

India and Global Financial Markets: Emerging Issues, Lessons and Responses

Kavaljit Singh

The Beginnings

With the opening up of its economy under the structural adjustment program since 1991, there has been a significant shift in several policies and programs of the Indian government. This shift is more pronounced in the arena of capital flows, from earlier policy regime of official and commercial borrowings to private capital flows - in the form of foreign direct investment (FDI) and portfolio investment (PI). Since then, various measures have been undertaken to open India's economy to foreign investment and earlier restrictions have been relaxed. There is no doubt that in the post-1991 period FDI flows in India have increased, but the growth in portfolio investment has been more dramatic. In 1993-94 and 1994-95, the portfolio inflows outnumbered the FDI, contributing over 70 per cent of the total capital inflows during this period. This trend continued until 1997. It was only in the wake of Asian financial crisis in 1997, which enhanced emerging market risk perception among the foreign investors, that

in India.

Unlike Chile and Japan, India did not follow the „Big Bang“ approach of financial deregulation and liberalization. But, the content of financial liberalization in India is similar - deregulation, privatization, and pro-market oriented policies. Given the fact that Indian financial markets are fragmented and even not integrated domestically, the critics argue that the rapid global integration of financial markets seems to be too early and premature. In 1992, the Indian government began the process of integration of its financial markets with global finance capital in two major ways. Firstly, by permitting foreign institutional investors to enter its capital markets and secondly, by allowing domestic companies to raise capital from abroad through the issuance of equity, Global Depository Receipts (GDRs), and other debt instruments.

the PI suffered decline in comparison with the FDI

SUMMARY

India started to liberalize its capital account regulations in the early 1990s. In 1994 it introduced current account convertibility. Since 1991 direct foreign investments as well as portfolio investments by institutional investors have increased considerably.

India is among the few countries which were not badly engulfed by the contagion effects of the Asia crisis of 1997. The slower and more cautious pace of capital account liberalization in India is one important reason for this. But

India's short-term debt and the reliance on volatile capital flows is increasing.

The debate on financial liberalization in India has remained restricted to a few experts, economists, concerned officials and market analysts. There is an urgent need to democratize the debates on international financial system by involving different sections of the Indian society and their representatives including trade unions, political groups, NGOs, farmers and community groups.

In the initial years, portfolio investments were strictly regulated by the regulatory bodies such as the Reserve Bank of India (RBI) and the Securities and Exchange Board of India (SEBI). Given the fact that portfolio investment is essentially short-term, quick to move in and move out and tend to be extremely volatile, the Indian authorities initially imposed taxes to attract only genuine investors and keep off fly-by-night operators in the Indian markets. The restrictions on foreign institutional investors included a special 20% tax rate on dividend and interest income and 10 per cent on long-term (12 months or more) capital gains and 30 percent on short-term capital gains.

These tax-based restrictions coupled with other measures were helpful in keeping off the speculators, for some time, but, the foreign investors, over the years, found several loopholes in the system. As a result, the very purpose of such measures to discourage speculative flows has been defeated. Rather than taking appropriate measures to close the loopholes developed in the system, the Indian authorities have been further removing controls and regulatory mechanisms. For instance, the aggregate cap on the holding of foreign institutional investors along with non-resident Indians (NRIs) and overseas corporate bodies (OCBs) on domestic company was raised from 24 % to 40 % in the 1998. Beside, foreign institutional investors can purchase and sell government securities and Treasury Bills. Forward covers in respect to fresh equity investment have been permitted. New financial instruments such as derivatives are to be introduced shortly in the Indian markets.

Capital Account Liberalization

Since 1997, the agenda of integrating Indian financial markets with the rest of the world has been extensively pushed by successive governments. Before the onset of the Southeast Asian financial crisis, convertibility on capital account had become the new buzzword in Indian financial markets and policy circles. In 1994, India had introduced current account convertibility and satisfied the VIII schedule of the IMF's Articles of Agreement. The Indian rupee is now convertible on current account which, in simple words, means that one can buy and sell foreign exchange for import, export and foreign

travel. For any capital transaction, there are ceilings and controls. However, domestic residents and companies are not allowed to invest abroad without permit and cannot operate in currency, stock and gilt market abroad.

In an attempt towards achieving capital account liberalization, the government appointed a committee headed by S. S. Tarapore in February 1997 to examine the issues related to capital account liberalization in India. In its report submitted to the government in June 1997 the committee has called for full liberalization by the year 1999-2000, provided that a few preconditions, like a lowering of the fiscal deficit, a low inflation rate, adequate level of „owned“ forex reserves, and reduction in non-performing assets of the banking sector are met. The policy makers have overlooked the concerns of many critics who argue that achieving capital account liberalization in 1999-2000 can be ill-timed because the economy is yet to achieve a sustainable growth rate; inflationary pressures are existing; fiscal deficit is not going down; and its position on the external front is uncertain. Any move towards reaching the target of full liberalization in the next two years can backfire, thereby causing a severe crisis in the external sector.

Initially, the report received tremendous support from the foreign institutional investors, banks, trading and business houses, and international financial institutions. However, with the eruption of financial crisis in the Southeast Asia in 1997, the initial euphoria was subsided for few months in India. But, now it appears that both domestic and international lobbies have, once again, started lobbying for full liberalization.

Except for rethinking on capital account liberalization in the wake of Asian financial crisis, the Indian authorities have, by and large, moved ahead with their plans of financial liberalization, which became very evident when India accepted the new WTO accord on financial services in December 1997. In a major development, the government announced the opening of the insurance sector to the domestic private sector in the Union Budget of 1998-99. Within a couple of months, the government suddenly reversed its stand and decided to allow foreign investment in the Indian insurance sector. The haste in which

this decision was taken without any meaningful consultation with labor unions and political parties has raised several doubts.

Emerging Issues:

The Growing Domination of Foreign Funds

Although India has been able to attract not more than 5 percent of the total capital flows to emerging markets (as the bulk has gone to Latin America and Southeast and East Asia in the 1990s), yet the impact of these flows on the Indian financial markets has been very profound in many ways. The authorities expected that by inviting foreign institutional investors, the Indian markets would increase in maturity and depth. But, this did not happen. On the contrary, the markets became shallow and volatile. The markets are unable to provide resources to promoters of new capital issues.

Although there are nearly 500 foreign institutional investors registered with the SEBI to operate in Indian financial markets, only a handful of them dominates the markets. As the cumulative portfolio investment in India by the foreign investors until November 1997 was about \$9 billion, just five top foreign institutional investors contributed over 40 percent of the total investments. Much of that money is going only to a couple of capital markets in the country and in a handful

of stocks. The entry of foreign institutional investors has weakened the strength of domestic institutional investors in India. With huge amounts of financial resources at their disposal, the foreign institutional investors are the real prime movers and shakers in the Indian stock markets. Except a handful of major public sector financial institutions, such as Unit Trust of India (UTI), no Indian institutional investor can match the resources of the foreign players. With retail business almost vanished, any action by the foreign institutional investors (whether buying or selling) determines the movements in the markets nowadays. Recent studies reveal a positive correlation between net inflows by foreign institutional investors and the movement in the

stock indices.¹ With the policy-makers still relying on foreign portfolio investments, it is ignored that these investments are not reliable and sustainable. For instance, in November 1997 - for the first time since India opened its doors to foreign institutional investors - their net investments in India turned negative, i.e. there was an outflow of funds.

In a like manner, restrictions on the external commercial borrowings (ECBs) by the Indian companies have also been further relaxed. The ECBs have been on the rise recently, as Indian corporate houses prefer cheap foreign loans. Since the foreign borrowings come cheaper, many companies have used ECBs to retire their high cost rupee debt. This works out to be much cheaper given the wide gap between the domestic and overseas interest rates. But, the depreciation of the rupee increases the repayment cost (in rupees) and causes problems for the management of the balance of payments for the country as a whole. This is what really happened in the case of Indonesia, South Korea and Thailand in 1997.

„Hot Money“ Flows: Cause of Concern

The growing proportion of „hot money“ flows to forex reserves of India in the 1990s is a matter of serious concern. It increased from 37.50 percent in 1994 to 53.52 percent by March 1997 and then further to 78.80 percent by February 1998. The stock of potentially „hot money“ can be arrived at by adding the stock of short-term debt, investments by foreign institutional investors, issuance of GDRs, and offshore funds. According to the RBI annual report for 1996-97, India's short-term debt was \$6.7 billion (but as per the Bank for International Settlements (BIS), estimates that are considered more reliable by international community, India's short-term debt was \$7.75 billion at the end of June 1997). Similarly, the GDR figure in March 1997 was \$5.4 billion and the portfolio investments amounted to \$8.8 billion. These figures add up to a staggering \$20.9 billion, against forex reserves of \$24.1 billion. In other words, the „hot money“ flows constitute a

¹ See, for instance, Aziz Jahangir, *Discretionary Trading and Asset Price Volatility*, Working Paper No. 95/104, International Monetary Fund, October 1995.

whopping 86.7 percent of India's total forex reserves. This figure is very high as compared to a maximum of 60 percent recommended by the Tarapore committee.

Lessons to be Learned

Rapid global capital mobility in the decades of the eighties and nineties has been accompanied by an increased frequency of financial crises in both the developed and developing countries. The advocates of the financial liberalization have admitted the fact that there is a positive correlation with international financial liberalization and financial crises. Attracted by short-term speculative gains, „hot money“ flows can leave the country as quickly as they come in. The problem is further compounded by the domestic structural weaknesses in the financial sector of recipient countries, which find it difficult to manage the volatile capital flows. As a result of these factors, one has witnessed the financial crises in the European Monetary System in 1992-93 (which also affected non-EMS countries such as Finland and Sweden), then came the Mexican currency crisis of 1994 and now the Southeast Asian crisis.

Since India's financial markets were not opened up until the early 1990s, the country was able to insulate itself from many of these international currency and financial crises. But, now the chances of being affected by the developments in the world markets have increased significantly because what happens all over the world markets, affects the Indian markets. Further, when financial markets crash, worldwide panic takes over and economic fundamentals (even if these are strong) are ignored. The recent financial crises have exposed the dangers of capital account liberalization and underscored the necessity for effective, constructive and well-coordinated regulation of financial markets by the state and its agencies. The Southeast Asian financial crisis has demonstrated how a sudden withdrawal of capital can seriously affect the exchange and interest rates, and thereby threaten macroeconomic management and economic stability not only in one country but several others, depending on the degree of economic integration. Thanks to controls on its capital account, India was not as badly engulfed by the Asian currency crisis as

other countries in the region. Many experts have rightly pointed out that slower deregulation of the financial sector in India has proved to be the saving factor. If India had adopted capital account liberalization; it would have been difficult to protect its economy from getting severely affected by the Asian turmoil. It is in this context that the impact of the Southeast Asian crisis on the Indian markets has to be understood.

Responses:

The Official Response

The Southeast Asian financial crisis has marked a dramatic shift in the opinion on capital account control among policy makers, international financial institutions and experts. In the context of India, the official position on capital account liberalization has changed largely because of the Asian crisis. But the pressure to move towards full capital account liberalization has not subsided. A number of market players both domestic and international are still advocating the need for full liberalization in India. However, it is unlikely that the government will be able to implement it by the year 2000. The Indian authorities are more likely to accept only partial liberalization of capital accounts in the coming years.

Surprisingly, the Indian government often takes a radically opposite stand on financial liberalization at the international forums while pursuing liberal policies in the domestic financial sector. This paradox was witnessed recently at the World Economic Forum at Davos, Switzerland and at G-15 Summit in Jamaica, both held in February 1999. In these forums, the Indian authorities strongly advocated the need to regulate capital flows and called for rule-based system of international financial flows. „We can't allow economies to be destabilized by someone pressing a finger on a computer key and moving billions in and out of markets. If we don't replace the present chaos with order, then globalization will remain a 13-letter dirty word,“² said India's Finance Minister, Yashwant Sinha in Davos.

² Quoted in T N Ninan, „Sinha Seeks Rules for Capital Flows,“ *Business Standard*, February 2, 1999, p. 1.

One would have expected that the Indian authorities will follow their own advice and consequently adopt policy measures to regulate capital flows. On the contrary, the authorities are quickly giving up policy instruments, which would allow it to exercise some degree of control over private capital flows.

The Response of International Financial Institutions

In the aftermath of financial crisis in Asia, there has been a significant change in the approach of the IMF on the issue of capital account liberalization and financial deregulation. The conditions attached to the loans by the IMF required countries to liberalize their capital account in order to enhance their attractiveness to private capital flows. Now, the fund realizes the importance of capital controls in dealing with volatile capital flows.

The World Bank, which had been globally promoting the financial deregulation and liberalization as part of „Washington Consensus“, has also done some rethinking on this matter in the aftermath of Asian financial crisis. In its latest report, *Global Economic Prospects 1998-99*, the Bank acknowledges the dangers involved in maintaining an open capital account and recommends the use of capital controls when necessary. In the case of India, the Bank has been asking for adopting a cautious approach and safeguards for adopting the capital account liberalization. The Bank's Chief Economist of the South Asia region, John Williamson, recently called for at least 20-30 years period to move towards full liberalization.

The Response of Domestic Corporate Sector

In the 1990s, India's domestic financial corporate bodies have come to an understanding with the global players of finance capital. This has become very evident in recent years as a number of foreign institutional investors have carried out mergers and amalgamations with domestic institutional investors. Some of the recent mega-mergers include Morgan Stanley with India's top domestic investment company, JM Financial; Merrill Lynch with DSP; Goldman Sachs with Kotak Mahindra and Lazard with Credit Capital. In the insurance sector too, domestic companies

are joining hands with foreign investors. Realizing that they cannot match the financial resources of foreign investors, the domestic corporate players have accepted the role of junior partner in the partnership with their foreign counterparts.

The Response of Foreign Investors

The foreign investors lobby, particularly international fund managers, and the foreign institutional investors are the consistent advocates of liberalization of financial markets and capital accounts. In the present global context, the investment liberalization (along with trade liberalization) is the main item of the economic agenda set up by the transnational capital. Since TNCs dominate much of the world's trade and investment, the combination of investment liberalization and free trade will immensely enable them to expand and restructure their operations. The opening of India's financial sector provides new business opportunities for the owners and managers of finance capital.

The Response of Political Parties, Trade Unions, Social Movements, NGOs, and Media in India

At the political level, except for a couple of issues such as opening up of insurance sector, there seems to be a growing consensus among mainstream political parties to open up India's financial markets. This is reflected by the continuation of "reform" in the financial sector by three governments belonging to left, center and right in the 1990s. In the absence of a major alternative political process at the national level, the political space to express and advocate alternative policies and strategies has significantly reduced, which makes unsound policy decisions a *fait accompli*.

In recent years, a number of peoples' movements, NGOs, women's and labor groups are active in the social and political arenas. But, by and large, the areas where peoples' movements have made the most progress is limited to social and environmental issues. Regarding issues related to international economic relations, these groups have focused on official capital flows (such as the World Bank, ADB, bilateral aid, etc.), trade

(GATT, WTO, etc.) and FDI. Very little work has been done by these groups on financial issues despite the fact that financial issues have a considerable impact on poor people, labor and natural environment. The issues related to financial markets are new to Indian groups. As global financial issues are much more complex, the Indian groups lack the expertise to understand and deal with them. As a result, there is very little input from Indian groups on these issues as compared to earlier developmental debates on environment, women, poverty and sustainable development. The social movements and groups in India have yet to familiarize themselves with these debates and respond to these debates by putting forward their concerns and perspectives.

Although a number of research institutes working on financial matters exist in the country, most of them only serve the information requests of the corporate sector. Since the reports and journals published by these institutes are very expensive, the grassroots groups and movements cannot afford these. Thus, the task of providing regular information to movements has been left to a handful of independent research groups and socially committed intellectuals. In recent months, a few efforts have been made to demystify the complex issues related to globalization of finance in order to democratize the debates.

Furthermore, I am of the opinion that Indian groups cannot effectively use the same strategies of campaigning, lobbying and advocacy in the case of finance capital (because it is largely footloose in nature) which they have successfully used in the case of official capital flows (e.g. Narmada dam campaign against the World Bank) and FDI (e.g. campaign against deep sea fishing). In the case of finance capital, the NGOs, labor groups, and movements will have to pay more attention to the regulatory mechanisms and regulatory agencies such as the SEBI and RBI. In the given economic and political context, an action program calling for total elimination of global financial flows is unlikely to succeed. Action programs based on restricting international financial liberalization and selective delinking from short-term and speculative funds may have better chances of success.

At the international and regional levels, a series of discussions on the need to regulate financial flows

and restructuring of international financial architecture are taking place at both official (e.g., G-7, G-15, Group of 22, Commonwealth) and non-official levels (e.g., World Economic Summit). But, just a handful of economists, experts, and concerned officials from India are taking part in these deliberations; there is hardly any process of democratization of these debates in

India in order to involve vast sections of society and their representatives in these debates.

Lastly, as far as national media is concerned, its response on financial issues is mixed. In particular, the financial media in India has been supporting financial liberalization in India largely as part of a general liberalization spirit and ethos, rather than as part of a well-argued and well-thought-out strategy.

Kavaljit Singh is the coordinator of Public Interest Research Group, based in Delhi. He is author of *A Citizen's Guide to the Globalization of Finance* (Madhyam Books, Delhi and Zed Books, London, 1998). His forthcoming book is *Taming Global Finance Capital* (Zed Books, London, 1999).

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Editor: Friedrich-Ebert-Stiftung
Godesberger Allee 149
53175 Bonn
Division for International Cooperation
Phone: +49 228 883 604
Fax: +49 228 883 600
<http://www.fes.de>
E-Mail: Ernst.Hillebrand@fes.de

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