

MANAGEMENT OF GLOBAL FINANCIAL FLOWS

LESSONS FOR INDIA

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THE revolution in communication and information technology has turned the world into a global 'village', where everyone can, sitting in any corner of the world, know what is going on around the world. The emergence of multinational firms and a global market has led to a deeper integration of economies. The diseconomies of scale have been pushed back as information technology has made it possible to manage large firms efficiently. This has accelerated the growth of large transnational corporations (TNCs.). Globalisation is no longer an option: it is a fact. Globalisation is most visible in financial sector. In the past two decades, world trade has expanded from \$200 billion to more than \$ 6.3 trillion, while international direct investment has grown from \$211 billion to \$ 3.2 trillion. The growth of both has been far more rapid than the growth of most domestic economies. As a result, nations are much more affected by international business than in the past. The foreign direct investment and portfolio investment in India has also shown substantial growth after the economic reforms started in early 1990s. After the reforms, India could get \$3.1 billion in the form of foreign direct investment. The financial inflows represent strength of a country and are welcome for better development of a country. Such financial flows have helped some countries grow rapidly. Though integration with the global economy provides opportunities for efficiency and growth, the management of global financial flows has emerged as a major challenge for any country due to highly competitive and dynamic business environment in the post-liberalisation era. Complete liberalisation of financial flows can cause a meltdown of domestic financial institutions, if these institutions are not properly supervised or if short-term borrowings are used for long term investments. Due to global financial flows, the country also gets exposed to economic risks, political risks, risks of international shocks and policy mistakes of other countries. Under the circumstances, it is very essential that the economy gets maximum benefit of inflows by proper allocation of funds for the required sectors for balanced growth and at the same time is guarded against the misuse of the funds and risks associated with such flows. This paper throws light on key issues relating to the global financial flows like the impact on Indian economy, opportunities from such flows, risks emanating therefrom, etc. and suggests the ways in which management should be made to secure the optimum benefit.

Impact of Global Financial Flows on Indian Economy

The balance of payments situation of India was precarious when the new government took office on June 21, 1991. The foreign exchange reserves were at a low level and the weakened international confidence had resulted in a sharp decline in capital inflows through commercial borrowings and non-resident deposits. Immediate need was felt to keep pace with the globalisation and the trade and other reforms were immediately implemented to start with in 1991. Introduction of Liberalised Exchange Rate Management System (LERMS) on March 1, 1992, unified market determined exchange rate w.e.f. March 1, 1993, full convertibility of rupee on current account w.e.f. August 20, 1994 and intention to make rupee fully convertible on capital account in due course, etc. have resulted into regaining of confidence of other countries thereby attracting more foreign funds

inflow which averted further crisis and also helped build comfortable level of foreign exchange reserves. Now when the country is ready to implement the next phase of economic reforms, it is necessary to understand what is to be learnt from our own experience and from the experiences of others. For the growth of industries and firms, they must be having low-cost access to debt and equity capital. In India, financial sector reforms have made it possible to attract more foreign fund inflow, which has resulted into lowering of the interest rates. However, the rates have only improved as compared to past but are not yet in line with the international standards and focussed efforts are called for to further reduce the same. The Capital market reforms have brought better liquidity in capital markets through electronic trading, dematerialisation of securities, transparency and regular settlements which helped attract foreign institutional investors (FIIs.) to invest in Indian capital market. However, the Indian banking sector and financial institutions are yet to make their mark in competing with the global banks and financial institutions. The system in India presents several challenges in terms of coping up with the risk of bankruptcy and impending bank failures. The trust in banks and financial institutions would greatly improve by permitting less risk taking. The banks and financial institutions should not be forced to lend to government-favoured clients. This is dangerous in the long run. We also need to plan for possible bank failures of the next few years, in order to cope with this contingency. Gross government borrowings have increased from Rs. 8988 crores to Rs. 95953 crores between 1991-92 and 1998-99. Interest burden on exchequer stands at Rs. 43712 crores as per revised budget estimates for 1998-99. This needs to be controlled to avert the risk of debt trap. In nutshell, the global financial flows have helped India avert the foreign exchange crisis and has brought forced competition in all sectors thereby compelling all to improve their performance in line with the global standards thereby helping overall growth of the country.

Opportunities and Threats of Global Financial Flows

Having understood that globalisation is a fact and not an option, one has only to search for the opportunities emanating therefrom and take maximum advantage thereof by adopting policies, which minimise the threats. Opening up of the economy and allowing global financial flows helps developing new technologies, enables one to allocate resources for good projects, can help finance the process of bringing innovative ideas to commercial success, and forces competition so as to divert investment only to those sectors which function efficiently. We have before us examples of so many countries, which have been able to boost their growth rates with the help of large inflows of foreign capital. The foreign funds come in three ways: loans, foreign direct investment and portfolio investment. The opportunities are evident from the outset. But there are threats also if the countries misuse the flows or fail to take full advantage thereof. The recent experiences of East Asian countries like Thailand, Indonesia, Malaysia, Philippines, China, etc. provide us an insight into the costs and benefits of an open, integrated and international capital market. Some of these countries recorded a steady and rapid growth with the help of growing global capital flows. At the same time, economies of many such countries particularly East Asian countries have collapsed all of a sudden amidst many myths and miracles due to policy inconsistencies and institutional shortcomings which resulted into abrupt reversal of capital flows giving shocks to economies world over. With the foreign debt one has to succumb to the speculative attacks by powerful lenders if such funds are not used for productive purposes. Dubious domestic lending of funds borrowed internationally may land the economy in crises when such domestic lending goes bad. If global inflows are used to finance stock market or real estate boom, it can create trouble when such boom bubble bursts, particularly when the valuations are far out of reach of the real underlying values. A balance must be ensured between the time period of borrowing and lending. Borrow short and lend long can create a mismatch and can become dangerous on due date of repayment. Thailand crisis that began on July 2, 1997 is the classic example of such risk. When it succumbed to a speculative attack on its currency, the *baht*, and was compelled to devalue it by 10%. Thailand had a large burden of short-term debt and was suffering from the after-effect of a burst property price bubble. Philippines was another regional country with strong recent growth and trade deficits, which had also to succumb to speculative pressure and it left its de facto peg to the dollar on July

11, 1997. Malaysia and Indonesia followed suit within two weeks. Korea also suffered from a large short-term foreign debt and a growing current account deficit. Its companies scrambled, as did those in the less developed countries of the region, to buy dollars to repay their obligations. This set of a vicious circle increased pressure on its currency and had to approach IMF for a bail out even though it was believed that Korea has graduated from developing country status and had the eleventh largest economy in the world. This was because it had short-term debt, which was fourteen times its reserves. Thus, a proper match in terms of foreign debt is of utmost importance. Portfolio investment can increase volatility in domestic stock market but has the potential to be self-stabilising. If foreign investors want to pull out of its investment, it will lead to fall in stock price, which may discourage them from pulling out. However, if they still decide to withdraw despite losses, a country with inadequate reserves may have an exchange crisis leading to devaluation. And when such crisis come to notice, it also has an effect of putting institutional leakage under the magnifying glass converting crisis in to a catastrophe. India, though could avert any crisis and has been prima facie benefited on account of foreign fund flows, has to learn lessons and should implement its second-generation reforms cautiously.

Suggestions

When going is good, every body joins the bandwagon. The economies of the East Asian countries, which were shattered by the financial crisis of 1997-98, were the darlings of the academic and business communities immediately before the crisis. Large segment of analysts and economists was overoptimistic about the performance of their economies and what was termed as strength of those economies have turned out to be myths. Barings Bank was England's oldest merchant bank (223 years old) and its first foray into derivatives in 1993 made it bankrupt by spring 1995. Its losses totaled about 900 million sterling pounds(\$1.3billion US) only because one of its employees Mr. Nick Leeson had entered into unauthorised trading in derivatives. What is to be learnt from those and such other experiences is that one has always to guard against the possible failures even when the economy is progressing or the going is good. The following are the suggestions.

- ✍ A slower but more sustainable pace of growth with strong emphasis on human development may be a better way to take advantage of the opportunities of global financial flows and minimise the vulnerabilities.
 - ✍ Good governance in its real spirit by the government, political parties, financial institutions and firms using foreign funds is a **sine qua non** for efficient management of global financial flows. Honest efforts in this direction by all concerned will not only help sustain adversities but will go a long way in improving the international business environment.
 - ✍ The international financial flow must be utilised productively and in the projects which can generate returns in most of the cases and also ensures timely repayment or repatriation when called for. They should under no circumstances be used for inefficient government undertakings or be diverted to government favoured persons or to firms without merit. We have before us the glaring examples of East Asian countries which were once considered as **pioneers of growth, Asian Tigers, economic dynamos** and their policies were considered **East Asian miracle**; but when the weaknesses came to fore and these countries faced the crisis, it was realised by all that the allocation of resources was not based strictly on merit but was many a times based on favours only. At the same time the funds must be allocated for developing new technologies, excellent educational system, better infrastructure and in venture capital funds as it plays a vital role in the knowledge based economy. India needs to become a knowledge-driven society and a major source of innovation. As compared to many Third World Countries, India has certain strengths-a democratic society where individualism can flourish, modern workplaces which are blind to differences between people of diverse ethnic, religious or national backgrounds, women are not barred from public places, a tradition of respect for learning, a host of educated and trained citizens who have proved themselves on a global
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scale by demonstrating their ability for creativity and expertise around the world, etc.- with which one can aspire to become innovator, the designer, the thinker and artist of the world. An investment of the fund inflows in human development will give fruitful results.

- ✍ The fund, which can not be utilised for viable projects, should not be borrowed or attracted and a strict vigil has to be kept on this aspect.
- ✍ Precondition of stringent fiscal discipline, banking sector reforms, flexible exchange rate policy and sufficient foreign exchange reserves as recommended by capital account convertibility committee of Reserve Bank of India must be complied with before going for full convertibility of rupee. The foreign exchange reserves should be sufficient enough for obligation on account of short-term debts, import needs, possible changes in the lead-lag relationship between import payments and export realisation and also to fight against the speculative attacks on currency.
- ✍ India needs investment to boost its export and her share in world export which was meagre 0.6% (Source: Handbook of Industrial Statistics, 1998) in 1995, needs to be increased substantially so as to make her less vulnerable to external shocks.
- ✍ Short-term global financial inflow should not be used for long term applications, as this will lead to crisis at least in the short run if the country's foreign exchange reserves are not sufficient.
- ✍ Trade and fiscal deficits of the country should be kept under control by an effective monetary policy.
- ✍ Steps be taken for reducing oil imports, which takes away a good amount of foreign exchange.
- ✍ Indian financial sector calls for, among other things, swift loan recovery procedure and liquidation of bankrupt firms. This calls for a paradigm shift in the attitude of trade unions and political parties. Though such financial sector reforms are as much a political challenge as a technocratic one, the government must give very high priority to the improvement in the health of financial institutions. If this is not being done on priority, the economy in my opinion, will have to suffer a serious jolt.
- ✍ Attempt should be made to bring less of debt funds and more of portfolio investments so that economic solvency is not at risk.
- ✍ Finally, as risk is involved even in good projects, one has to be willing to take risks but at the same time the system should offer the means (derivatives) through which the risks can be shared or transferred. However, speculation should be avoided. In the words of Mark Twain: ***"There are two times in a man's life when he should not speculate; one when he cannot afford it, and when he can."***

Conclusion

Opening up of the economy and allowing free flow of international funds helps availability of larger capital to supplement domestic resources and thereby higher growths; it helps reducing cost of capital and improving efficiency by enforced competition. However, global inflows have certain challenges and threats, which if not handled with care, can result into crisis leading to devaluation, disruption in the growth process and much social pain. Howsoever able a country or its economic advisors may be, one cannot make management of global financial flows risk free or can tame all risks. Markets will continue to be volatile, economic cycles will persist, risks will not be completely tamed, and crisis will continue to occur. The best one can do is to manage the affairs in such a way that the risk is minimised and in the cases of crisis an economy should be able to sustain and does not collapse. The things, which cannot be cured, have to be endured. What one needs are the measures to withstand the crisis. The world economy has become closely integrated and hence

countries have to manage themselves well and at the same time they must keep watch and adapt to economic mismanagement in other countries.

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