probability have been a decade of developmental advance. Yet, the policy choices made ensured that neither was this achieved, nor were the desired targets of fiscal compression met. It is evident that the failure of the government to realise its objective of reining in the fiscal deficit was a result of this type of economic reform rather than of abnormal expenditures.

4. Financial flows and exchange rate management

The question that remains is whether this 'abolition' of the monetised deficit in order to appease financial capital actually resulted in central bank independence. As noted above, by March 2008 India's foreign exchange reserves exceeded $300 billion. The process of reserve accumulation is the result of the pressure on the central bank to purchase foreign currency in order to shore up demand and dampen the effects on the rupee of excess supplies of foreign currency. In India's liberalised foreign exchange markets, excess supply leads to an appreciation of the rupee, which in turn undermines the competitiveness of India's exports. Since improved export competitiveness and an increase in exports is a leading objective of economic liberalisation, the persistence of a tendency towards rupee appreciation would imply that the reform process is internally contradictory. Not surprisingly, the Reserve Bank of India (RBI) and the government have been keen to dampen, if not stall, appreciation. Thus, the RBI's holding of foreign currency reserves rose as a result of large net purchases.

This kind of accumulation of reserves obviously makes it extremely difficult for the central bank to manage money supply and conduct monetary policy as per the principles it espouses and the objectives it sets itself. An increase in the foreign exchange assets of the central bank has as its counterpart an increase in its liabilities, which in turn implies an injection of liquidity into the system. If this 'automatic' expansion of liquidity is to be controlled, the Reserve Bank of India would have to retrench some other assets it holds. The assets normally deployed for this purpose are the government securities held by the central bank, which it can sell as part of its open market operations to at least partly match the increase in foreign exchange assets, reduce the level of reserve money in the system and thereby limit the expansion in liquidity.

The Reserve Bank of India has been resorting to this method of sterilisation of capital inflows. But two factors have diminished its ability to continue to do so. To start with, the volume of government securities held by any central bank is finite, and can prove inadequate if the surge in capital inflows is large and persistent. Second, as noted earlier, an important component of neoliberal fiscal and monetary reform in India has been the imposition of restrictions on the government's borrowing from the central bank to finance its fiscal expenditures with low cost debt. These curbs were seen as one means of curbing deficit-financed public spending and as a means of preventing a profligate fiscal policy from determining the supply of money. The net result, it was argued, would be an increase in the independence of the central bank and in its ability to follow an autonomous monetary policy. In practice, the liberalisation of rules regarding foreign capital inflows and the reduced taxation of capital gains made in the stock market that have accompanied these reforms, has meant that while monetary policy is independent of fiscal policy, it is driven by the exogenously given flows of foreign capital. Further, the central bank's independence from fiscal policy has damaged its ability to manage monetary policy in the context of a surge in capital flows. This is because one consequence of the ban on running a monetised deficit has been that changes in the central bank's holdings of government securities are determined only by its own open market operations, which in the wake of increased inflows of foreign capital have often involved net sales rather than net purchases of government securities.

Thus, the monetary policy of the central bank, which has been delinked from the fiscal policy initiatives of the state, with adverse consequences for the latter, is no longer independent. More or less autonomous capital flows influence the reserves position of the central bank and therefore the level of money supply, unless the central bank chooses to leave the exchange rate unmanaged, which it cannot. This implies that the central bank is not in a position to use the monetary lever to influence domestic economic variables, however effective those levers may be.

There is also a larger cost borne by the country as a result of the inflow of capital that is not required to finance the balance of payments. This is the drain of foreign exchange resulting from the substantial differences between the repatriable returns earned by foreign investors and the foreign exchange returns earned by the Reserve Bank of India on the investments of its reserves in relatively liquid assets.

The RBI's answer to the difficulties it faces in managing the recent surge in capital inflows, which it believes it cannot regulate, is to move towards greater liberalisation of the capital account (Reserve Bank of India 2004). Full convertibility of the rupee, the lack of which is seen as having protected India against the Asian financial crisis of the late 1990s, is now the final goal.

5. Financial liberalisation and financial structures

But besides these difficulties resulting from external financial liberalisation (or rules applying to flows of foreign capital into the country and the repatriation of capital and the returns associated with such flows), there are a number of adverse macroeconomic effects of what could be termed internal financial liberalisation, necessitated in large part by the effort to attract portfolio and direct foreign investment. Financial liberalisation of this kind beingadopted in India not only results in changes in the mode of functioning and regulation of the financial sector, but in a process of institutional change. This process of institutional change implies that the role played by the pre-existing financial structure, characterised by the presence of state-owned financial institutions and banks, is substantially altered.

The fact that pre-existing structures are being dismantled is illustrated by this transition in Indian banking, driven by a change in the financial and banking policy regime of the kind described earlier. A consequence of that transformation of banking is excessive exposure to the retail credit market with no or little collateral. Total bank credit grew at a scorching pace from 2004–2005 till 2007–2008, at more than double the rate of increase of nominal GDP. As a result, the ratio of outstanding bank credit to GDP (which had declined in the initial post-liberalisation years from 30.2 per cent at the end of March 1991 to 27.3 per cent at the end of March 1997) doubled over the next decade to reach about 60 per cent by the end of March 2008. Thus, one consequence of financial liberalisation was an increase in credit dependence in the Indian economy, a characteristic imported from developed countries such as the USA. The growth in credit out-performed the growth in deposits, resulting in an increase in the overall credit-deposit ratio from 55.9 per cent at end March 2004 to 72.5 per cent at end March 2008. This increase was accompanied by a corresponding drop in the investment-deposit ratio, from 51.7 per cent to 36.2 per cent, which indicates that banks were shifting away from their earlier conservative preference to invest in safe government securities in excess of what was required under the statutory liquidity ratio (SLR) norm (data on this and for the subsequent four paragraphs are from CFSA 2009.)

Not surprisingly, these changes were not primarily driven by an increase in the commercial banking sector's lending to the productive sectors of the economy. Instead, retail loans became the prime drivers of credit growth. The result was a sharp increase in the retail exposure of the banking system, with personal loans increasing from slightly more than 8 per cent of total bank credit in 1992–1993 to more than 23 per cent by 2005–2006 (figure 1). Though there has been a subsequent decline in that ratio, it still stood at 19.4 per cent at the end of 2008–2009. The decline appears to be the result of an overall correction in bank lending growth, which also declined in this period, with the adjustment being much sharper in the case of personal loans when the transition occurred in 2004–2005.

Of all the components of retail credit, the growth in housing loans was the highest in most years. As figure 2 indicates, the rate of growth of housing loans gathered momentum at the end of the 1990s and remained at extremely high levels right up to 2006–2007. As a result, the share of housing finance in total credit rose from 5 per cent in 2001–2002 to 12 per cent in 2006–2007 and was still at 10 per cent in 2009–2010. The increase is often attributed to the low level of penetration of the mortgage market in India, standing at 7 per cent in 2006, as compared to 12 per cent in China, 17 per cent in Thailand, 26 per cent in Korea, 29 per cent in Malaysia and a huge 80 and 86 per cent in the US and UK respectively. But these differential penetration rates have to be seen in the light of differentials in per capita income and the degree of income inequality, neither of which favour a significantly large mortgage market in India.

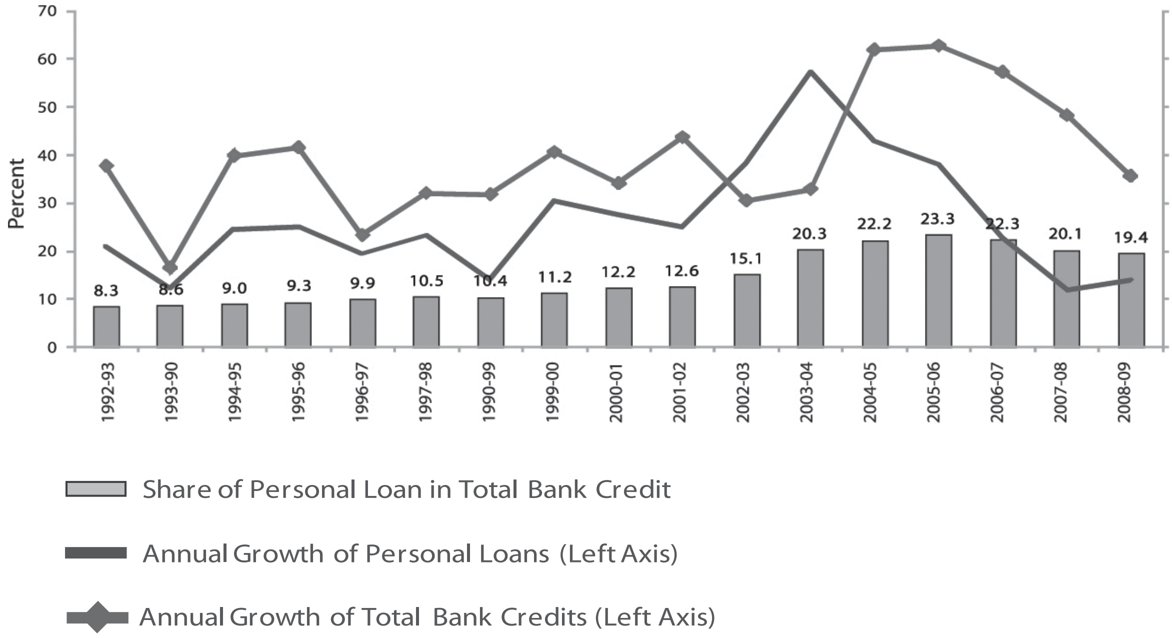

Figure 1: Trends in Personal Loans
Source: CFSA 2009

This development has resulted in the accumulation of loans of doubtful quality in the portfolios of banks. Addressing a seminar on risk management in October 2007, when the subprime crisis had just about unfolded in the US, veteran central banker and former chair of two committees on capital account convertibility, S.S. Tarapore, warned that India may be heading towards its own home-grown sub-prime crisis[8]. Even though the suggestion was dismissed as alarmist by many, there is reason to believe that the evidence warranted those words of caution at that time, and are of relevance even today. Besides the lessons to be drawn from developments in the US mortgage market, there were three trends in the domestic credit market that seemed to have prompted Tarapore's comment.

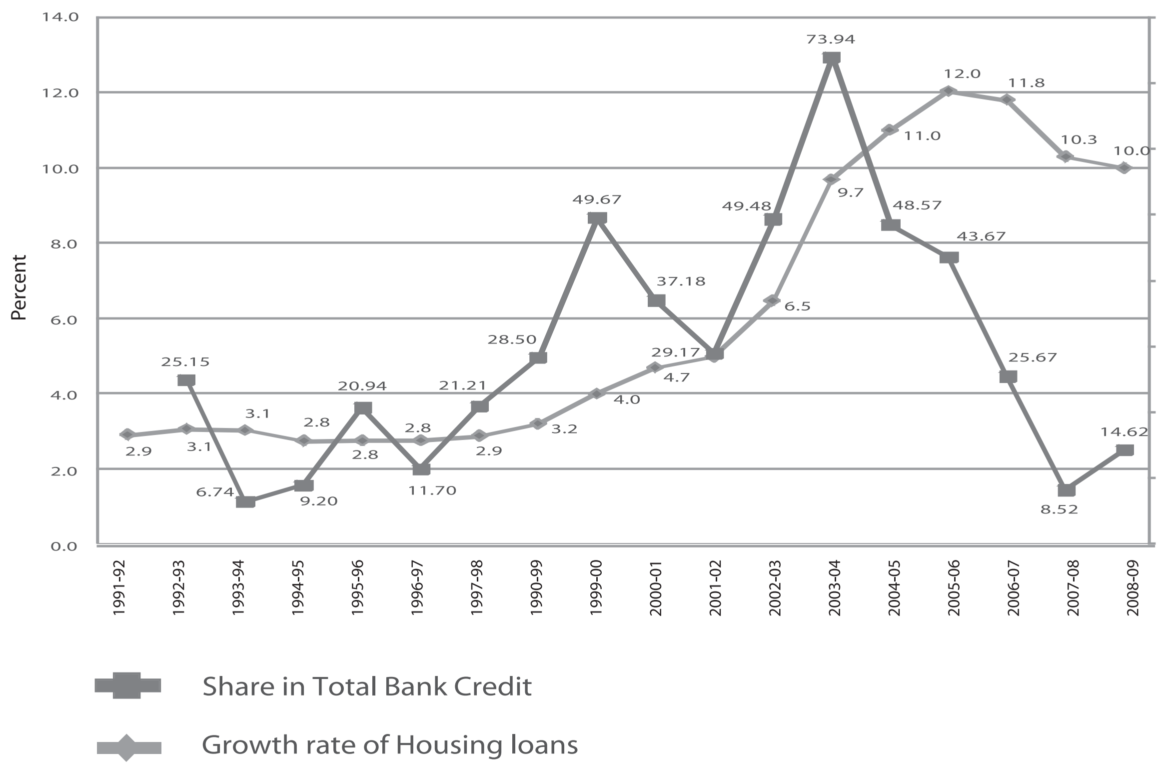

Figure 2: Trends in Housing Loans
Source: CFSA 2009

The increase in retail exposure was also reform related. Financial liberalisation expanded the range of investment options open to savers and, through liberalisation of controls on deposit rates, increased the competition among banks to attract deposits by offering higher returns. The resulting increase in the cost of resources meant that banks had to diversify in favour of more profitable lending options, especially given the emphasis on profits, even in the case of public sector banks. The resulting search for volumes and returns encouraged diversification in favour of higher risk retail credit. Since credit card outstandings tend to get rolled over and the collateral for housing, auto and consumer durable loans consists essentially of the assets whose purchase was financed with the loan concerned, risks are indeed high. If defaults begin, as the US mortgage crisis made clear, the value of the collateral declines, resulting in potential losses. Tarapore's assessment, which clearly was and possibly still remains relevant, was that an increase in default was a possibility because a substantial proportion of such credit was sub-prime in the sense of being provided to borrowers with lower than warranted creditworthiness. Even if the reported incomes of borrowers do not warrant this conclusion, the expansion of the universe of borrowers brings in a large number with insecure jobs. A client with a reasonable income today may not earn the same income when circumstances change.

Another feature of concern was that the Indian financial sector too had begun securitising personal loans of all kinds so as to transfer the risk associated with them to those who could be persuaded to buy into them. Although the government has chosen to hold back on its decision to permit the proliferation of credit derivates, the transfer of risk through securitisation is well underway. As the US experience had shown, this tends to slacken diligence when offering credit, since risk does not stay with institutions originating these retail loans.

Liberalisation did not result in a similar situation during much of the 1990s, partly because the supply-side surge in international capital flows to developing countries, of which India was a major beneficiary, was a post-2002 phenomenon. Credit expansion in those years was also restrained by the industrial recession after 1996–1997, which reduced the demand for credit. Put these together and the risk of excess sub-prime exposure was high. Tarapore himself estimated that by November 2007 there was a little more than Rs.400 billion of credit that was of sub-prime quality and prone to default, defaults on which could trigger a banking crisis.

The problem that Tarapore was alluding to was part of a larger increase in exposure to risk that had, encouraged by liberalisation, accompanied imitations of financial innovation in the developed countries. Another area in which the risk fall-out of liberalisation was high was the exposure of the banking system to the so-called 'sensitive' sectors, like the capital, real estate and commodity markets.

The exposure of banks to the stock market occurs in three forms. First, it takes the form of direct investment in shares, in which case the impact of stock price fluctuations directly impinges on the value of the banks' assets. Second, it takes the form of advances against shares, to both individuals and stockbrokers. Any fall in stock market indices reduces, in the first instance, the value of the collateral. It could also undermine the ability of the borrower to clear his dues. To cover the risk involved in such activity, banks stipulate a margin, between the value of the collateral and the amounts advanced, set largely according to their discretion. Third, it takes the form of 'non-fund based' facilities, particularly guarantees to brokers, which renders the bank liable in case the broking entity does not fulfil its obligation.

The effects of this on bank fragility become clear from the role of banks in the periodic scams in the stock market since the early 1990s, the crisis in the cooperative banking sector and the enforced closure-cum-merger of banks such as Nedungadi Bank and Global Trust Bank. However, this evidence only begins to reveal what even the RBI has described as 'the unethical nexus' emerging between some inter-connected stockbroking entities and promoters/managers of banks. The problem clearly runs deep and has been generated in part by the inter-connectedness, the thirst for quick and high profits and the inadequately stringent, laxly implemented regulation that financial liberalisation breeds.

6. Conclusion

In summary, the Indian experience indicates that, *inter alia*, there are three important outcomes of financial liberalisation. First, increased financial fragility, because of vulnerability to the boom-bust cycles resulting from large inflows of capital. Second, a deflationary macroeconomic stance that adversely affects public capital formation and the objectives of promoting output and employment growth. Finally, the danger of increased fragility within the domestic financial sector, combined with a shortfall in credit for the commodity producing sectors, especially agriculture and small scale industry, as financial investments flow into housing and commercial real estate and the stock markets. These are features that are ignored by those who treat evidence of large capital flows, substantial reserves and high growth as indications that India is not prone to the problems that afflicted East Asia in 1997 and the developed industries countries a decade later.

1 The author would like to thank Karin Küblböck, Johannes Jäger and two anonymous referees for comments on earlier versions of this paper. However, they are not responsible for any errors that remain.
2 Involving inter alia enhanced convertibility for capital account transactions, especially for foreign investors in financial markets, interest rate deregulation, easier entry conditions into financial markets for private operators, permission for banks to enter non-banking financial activities and convert themselves to 'universal banks' and freedom to securitise and create derivative products.
3 Figures quoted here are from the RBI's balance of payments statistics and are available at www.rbi.org.in.
4 The revenue deficit is the excess of current government expenditures over its current tax and non-tax revenue reciepts. It differs from the fiscal deficit, which is the excess of both current and capital expenditures of the government over its current receipts.
5 FIIs are foreign institutions that meet government regulatory requirements with respect to foreign investors in stock markets and are registered for the purpose.
6 This was more or less 'successfully' implemented in a two stage process, initially involving a ceiling on the issue of Treasury Bills in any particular year, and subsequently the abolition of the practice of issuing Treasury Bills and substituting it with limited access to Ways and Means advances from the Central Bank for short periods of time.
7 For an estimate of the impact the end to monetisation had on the government's budget, refer to Chandrasekhar and Ghosh (2004: 81).
8 Tarapores's statement in a speech in Mumbai was backed with estimates by M.G. Bhide and is cited in Business Line Bureau (2007).

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Abstracts

"Emerging markets" are seen to have been insulated from the worst effects of the crisis because of well regulated financial markets. However, though the process had been reined in by the East Asian crisis, India has been substantially liberalising its capital account. While it has not as yet opted for full capital account convertibility, India has also pushed ahead rapidly in terms of financial liberalization. The result has been that India has attracted substantial capital flows, which, despite a persisting current account deficit, has led to the accumulation of large amounts of foreign reserves. Given that, unlike China, India runs a current account deficit, it has experienced upward pressure on the currency and speculative bubbles in stock and real estate markets. Overall, the Indian experience indicates that financial liberalisation leads to increased external vulnerability, a deflationary macroeconomic stance and increased fragility within the domestic financial sector, combined with a shortfall in credit for sectors like agriculture and small-scale industry.

In der aktuellen Diskussion wird oft angenommen, dass „Emerging Markets" aufgrund ausreichender Finanzmarktregulierung von den schlimmsten Auswirkungen der Finanzkrise verschont geblieben sind. Auch wenn die Finanzkrise den Liberalisierungsprozess in Indien gebremst hat und keine volle Konvertibilität eingeführt wurde, wurden dennoch weitreichende Kapitalverkehrs- und Finanzmarktliberalisierungen durchgeführt. Das Ergebnis war, dass große Mengen an Kapital nach Indien geflossen sind. Dies hat zu einer Akkumulation hoher Devisenreserven

geführt. Obwohl Indien im Unterschied zu China ein Leistungsbilanzdefizit aufweist, kam es zu einem Aufwertungsdruck sowie spekulativen Blasen am Aktien- und Immobilienmarkt. Die indische Erfahrung zeigt, dass Finanzmarktliberalisierung zu erhöhter Fragilität, einer deflationären makroökonomischen Politik und einer erhöhten Instabilität des heimischen Finanzsektors, kombiniert mit Kreditknappheit in Sektoren wie Landwirtschaft und Kleingewerbe, führt.

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