Capital Flows and Indian Policy Response*

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After such an illuminating lecture by Prof. Krueger and a very lively discussion, I would with your permission, dispense with the formality of a formal address. However, as is expected of me, I will make a few comments.

At the outset, I should confess the main reasons for my being here. It is out of my personal affection, great respect for scholarship and admiration for the leadership as well as diplomatic skills of Prof. Krueger, that I made it a point to be here. Of course, as the Chairman of the Governing Council of NIBM, it is also my duty to be here when there is such a distinguished visitor. I am fulfilling my responsibilities as Chairman in several ways; have met the NIBM faculty for an hour in the forenoon and hope to meet and interact with the young students here at 2.30 pm. Apart from these reasons, being here also gives me an opportunity to be a little more free in whatever I say, as I can claim I was just being an academic and not Governor, RBI. So in case some media is present and they quote me, I also keep the liberty of saying that I was indulging in academic discourses and not in policy-statements.

You must have heard that we had the World Social Forum meeting in Mumbai. Prof. Joseph Stiglitz was a distinguished visitor to Mumbai a couple of days ago for the meeting. And we are going to meet Mrs. Krueger tomorrow in RBI. Thus, we would be able to have advantage of understanding diverse opinions. That is normally what India believes in and from the days of Buddha, India has followed the philosophy of preferring the middle-path. We have imbibed it in our policies as well, and have done reasonably well in managing the economy since 1991 when the IMF had to come to our rescue. Balancing is the crux of middle path and requires an awareness of theory as well as international practice. While theory is indeed important, at the same time, one should not become a prisoner of any ideology. Although this non-ideological approach or preference to pragmatism may create some confusion on occasions, even in our own minds in some ways, it also helps and gives us a certain amount of resilience to the process of change in a complex, uncertain and dynamic setting.

While Prof. Krueger's talk has given some boost to our 'feel good factor' she has at the same time indicated the type of things that should be done if we have to feel better, such as in the area of public debt. We take the advice very seriously. I also agree that the most ideal time to move forward with the

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reform is during good times because good times are generally associated with progress on several fronts. So, adjustments in terms of burden sharing of the reforms are easier in a growth process than in a crisis situation. So in that sense, I would reinforce Prof. Krueger's point that good times are ideal times to move forward in the reforms because it is easier to reconcile the differing perceptions and differing interests in regard to burden sharing during the process of transition. And in fact one can see different segments of India actually benefiting through liberalisation - with the highly skilled going to USA, the not-so-skilled going to Middle East and semi-skilled deriving the benefit of outsourcing through the computers. So it is different generations as well as people of different skills that are able to take advantage of globalisation. In this context, we certainly endorse the view that the signs of revival of protectionism in the world particularly among industrialised economies are extremely disturbing.

In emphasising the advantages of deregulation, globalisation and economic reforms, a word of caution is necessary; that for a society like India, which is complex and diverse, comprising different states with different levels of development, social disruption has to be avoided. The total cost of the social or political disruption or market disruption has to be weighed against the flow of benefits whenever we talk of economic reforms. So in that sense again, it involves balancing between benefits over a period and costs of immediate disruptions.

Very often, there may be broad intellectual agreement on where to go but, the problem often is 'how' to go. Here, we will continue to adopt the middle path. Basically there are two aspects to the macroeconomics of reforms: the monetary and fiscal policy and the players are RBI and Government. Correspondingly, there are two dominant factors in proceeding with the reform; first is how to avoid social or political disruption, which is the main concern for Government and second is how to avoid the adverse consequences of extreme market volatility in the process of reforms which is the main concern for RBI. Over a period, therefore, there should be a social consciousness to accept the logic of reforms and also the markets should be developed enough to be able to handle the volatility that may be involved in the process. In fact, you will find a reflection of this extremely difficult balancing act even in matters related to interest rates.

As Prof. Krueger rightly pointed out, capital inflows play a very important role in capturing the benefits of globalisation, and in fact, our own assessment is that it is not so much the quantity but the quality that is making the difference. In the old two-gap theory, we thought, it is the quantity of money that counts. We are now conscious that it is the technological and managerial skills, the work culture, and the synergies accompanying capital flows that seem to give a lot more contribution to growth. Even with regard to portfolio flows from Foreign Institutional Investors (FIIs), the way in which FIIs assess market practices in stock exchanges have enhanced our own practices and skills among participants to global standards. So one has to look at the capital flows in a broader sense rather than as mere numbers and in any case the issue has to be evaluated in the country context with a medium-term perspective. In this connection, we believe that of late, there is strong universal endorsement of our policy of calibrated capital account liberalisation. Although the pace of liberalisation required might be debatable, we feel that there is an agreement on the need for some calibration, and Prof. Krueger also confirmed this today.

Prof. Krueger has also made a very good point about the importance of prudential regulations in the financial sector. In fact, to give an example, you would have noticed the recent liberalisation of the external commercial borrowings. The whole process of permitting such external debt may be either through the automatic route or non-automatic route, but slowly the automatic route is being expanded and the non-automatic route reduced. Again, in the capital account apart from the government's there are three balance sheets that we take into account whether for residents or non-residents: The balance sheet of the households, the corporates, and the financial intermediaries. Though in theory, everything may be integrated, in our phase of development, definitely these three are distinct in terms of their immediate reactions to market forces. That is the reason, the recent External Commercial Borrowings (ECB) policy makes a clear distinction between financial intermediaries and corporates. So, depending on the situation and the nature of balance sheets, one has to define the capital account convertibility. In this context, definitely I would agree with Prof. Krueger, and I think it has been recognised by the Tarapore Committee Report on Capital Account Convertibility also, that there is a greater comfort for more rapid capital account liberalisation when the fiscal deficit is reasonably under control. So, though our financial sector is perhaps a lot more resilient and more efficient now than other comparable countries, as Governor RBI, I would not like to take too many risks on the financial sector. Therefore, taking an integrated view of the domestic financial as well as the fiscal situation and the imperatives of the international financial architecture, our carefully calibrated capital account liberalisation precisely captures this objective.

On the question whether the international financial architecture is in a position to give us comfort if we get into or happen to have a problem, there are two aspects. I entirely agree with Prof. Krueger that the resilience of the world today to handle their economies and the private capital market has improved enormously since 1997. Government's macro policies, and approaches of international financial institutions as well as the resilience of the markets have improved. But the risks are not eliminated. They are mitigated to some extent though not to the extent needed for countries like India. So we have to take into account the possible risks. Indian public policy also takes into account the geo-political considerations which do influence the comfort that international financial architecture provides to a specific country in times of crises. This requires a continuous assessment of the degree or extent of risks that can be taken by any country's public policy, the capital account convertibility has to be packaged within that overall contextual framework. Therefore, even non-domestic economic factors figure as inputs in determining the pace and the nature of capital account liberalisation.

Exchange rate management is again one of those cases where we totally practice what we preach. We were one of the earliest to accept, as advised by Rangarajan Committee in 1992-93 the principle that the exchange rate should be flexible. In fact, it is determined by demand and supply but the critical question is where does flexibility stop and volatility begin. That line keeps on changing depending on the country context, especially the views relating to behaviour of domestic as well as international financial markets, and in particular the currency markets. In the last ten years, we have been avoiding volatility and also moving to greater flexibility to the extent the policy and state of development of financial markets permit. So I think, it is absolutely right that flexibility in the exchange rate provides greater comfort, as also freedom to monetary policy but it is a contextual and judgemental matter for policy makers to determine when flexibility ends and volatility begins.

Public debt is another important aspect of macroeconomics of reforms, which has global linkages and global ramifications. It may not be a serious issue for many emerging countries though for some it is a matter of concern, either constraining growth or undermining stability or both. However, given the demographics and the recent events, in the years ahead the debt dynamics can be a bigger problem for developed countries also. Then we are going to have a situation where we have to revisit the old hypothesis that the benefit of globalisation is that capital will flow from developed countries to developing countries to fill the gap between investment needs for growth and domestic savings. It is quite possible that capital can go from developing countries to developed countries as is seen to be happening in a limited sense between Asia and USA now. So the fact remains that public debt is an important issue. And it has to be handled over the medium term and in the global context. The sooner the process starts and is brought under reasonable level, the better it is in shaping the universal or unanimous perceptions of all those concerned. Having said this, I would certainly agree with Prof. Krueger that there is no imminent crisis or problem in India, but even the most remote case of a threat to stability can be totally avoided if the fiscal deficit in the medium term can be brought into shape. More importantly, the growth rate can be accelerated – to the extent of its exceeding 8 per cent and upto 9 per cent, as is being talked - once we take demonstrably credible actions for a very sound fiscal adjustment in totality.

Finally, I would touch upon the importance of the banking and financial sector. Indeed financial sector is important and, in particular, banking is important. However much, the capital market may develop, particularly in the emerging markets, the linkages are strong in regard to banks with the real sector and hence banks are very special in their role in maturity transformation, pooling and monitoring of risks and in reducing information gaps or asymmetries. As banks are special, the National Institute of Bank Management has a very important role to play. Nowadays it looks very often as though the practitioners are forging ahead and the research catches up in the financial and the banking sector. We should, therefore, attempt more and more of acquisition of domain knowledge and in spillovers of codified and tacit knowledge. Linkages with practitioners is necessary to be able to grasp and get back into the research. I am sure, in the next Governing Council, Director Saha and others would help us and I will do whatever I can in this regard.

Let me conclude with the priorities indicated by Prof. Krueger (i) fiscal deficit and (ii) capital flows. On fiscal deficit, we agree with Prof. Kreuger that we should give priority to fiscal adjustment if we want our economy to grow and address issues relating to poverty. Prof. Krueger has emphasised the importance of trade and capital liberalisation and as you know, there have been significant announcements of trade liberalisation in India, in recent months. Trade and capital flows are interrelated in our country. I, therefore, welcome the trade liberalisation measures in the current context of the capital inflows.

Finally, I would like to conclude with a statement. There was a question from one of my colleagues here about the difference in the state of Indian economy in 1993 and 2003. The answer can be summed up thus: in the past, there was a very strong consensus for a very weak economic reform and the view now is that, there is a very strong consensus for a reasonably strong economic reform. That is good news.