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Working Paper No. 813

Economic Policy in India: For Economic Stimulus, or for Austerity and Volatility?

by

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Abstract

The implementation of economic reforms under new economic policies in India was associated with a paradigmatic shift in monetary and fiscal policy. While monetary policies were solely aimed at “price stability” in the neoliberal regime, fiscal policies were characterized by the objective of maintaining “sound finance” and “austerity.” Such monetarist principles and measures have also loomed over the global recession. This paper highlights the theoretical fallacies of monetarism and analyzes the consequences of such policy measures in India, particularly during the period of the global recession. Not only did such policies pose constraints on the recovery of output and employment, with adverse impacts on income distribution; but they also failed to achieve their stated goal in terms of price stability. By citing examples from southern Europe and India, this paper concludes that such monetarist policy measures have been responsible for stagnation, with a rise in price volatility and macroeconomic instability in the midst of the global recession.

Keywords: Austerity; Development Expenditures; Exchange Rate Volatility; Fiscal Deficit; Fiscal Policy; FRBMA; Inflation; Interest Payments; Interest Rates; Monetarism; Monetary Policy; Sound Finance

JEL Classifications: E12, E31, E44, E50, E51, E52, E58, E62, E64

I CONFLICTING GOALS IN ECONOMIC POLICY

There seem to be conflicting notions in the goals set by the policy makers today, as well as in their choice of tools to achieve these goals. The dominant theoretical frame which currently drives the majority of policies includes monetarist principles which rely on inflation targeting as a major tool to achieve financial stability. In contrast to this approach is the Keynesian perspective which targets growth and full employment as the primary goal and relies on aggregate demand management as the main tool to achieve this goal. Questioning the virtue of the monetarist position which, as held by the Keynesians, may be at cost of growth and equity, recommendations are offered for expansionary policies, especially when faced with unemployment and under-utilization of resources.

One can, at the outset, consider the implications of the two policies mentioned above, and their respective impacts. For the monetarists, financial stability demands a tight rein on inflationary price movements, which, they hold, introduces disruptive price expectations, thus deterring long-term investment and growth in the economy. Seen from this perspective, expansionary fiscal policies are unacceptable for several reasons. One is the potential for “crowding out” effects by public investments which, by raising the rate of interest, dampens the prospects for private investment. However, the underlying assumption that there exists a fixed pool of savings which is invested between the public and the private sectors, does not hold since savings is liable to increase *pari passu* with the rising income created by public investment. Seen from this angle, higher government expenditure always creates an equivalent level of additional savings at any given interest rate,¹ either by increasing the output level (through the Kahn-Keynes multiplier in a demand-constrained system) or by raising the price level relative to money wages (thus generating a “forced savings” by depressing the real wage, and hence the consumption, if the system is supply-constrained).

The “crowding out” argument is also supported by recognizing that output can expand with rise in public investments, thus causing the related rise in savings; this is because the related excess demand in the money market itself can cause the rise in interest rates.² An increase in government expenditure, *ceteris paribus*, in terms of an endogenous supply of money (including

¹ Interest rate is determined in the asset market and hence, in a stock equilibrium independent of the flow equilibrium, and specifically depends on the decisions of the central monetary authority.

² The argument goes back to Hicks, J.R. (1937). “Mr. Keynes and the Classics: A Suggested Interpretation,” *Econometrica*, Vol 5, No. 2, pp 147–159

credit [Arestis and Sawyer, 2004]), would automatically expand the money supply without raising the rate of interest, unless of course, the central bank deliberately raises the rate.

Finally, monetarists challenge the effectiveness of fiscal deficits as a policy tool which, with its inflationary consequences, follows an automatic monetization of such deficits. Despite its wide acceptance in policy making, the argument can be dismissed as a variant of quantity theoretic premises which, as held by Keynesians, ignore the role of money as a financial asset to speculate on, especially when the future is uncertain. Clearly, a rise in the money supply, as may follow a monetized fiscal deficit (to the extent it is held in the form of financial assets, which are used to operate in the secondary markets for stocks), will not necessarily cause a rise in prices in the market.

Monetarist arguments against expansionary policies that rely on incurring debt to finance fiscal deficits also take the form of what is described as “debt-sustainability,” or the stabilization of debt with respect to the level of GDP (i.e., the debt-GDP ratio) over time. While such ratios clearly are not dependent on the absolute level of debt (Pasinnetti, 1998) as pointed out, stabilization of the debt-GDP ratio over time requires that the gross fiscal deficit (as a proportion of GDP) should not exceed the product of growth rate and any given debt-to-GDP ratio at the given time period (Evsey, 1944). Further, as pointed out, “solvency” may be compromised as the discounted present value of the current and future liabilities of the government as a ratio of GDP at any time period turns excessive (Buiter, 1990). However, such arguments are simply untenable in view of the fact that governments are usually in a position to roll over debt and the private sector usually continues to lend (Rakshit, 2005).

The dismissive approach of monetarist doctrines to policies that target full utilization of capacity, as well as full employment via demand generation, can also be questioned from the angle of a “balance-sheet” approach to the economy (Wray, 2012). The latter questions the notion of “financial imbalance” for an economy, on the ground that surpluses/deficits by definition have their counterparts as deficits/surpluses, both at the national and global levels. For the circuit to operate without hindrances, sectoral deficits or surpluses, which cover those held by the government, are in consonance with their opposite between the private (i.e., household and corporate) and the external sector (i.e., the current account balance).

Pressure on the government to refrain from running deficits and incurring debt can be viewed as a tactic by the high-powered financial community, which holds the surpluses in the form of financial assets. This protects the respective values of these assets from possible

disruptions that could be caused by defaults on the part of government, and also avoids scaling down their value in real terms. The global financial community is often in a position to exercise its power over national governments by using several channels, including multilateral financial institutions (e.g., the International Monetary Fund, World Bank, Bank of International Settlement), along with the respective governments. The latter, taking on the role of a “predator state (Galbraith, 2009),” fortifies its position by aligning itself with the global financial community, which relies on devices best described as “money manager capitalism (Wray, 20120).”

Efforts to restrain expansionary policies of the state by limiting fiscal deficits introduce a process of contraction in economies already suffering from demand shortage. The consequences may include curtailed demand for bank credit from the private sector (corporates as well as households), which further reduces aggregate demand in such economies (Koo, 2013).

Since financial assets held by the lenders can be deployed to leverage and speculate during periods of market uncertainty, there can be changes in the composition of portfolios held by the private sector, and especially by corporates. Assets deployed in the secondary markets for stocks or currencies and commodities, while fetching handsome returns in terms of capital gains, do not, in the first round, create more activity (Sen, 2003) in the real economy.

Monetary tightening *sans* expansionary fiscal policies, as mentioned above, is used by the monetarists to monitor and contain inflation. In achieving such targets, policies often ignore or even contradict other goals like growth, employment, and distribution, which are no less important. Arguments that disapprove of fiscal spending that relies on budget deficits have been described as the “Treasury view,” which relies on what it views as “sound finance.” In this view, financial stability is the primary goal of monetary policy, notwithstanding the consequences in terms of slow growth, unemployment, and underutilized capacity.

For countries managing their exchange rate in the face of unpredictable flows of finance from overseas, the problem can become one in which policy makers face an “impossible trilemma,” as described in the literature (Palley, 2009; Krugman, 1999). The trilemma is one of managing the exchange rate of the domestic currency as well as the domestic price level, along with free flows of overseas capital, which in turn become volatile, excessive, or inadequate. Following monetarist practices, movements in exchange at a rate beyond the accepted range demands the use of monetary policy to bring about the desired changes in interest rates and/or credit flows in the economy. Thus when inflows of capital push up the exchange rate of the

domestic currency to levels which are unacceptable from the point of view of export competitiveness as well as sustainability of debt in local currency, the central bank usually intervenes, initially by purchasing foreign currency from the market, which in turn adds to official reserves, entered as high-powered money. Related expansions in the credit supply, considered as potentially inflationary in the monetarist lexicon, prompt further actions by the central bank to control credit, including interest rate hikes and the tightening of credit by commercial banks. On the whole, the direction of monetary policies in such cases remains pre-determined by the pace of financial flows from overseas, which, in the absence of capital controls, remains as one of the imponderables for domestic policy makers. These kinds of policies are also launched when there is volatility in the foreign exchange market that causes changes in exchange rates which are considered undesirable. The end result is a loss of autonomy in monetary policy; countries operating under such policies thus cease to be sovereign in this regard (Arestis and Paliginis, 2000).

What then remains of the other goals, such as growth, employment, and distribution, in an economy where policies are driven by the monetarist pursuit of inflation targeting above all else? Restraints on credit flows achieved by increasing the interest rate high and using other limits on the expansion of bank credit may compromise growth and create austerity in such economies, more so when policies that rely on fiscal expansion are censured because of a monetarist agenda.

II MONETARISM IN ACTION: THE CASE OF SOUTHERN EUROPE

It is not difficult to identify the contractionary effects of the conservative neo-liberal economic policies in recent times. Let us refer very briefly to the Great Recession which started in 2008. The underlying causes of the recession were related to the unbridled expansion of private financial activities that contributed very little to proportionate growth in the real sector. In the process some countries in southern Europe that were affected by the global crisis were badly hit by the contagion and were close to insolvency. It is worth noting that the financial institutions including the European Central Bank (ECB), European Union (EU) and the IMF actually added to the crisis for debt-ridden countries like Greece, Portugal and Ireland by requiring them to implement austerity measures which worsened the catastrophe.

Looking at Greece alone, the drop in its GDP has been about 5.6% on average during 2010 to 2013. The official figures for unemployment in Greece stand at 27% and the rate for

youth unemployment is 60%. Wages have dropped by 25% or more since 2010 (Polychroniou, 2014).

What were the proximate causes of outcomes? There was a loan package in May 2010 and March 2012 from international financial institutions for 110 billion euros to bail out Greece from its debt trap. The bailout came with strict IMF austerity measures, which plunged the economy into a deeper crisis. Exiting the euro was clearly not an acceptable alternative to big capital and the eurozone. Greece was forced to comply with the conditions of the bailout, cutting wages, pensions, social benefits, employment, raising direct taxes, and deregulating labor markets and undertaking wide-ranging privatization in the economy (EUbusiness 2010).

In terms of a study by the South Commission (Polychroniou, 2014), cuts in government expenditure in real terms during the period 2010–12 (as compared to 2008–09) amounted to (-)8.6% in the developing countries and (-)6.5% in high-income countries. As a consequence, by 2014, persons affected by the crisis represented 85% and 95% of total population in developing and high-income countries, respectively.

Citing some news clippings on the current level of misery for people in the crisis-ridden Greek economy, one reads, “...Suddenly, hard-working Greeks in their late 30s and mid-40s have no money to turn on the heat, to buy gifts for their children and loved ones, to fill the tank with gas, to fill the fridge with food, to invite friends for dinner, to go out and enjoy a drink in fine company.” Or again, “...Hundreds of striking Greek city workers are marching through Athens to protest public sector job cuts.” Also, “Greek hospital doctors have embarked on a three-day strike, joining high school teachers who walked off the job a day earlier in a week of public sector strikes protesting planned job cuts.” And similarly, “...Suicides increased by 45 percent during the first four years of Greece's financial crisis, a mental health aid group said (World Post, 2013).”

III MONETARISM IN ACTION: CASE OF INDIA

The actions outlined above, focusing on “austerity” as a cure-all for the ills of an economy, prevailed not only in the crisis-stricken countries of southern Europe, but also in developing countries which have recently been relatively integrated with overseas markets of finance. India

is among these countries described as an emerging economy,³ and has been receiving record inflows of finance second only to China.

As in the other BRIC (Brazil, Russia, India and China) countries, India has been experiencing rising inflows of overseas capital since the deregulation of its financial sector, which started by the early 1990s. Between 2011–12 and 2012–13, net financial inflows to the country amounted, on an annual basis, to \$20.8 billion as foreign direct investment (FDI) and \$22.0 billion as Portfolios (RBI Handbook of Statistics on Indian Economy, 2012).

Financial opening in India was combined with a great many economic reforms starting in 1991. This brought an end to a policy regime that had been subject to segregated banking, which included manifold restrictions on overseas capital flows. Successive reforms, implemented over the next decade and a half (during the 1990s and early 2000s), introduced several changes, which included easier access of FDI, free access of (foreign indirect investment [FII]) investments to stock markets, a gradual lifting of bans on derivative trading in stocks, currencies and commodities, and over-the-counter (OTC) trading along with liberalized norms for overseas investments and external commercial borrowings (ECBs) by corporate businesses (and mutual funds). The country, in addition, initiated a move to limit the fiscal deficit as a ratio of GDP by enacting the Fiscal Responsibility and Budget Management Act (FRBMA) in 2003. Under the terms of the Act borrowing to meet budgetary expenditures was no longer available from the central bank and had to be raised from the capital market.

Deregulated Finance and Booming Stock Markets

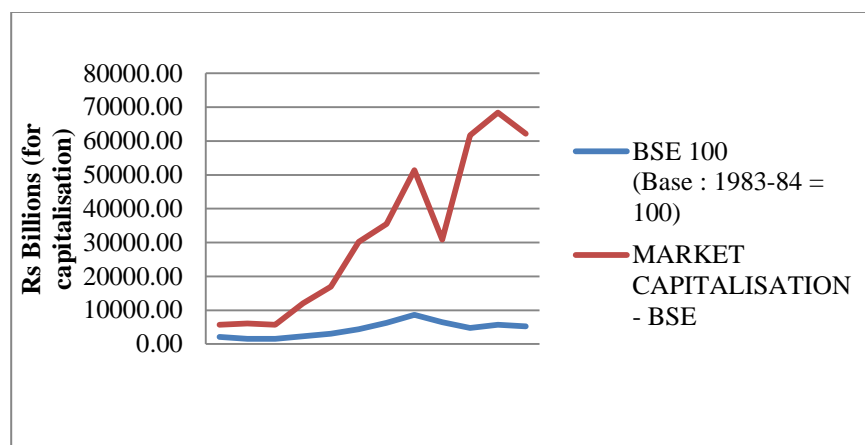
The events outlined above provide an indication of the pace of financialization in the economy, which was triggered by finance deregulation. Deregulation created space for investments in short-term assets of the high-risk, high-return variety. This was reflected in the rising turnovers of the secondary stock market and the similar increases in prices of stocks (Chart 1).

Several rounds of liberalization, as above, have changed the pattern as well as the magnitude of turnover in India's financial sector. This can be noticed in the increased transactions and the rising volatility in India's stock markets, along with increased OTC

³ As for growth of GDP in the Emerging economies, India, along with China and three more countries (Brazil, Russia, South Africa) together described as BRICS, have consistently maintained growth rates much higher than those in the rest of world including the advanced economies. The BRICS also has maintained an impressive performance in terms of net FDI inflows, as recorded by the \$425bn total FDI inflows on average during 2011 and 2012. Of the above, China alone accounted for nearly \$200bn. See www.data.worldbank.org.

trading in derivatives. Increased inflows of Foreign Institutional Investments (FII), both on a gross and net basis, and a rise in price/earnings ratios (P/E) of stocks traded were the conditioning factors. Thus with the P/E ratios often at levels higher than those in overseas stock markets, Indian stocks became relatively more attractive for footloose portfolio investors like the FIIs. As a consequence, the value of stocks transacted in the secondary markets turned out to be much larger than those sold in the primary markets as Initial Public Offerings (IPOs).

Chart 1 Bombay Stock Exchange: Stock Prices and Capitalization

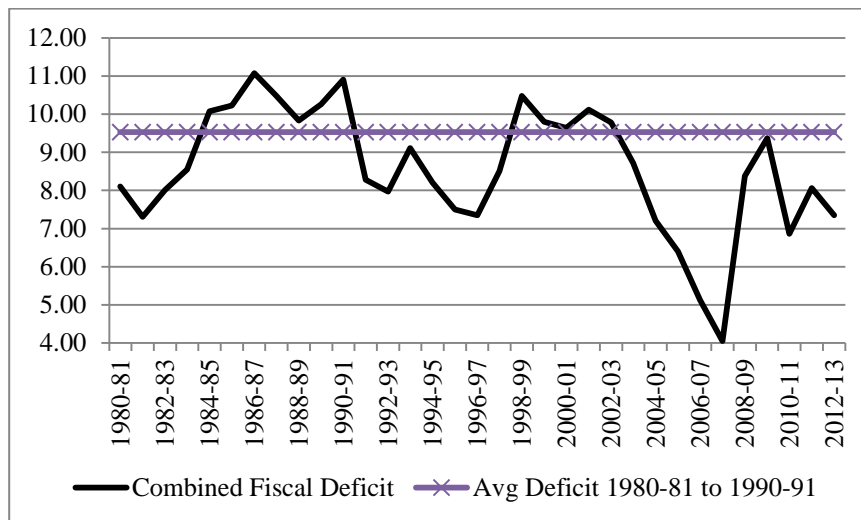


Source: Reserve Bank of India, Handbook of Indian Economy

Fiscal Constraints for Austerity

The implementation of reforms in 1991, adhering to the new economic policies in India, had been associated with a paradigmatic shift in fiscal policies. While the FRBMA (2003) was an explicit reflection of this policy stance, major objectives of deficit reduction and maintaining “fiscal prudence” continued into the 1990s. This was reflected by a sharp reduction of fiscal deficits in the 90s, with the exception of the last three years of the decade, which reflected the implementation of the fifth Indian pay commission recommendations (see Chart 2). It should be noted that, with the exception of the brief period between the pay commission recommendations and FRBMA, the share of the fiscal deficit in GDP remained below the average of the 1980s each year following the implementation of new economic policies. Further, except for the two periods—one during the implementation of pay commission recommendations and the other after the emergence of the global recession followed by stimulation over a limited period (to be discussed below)—fiscal policy in India has been characterized by a downward trend in fiscal deficits.

Chart 2 Share of Combined (Centre and State) Fiscal Deficit in GDP

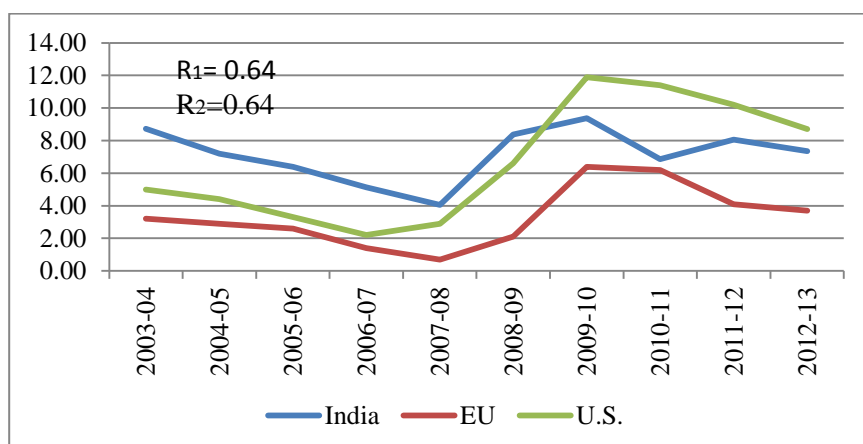


Source: Reserve Bank of India, HandBook of Indian Economy

We next turn to the role of the FRBMA (2003) in limiting the ratio of fiscal deficits to GDP, which has further restrained the use of public expenditures in India as a policy measure. This was reflected by a sharp fall in deficits, particularly from 2002–03 to 2007–08, until the emergence of the global economic crisis (see Chart 2). Interestingly, austerity measures as were implicit therein were temporarily suspended, not only in India but in a large number of other countries between 2007–08 and 2009–10. This happened as the state attempted to provide what can be described as “stimulus” to the respective economies facing the global crisis and recession of 2008. For India, a peak ratio of fiscal deficit to GDP, which was reached in 2009–10 at 6.46%, matched similar surges in the ratio for the US and the EU. The pattern, again, was similar to the brief spell of stimulus that ended by 2010, both for India and for the advanced economies, with the renewal of austerity by 2010–11.

With the IMF providing the directive to cut fiscal deficits, the withdrawal of fiscal stimulus in 2010–11 returned in India at roughly the same time as similar actions occurred in the US and in the EU. In fact, as reflected in Chart 3, the fiscal deficit in India followed the same trend as those in the US and the EU; the correlation coefficient between India’s combined fiscal deficit and those of the EU and US being at 0.64, respectively (see Chart 3). The ratio of fiscal deficit to GDP in India fell during the year to 4.76% as a result of a withdrawal of the stimulus. The ratio was 5.20% in the 2012–13 budget of the central government, which indicates an attempt to continue the restraint (Chart 4).

Chart 3 Share of Fiscal Deficit in GDP for India, EU and US

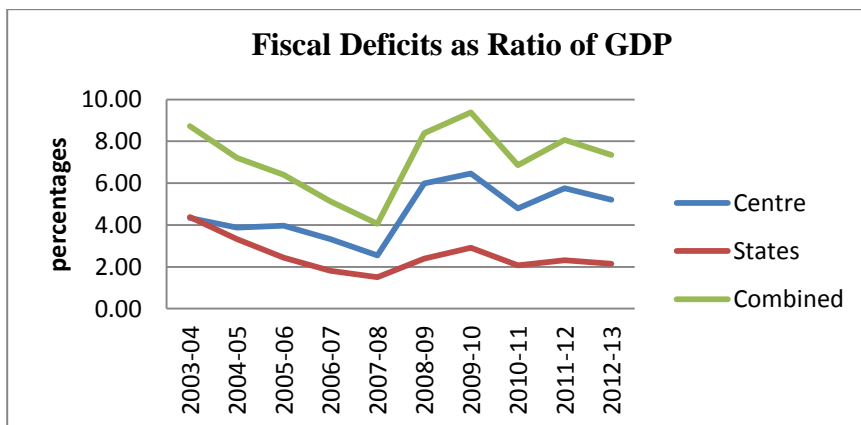


Source: RBI Handbook of Statistics and OECD, various publications.

As mentioned above, official borrowing, as stipulated under the FRBMA, was to be raised from the market. A rapid pace of market borrowing contributed to a proportionate rise in the budget under the head of interest payments. This was reflected in the reduced share of the primary deficit as compared to the fiscal deficit, as ratios to GDP. This was due the exclusion of interest payments as expenditure in the primary budget.⁴ In the process, requirements for the government to borrow from the market continuously increased the interest bill which soon became the largest component of expenditures in the fiscal budget (see charts 4, 5, and 6). As a result, the expenditures in the budget under other heads, and especially on capital expenditures and subsidies, turned out to be small as compared to interest payments.

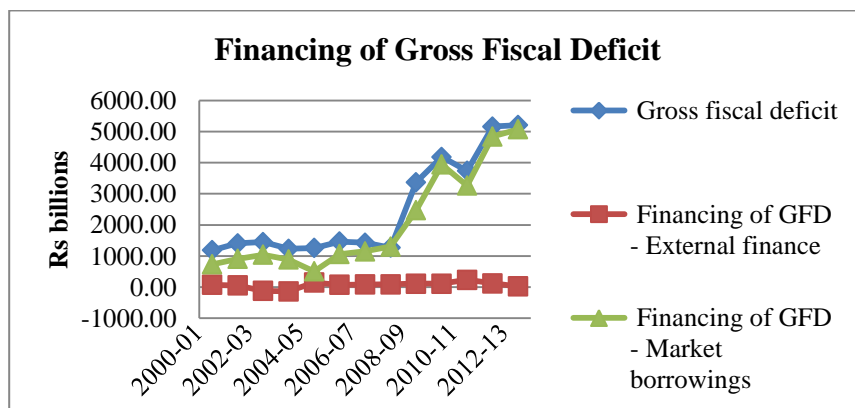
⁴ Fiscal deficit – interest payments = Primary deficit.

Chart 4 Financing of Gross Fiscal Deficits in Central Budget



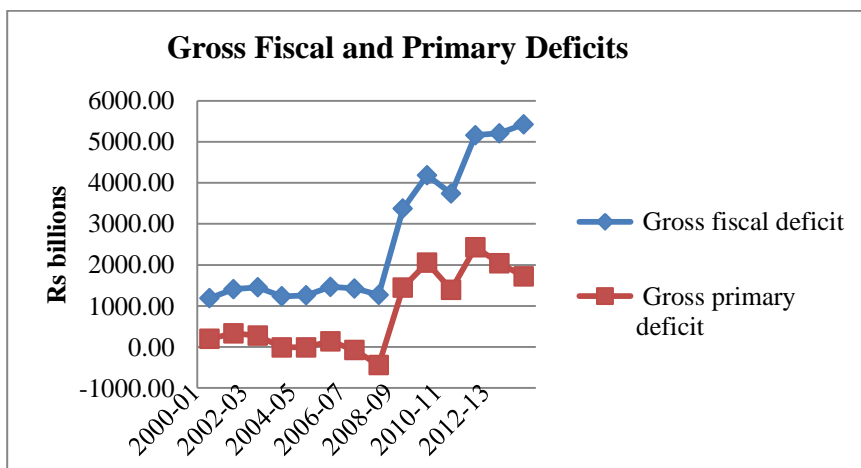
Source: RBI, HandBook of Statistics for the Indian Economy

Chart 5 Financing of Gross Fiscal Deficits in Central Budget



Source: RBI, HandBook of Statistics for the Indian Economy

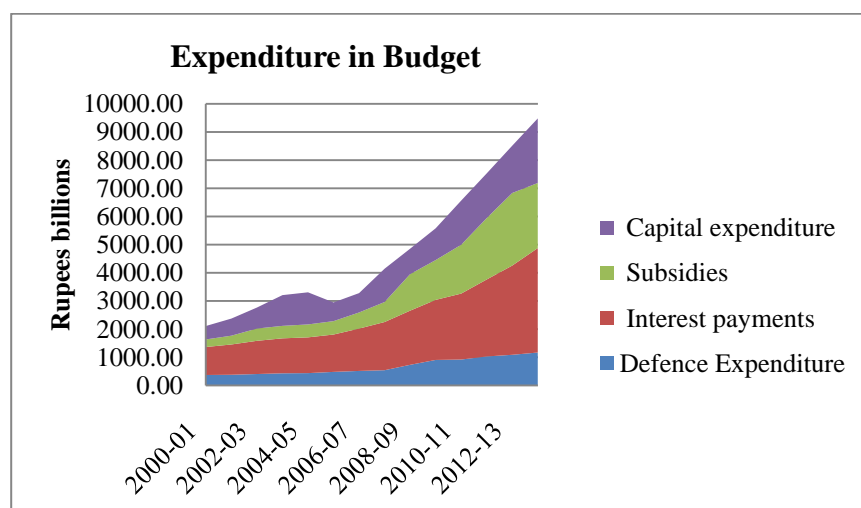
Chart 6 Fiscal and Primary Deficits



Source: RBI, HandBook of Statistics for the Indian Economy

The temporary rise in subsidies, especially in terms of the stimulus administered between 2007–09 and 2009–10, did not, however, amount to much in terms of distribution. We have calculated, by using the GDP deflator used in India, the growth in real per capita public expenditures⁵ for the social plus the rural sector (as in the budget). The rate, with the exception of a single year 2008–09, failed to increase beyond the level attained in 2003–04, the year when the FRBMA actually started (see chart 7). It is notable that despite the short-lived phase of a fiscal stimulus during 2008–09 and 2009–10, the conditions for the bulk of the population in India, as judged by the sharp decline in the employment growth rate and a rise in the poverty level, have continued to worsen (Patnaik, 2013). Evidently, the deflationary stance of the government, with its attempts to cut fiscal deficits, was instrumental in aggravating such tendencies.

Chart 7 Expenditure in Budget



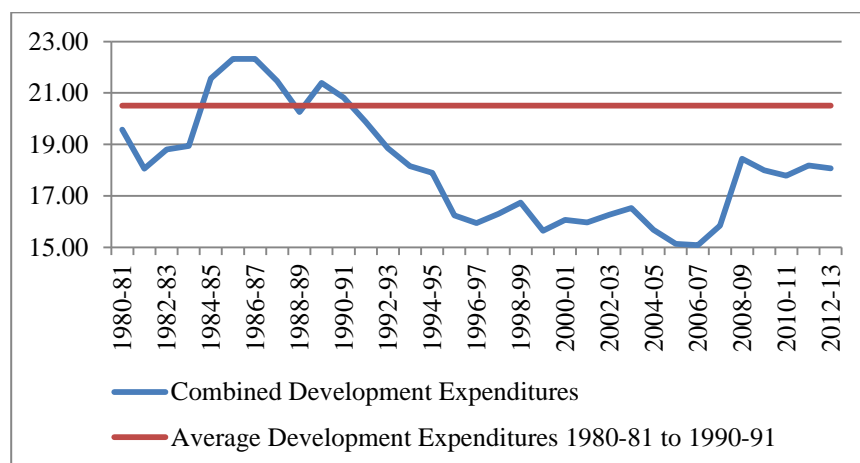
Source: RBI, HandBook of Statistics for the Indian Economy

The overall austerity measures undertaken by the Indian state, along with the phenomenon of rising interest payments (with market borrowings), led to a sharp reduction in the share of development expenditures in GDP during the post-liberalization period. The share of development expenditures reached its lowest during 2006-07 (see Chart 8). Even the temporary rise in deficits and development expenditures, especially in terms of the stimulus administered

⁵ Rural Expenditures comprise expenditures on Agriculture and allied services, Fertilizer Subsidy and Power, Irrigation and Flood Control. Social Sector Expenditures comprise of expenditures comprise of the items under the head “social and community services” in Indian Public Finance Statistics. Real Expenditures are calculated by deflating social and rural expenditures with GDP Deflator. The GDP Deflator is calculated in the following manner: $100 \times (\text{GDP at Market Price} / \text{GDP at Constant Price})$.

from 2008–09 and 2009–10, was not significant in terms of distribution. The share of development expenditures in GDP even during this period remained far below the average development expenditures of the 1980s. The fact that the stimulus was grossly inadequate in addressing the distress of working people in the midst of the recession becomes apparent when viewing the conditions of the bulk of the population in India, which have continued to worsen (Patnaik, 2013). This is evidenced by the sharp decline in the employment growth rate and a rise in the poverty level, despite the short-lived phase of a fiscal stimulus during 2008–09 and 2009–10. Evidently, the deflationary stance of the government, with its attempts to cut back fiscal deficits, was instrumental in aggravating such tendencies.

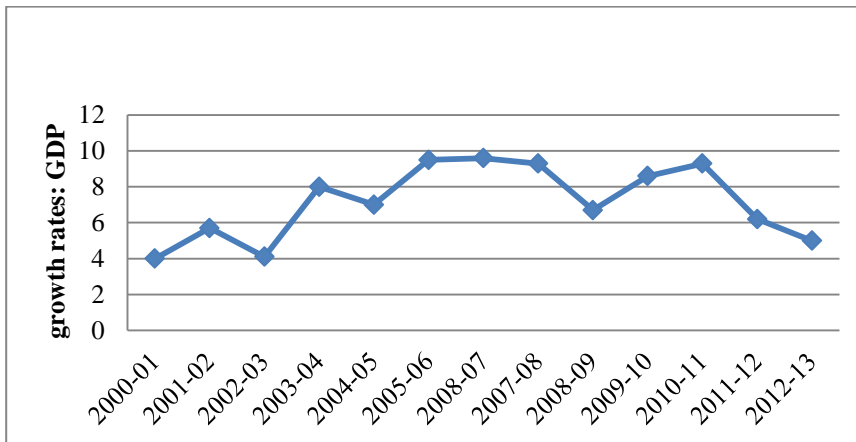
Chart 8 Share of Combined Development Expenditures in GDP



Source: Reserve Bank of India, HandBook of Indian Economy

Late growth in the Indian economy has been driven by the services sector, with its contribution to GDP growth at around 65% or more in recent times. Much of the services sector is related to India's skilled manpower in the provision of off-shore Business Processing (BP) services and services in the IT sector. The performance of the economy was stellar between 2004–05 and 2010–11, with the exception of the dip in 2008–09, and ended in 2011–12 with the growth rate dropping to a record low of 5% in recent times. Much of this has been due to stagnation in agriculture and industry, reflecting the state of recession in the economy.

Chart 9 Growth Rates of GDP at 2004-05 Prices



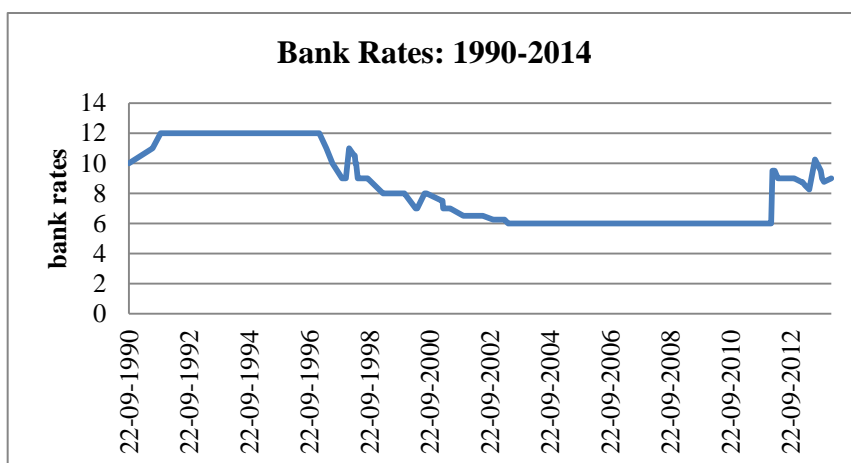
Source: Government of India Economic Survey 2012-13

Austerity and Monetary Policy

With fiscal policy rather prohibitive in its capacity to generate demand by running deficit budgets, monetary policy can be the natural option for policy makers in following expansionary strategies. However, the indoctrination to monetarism, and blind faith in the same as prevails in official circles in India, has been responsible for shaping policies along the prescribed route, by using monetary policy solely to target inflation.

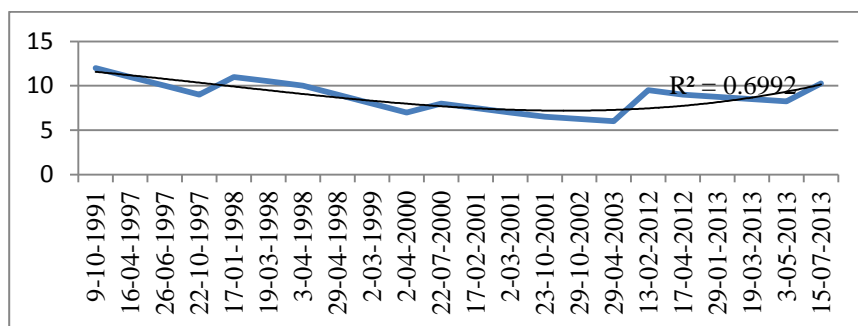
Thus, notwithstanding its proven inadequacy in controlling prices, monetary policy in India has continued to be conditioned by the norms of inflation targeting. This often necessitated a stop-go rhythm in its interventions in the credit market. The tools that were used included frequent adjustments, in interest rates and cash reserve ratios with use of market borrowings to finance fiscal deficits.

Chart 10A Bank Rates: 1990–2014



Source: Reserve Bank of India, HandBook of Indian Economy

Chart 10B Bank Rates



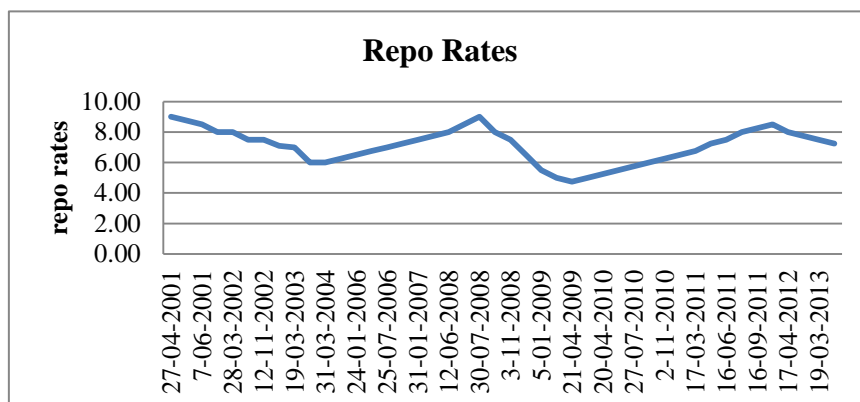
Source: Reserve Bank of India, HandBook of Indian Economy

One notices, in Charts 10A and 10B above, the variations in the bank rate between 1990 and 2014. The high rate at around 12% from 1992–97 dropped steadily to 6% by 2002 and remained at around the same level until 2012 when it started to shoot up again, reaching 9.5% in February 2012 and later 10.25% in July 2013. Of late, the bank rate has been hovering around 9%, a level considered too high in view of the low GDP growth and stagnation in the economy. Measures such as those above relating to hikes in bank rates relate to the efforts on part of monetary authorities to monitor inflation, as well as to arrest possible appreciations as could occur in the real exchange rate of the rupee caused by rising prices. The steps initiated to achieve this goal included the use of the Liquidity Adjustment Facility (LAF) with frequent upward revisions in repo and reverse repo rates, which sought to curtail excess liquidity in the market⁶ (see chart 10). In 2000, an auction system of repos and reverse repos was introduced, to draw out

⁶ Repos were the rates at which banks could refinance against securities used as collaterals with the RBI, and also to park funds with RBI to get back the securities. The opposite was the case with reverse repos

as well as to inject liquidity into the market. Use also was made of the Monetary Stabilisation Scheme (MSS) which included measures like changes in cash reserve ratios (CRR), the sale of government bonds to absorb excess liquidity via open market operations (OMO) and a raise in overnight call rates and cuts in bid-ask spread in call rates.

Chart 11 Repo Rates



Source: Reserve Bank of India, HandBook of Indian Economy

On the whole, the outcome of policies described above has been a “stop-and-go” strategy that relied on the sterilization or injection of funds in the market in a bid to arrest the related impact on the money supply.

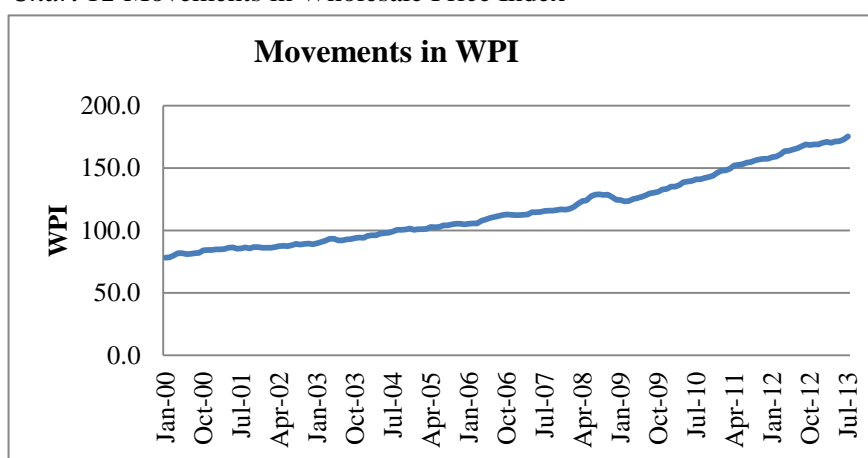
Successive phases of growth-inflation combinations and adjustments in policies can be documented as follows:

Phase I 2003-2008	High domestic growth; Rising inflation	Repo rate raised from 6 to 9 percent	CRR raised from 4.5 to 9 percent
Phase II	Growth drops with global financial crisis	Repo rate reduced from 9 percent to 5.25 percent	CRR was reduced from 9 percent to 5.75 percent
Phase III	Rising inflation; Growth rises to 9.3 percent	Repo rate raised from 5.25 percent to 8.5 percent	CRR reduced to 5.5 percent
Phase IV	Monetary easing	Repo rate reduced to 7.25 percent	CRR lowered to 4.0 percent
Mid-July 2013	Tightened liquidity	No change in repo rate	No change in CRR
November 11, 2013 ⁷		Repo rate raised from 7.50 percent to 7.75 percent	

⁷ Reserve Bank of India Second Quarter Review of Monetary Policy 2013-14 November 11, 2013

The challenge of inflation targeting is visible in the different phases of the growth-inflation scenario presented above and in movements of bank rates and repo rates. In Phase I, while high growth coincided with low inflation, the latter part of the period warranted monetary tightening as inflationary pressures went up. In Phase II, growth decelerated with the impact of the global financial crisis weakening commodity prices in global markets. Combined with relatively stable exchange rates the next phase created the space for monetary easing. India seems to have recovered ahead of the global economy in Phase III, and actual growth in 2010–11 was at 9.3%. However, with a sharp recovery in growth, inflation also caught up rapidly, partly complicated by a rebound in global commodity prices. The anti-inflationary thrust of monetary policy, as held by the authorities was, “...considered unavoidable to contain inflation and anchor inflationary tendencies.”⁸

Chart 12 Movements in Wholesale Price Index



Source: RBI, Hand Book of Indian Economy

Financialization Matches with Austerity

“Austerity” measures combined with tightening credit and fiscal deficits created space for financialization by providing opportunities for investments in financial assets. This was accomplished by protecting the real value of financial assets in the face of changing prices in the economy. Simultaneously, while the deregulation of finance was a part of the ongoing pace of economic reforms, it increased the opportunities for speculation under uncertainty, especially by holding on to financial assets; in stocks, currencies, commodities or even with real estate. The

⁸ Speech by Shri Deepak Mohanty, Executive Director, Reserve Bank of India, delivered to the Association of Financial Professionals of India (AFPI), Pune, August 23, 2013

liquidity needed to engage in speculation was forthcoming with easy inflows of finance provided by the FIIs, which led short-term capital flows. The impact was evident in the rising turnovers as well as in rising stock price indices in the secondary stock market. A large part of these transactions was related to trade in derivatives, consisting of swaps, options, futures and similar devices to hedge in the face of uncertainty. A similar pattern prevailed in markets for commodities, real estate, and currencies where financial assets were held as hedges against uncertainty. The spurts in turnovers and prices in the secondary stock market went hand in hand with the ongoing pace of financial deregulation. As mentioned above, much of the above circumstances were related to the uninterrupted FII-led short-term capital flows in the new regime of liberalised capital inflows.

Between “austerity” measures to target inflation and the liberalised capital flows which provided the liquidity in the market for speculation in holding assets, investments in financial assets opened new opportunities for profits which were more lucrative as compared to those held against real assets. The spurts in capitalisation as well as the rising stock prices, as observed in the Bombay Stock Exchange (BSE), provide an indication of the same pattern. (Chart 12)

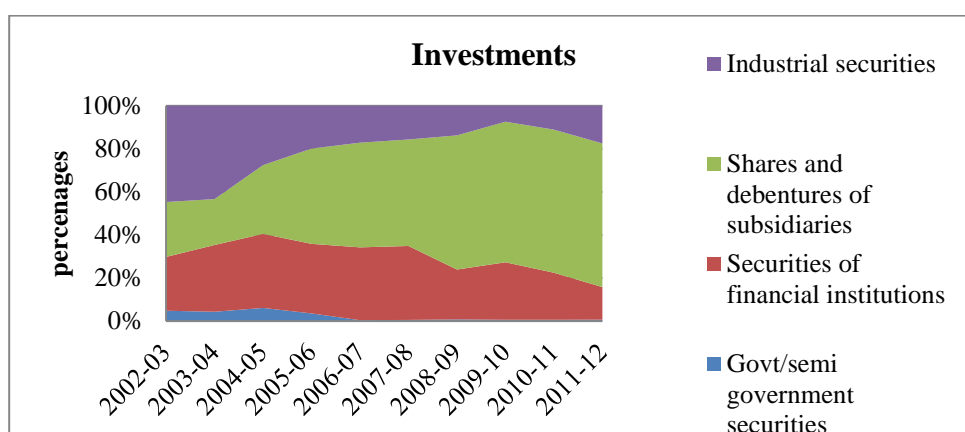
Financialization and Corporate Investments

Financialization in combination with austerity measures provided a strong impetus to hold financial assets, both with good returns and prospects for capital gains. Tendencies of this can be identified in the pattern of investments by the corporate sector. As pointed out in connection with large corporates in advanced economies, one can detect some “owner-manager” conflict which creates a “growth-profit trade-off” in business decisions at firm level (Crotty, 1990). Thus shareholders typically prefer short-term profitability and low investments in capital stock which can lead to long- term growth of the firms. In the process, managers also tend to become aligned with shareholders’ preferences for short-term profits rather than for growth. This happens with the introduction of “market-oriented remuneration schemes,” which link bonuses (or employees’ stock options, known as ESOP) to balance-sheet performance at the firm level. As pointed out, “...the traditional managerial policy of ‘retain and invest’ is replaced by the shareholder-oriented strategy of downsize and distribute (Hein, 2010).” The accuracy of this hypothesis has been verified in the context of advanced economies using econometric evidence that “... financialisation has caused a slowdown in accumulation (Stockhammer, 2004)” (van Treeck, 2008; Organhazi, 2008). As pointed out, this can be verified by considering that the “...rising

share of interest and dividends in profits of non-financial business (which is) an indicator for the dominance of short-term profits in firms' or in managements' preferences (which are) negatively associated with real investment (Hein, 2010).” The rising rentier income shares, observed in advanced economies (Power et al., 2003), may not lead to a pattern of “finance-led-growth” unless the consumption propensity of the rentiers are higher than the those as national average (Boyer, 2000).

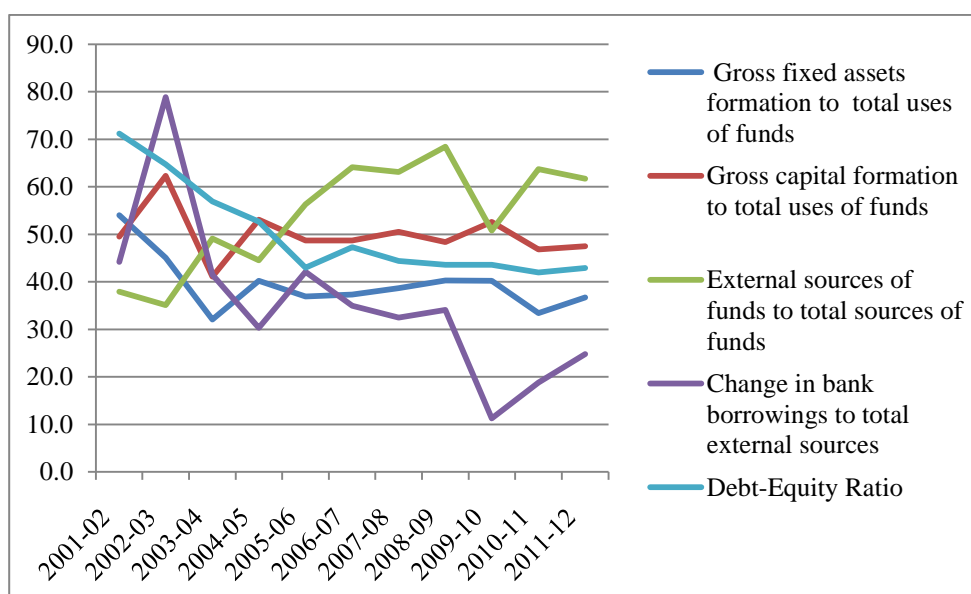
Preferences and trade-offs as described above are also reflected in the balance sheets of corporates in terms of their distribution of investible resources between industrial and other (primarily financial) securities. If one looks at India, where growth in the real economy has been dismally low despite the high levels of activity in stocks, currency trading, commodity markets and related activities like those in real estate, one notices similar effects of financialization in corporate finance. We point to the changes in the balance sheet of corporates using estimates provided by the RBI on corporate investments. The data show a steady drop in industrial securities as a proportion of total investments by non-financial public limited companies. (Chart14). The above were complemented by proportionate increases in financial securities which were held between securities issued by the government, financial institutions and as debentures. Corporates in India also have been less active recently, as compared to in the past, in borrowing from banks, both with intermittent hikes in rates and also with the slowing down of growth in the economy; especially in the industrial sector. This has led to sharp declines in the ratios of gross fixed assets as well as in gross capital formation as a ratio of total use of funds by these corporates (Chart 14). Evidently, changes in the economy, such as those above, indicate a unidirectional pattern where issues relating to real sector investments have been of lower priority to the private corporate sector.

Chart 13 Investments by Non-financial Public Limited Companies



Source: "Survey of Non-Financial Public Limited Companies" in Reserve Bank of India Bulletins , various issues

Chart 14 Ratios Relating to Non-financial Public Limited Companies



Source: "Survey of Non-Financial Public Limited Companies" in Reserve Bank of India Bulletins , various issues

Austerity in Regimes of Free Capital Mobility

Finally, we draw attention to an implication of austerity under deregulated finance which links up with free capital mobility. By monetarist logic, the rise in prices, which is supposed to be caused by inflows of capital needs to be controlled by monetary authorities, by tightening credit in the market, credit sterilization by using open market policies, and, finally, by direct purchases of foreign currency from the market. The latter, however, adds to reserves with related expansions in M3 which in monetarist principles is considered inflationary, demanding further doses of

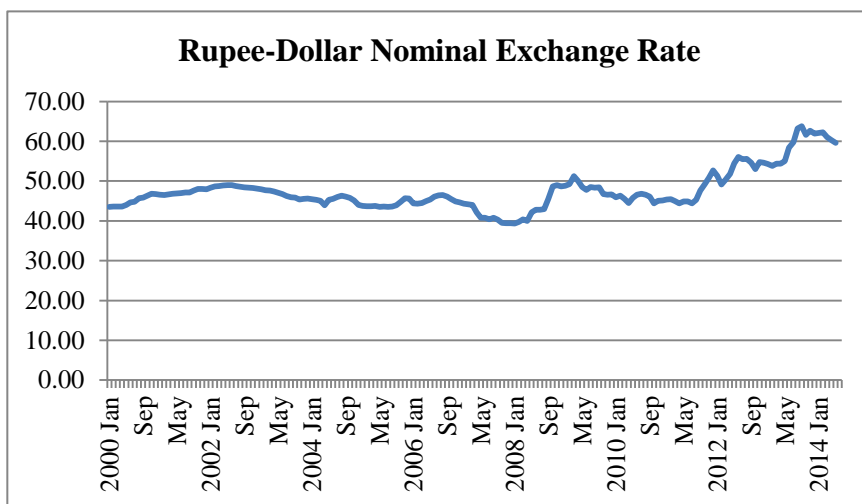
austerity measures. As mentioned above, the sequence, described in the literature as situations of “impossible trinity,” render monetary policy⁹ lose autonomy in the choice over options, say to provide a fillip for expansion in the economy by loosening credit.

In India the rift between the RBI and the Ministry of Finance (MoF) on growth vs inflation as goals in official policy has been out in the open for some time. A recent discord between the Ministry of Finance and RBI on priorities between growth and inflation-targeting for the economy came up at the end of December 2012 when the government was alerted that the projected GDP growth may fall to a low of 5 per cent or even lower. Despite the continuing drop in growth rates, which in 2014 has fallen below 5%, the RBI has chosen to continue with inflation targeting by pitching the bank rate high. Simultaneously, the government continues its adherence to the FRBMA, imposing fiscal restraints which also targeted inflation. Clearly growth was of a lower priority for both wings of the government (Sen, 2012)!

As for exchange rate movements, volatility in capital flows has led to sharp changes in the exchange rate of the rupee, thus violating the monetarist goal of achieving “financial stability.” Despite efforts to counter the impact of foreign currency inflows on the exchange rate of the domestic currency, unwanted depreciations of the nominal rate in recent times could not be avoided, especially when the rupee faced a sudden depreciation in 2012–13. This was a reaction to an expected tapering off in Quantitative Easing (QE) which was practiced by the United States since the onset of the global crisis. Causing dramatic changes in expectations in India’s currency market, the rupee took a sharp fall in terms of the dollar, especially by August 2013. The rate fell from Rs 63.4 to a US dollar in August 2013 to Rs 68.3 on Aug 28, 2013 (RBI Database of Indian Economy). At the same time, with rising prices, occasional appreciations in the real exchange rate that took place in earlier years (or presently, in 2014) has been undermining the cost competitiveness of Indian goods in the domestic and overseas markets. The successive changes in these rates can be noticed from Chart 15 below.

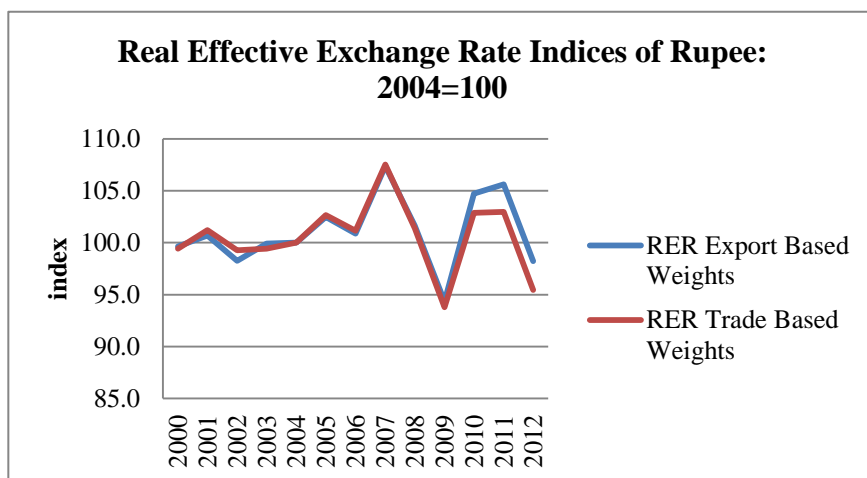
⁹ See a more detailed analysis in Sen, 2014.

Chart 15 Rupee-Dollar Nominal Exchange Rate



Source: Reserve Bank of India, Database of the Indian Economy

Chart 16 Real Effective Exchange Rate Indices of Rupee: 2004=100



Source: Reserve Bank of India, Database of the Indian Economy

Successive rounds of deregulation of the capital account, which generated steady inflows of short-term capital to the country since the early 1990, restrained monetary authorities from having full sway over what could otherwise be considered as appropriate from the perspective of domestic output growth, employment, or even distribution of credit (Rakshit, 2005). However, as already mentioned above, efforts to counter the impact of foreign currency inflows on the exchange rate of the domestic currency failed to arrest occasional appreciations in the real exchange rate that came up over those years, thus undermining the cost competitiveness of Indian goods in both the domestic, as well as overseas markets. It is noticeable that the boom in the country's stock markets also spilled over to its commodity exchanges including the Multi

Commodity Exchange (MCX), trading in which had official sanction since 2003. Trade in derivatives (especially currency futures) had a major presence in these transactions, both in stock markets as well as the MCX.¹⁰

As for the other implications of tight monetary policy, the measures have contributed to a steep climbs in bank rates over time and in the curtailing of credit, especially for the sensitive sectors like the poor and the small/medium enterprises (SME). In particular, the compliance with the Bank of International Settlement (BIS), which instituted the globalized norms for risk-adjusted credit, has intensified financial exclusion, especially for the poor and the SME in the country.¹¹

As mentioned above, with compression of the fiscal deficit as a proportion of GDP (under FRBMA), the primary deficit shrank, more than the fiscal deficit This was related to the market borrowings on part of the government, generating interest payment liabilities which had to be met in the fiscal budget. The primary budget, which excludes interest payments, naturally showed a deficit smaller as compared to the fiscal deficit. However, expenditure in the primary budget, which include defence (subject to strategic concerns), could be squeezed with reductions of the remaining two, viz., capital expenditure and subsidies. It may be pointed out that per capita growth rate (in real terms) of expenditures in the Social and Rural Sector actually fell (as percentage of GDP) from 25% to (-) 2.5% within a year between 2008–09 and 2009–10, and followed by reduced levels at 5.5% of GDP in 2011–12.

Concluding Observations

This paper has dwelt on limitations of monetarism, both at level of theory and as a tool to guide economic policies. Our analysis confirms the hypothesis that monetarist principles and policies, as have been practiced in different countries, can be held responsible for both the stagnation and instability in different parts of the world economy as can be witnessed today. An outcome, such as the one above can be observed, both in the crisis-ridden countries of southern Europe and in developing countries like India and China, both maintaining a high order of integration with global financial markets.

¹⁰ See Sen, 2011a.

¹¹ For details of the impact of Basel II norms on credit to poor, see Sen, 2011b .

As compared to Greece, one of the worst crisis-hit countries in southern Europe, India's trajectory in terms of austerity-driven stagnation has been somewhat different. While financial deregulation has generated a spate of finance-driven activities in both countries, Greece experienced a flood of unrestrained borrowing by private financial institutions which landed the country in a state of near bankruptcy as an aftermath of the global financial crisis. This has prompted the donors including the IMF and the international financial community (backed by the European Central Bank and the rich countries of the Euro-land) to enforce strict fiscal and monetary discipline in the country. The multiple compulsions faced by the Greek authorities included first, the rules under the Maastricht Treaty, the movements in the euro which often proved overvalued in terms of trade competitiveness and finally, the debt-peonage enforcing austerity in terms of the conditional loan packages offered by the donors.

For India the story of finance-driven austerity and the pledge to adopt the package of monetarism has followed a different path. India ceased to be a high external debtor country since the late 1990s and the compulsions to enforce fiscal and monetary discipline as happened in 1991 in terms of the conditional loan package from the IMF has not recurred in later years. The gradual shift in policies which came up over the next two decades can thus be related to the change in the mind-set of those who controlled policies, with a leap in the direction of neoliberal strategies which gave a free rein to global finance. As a consequence the latter had a full sway over economic policies like limiting fiscal deficits, tightening credit (with high interest rates and other devices), easy inflows of short-term capital (often used to fetch profits in speculation), tax concessions on capital gains and corporates as well as households. Thus the Indian state was found in a collaborative mood, or even as a predator to facilitate the above transformations. The least was done to arrest the related consequences in the economy which include the sharp drops in capital expenditure (and sometimes even social expenditure) by the state, reduced share of investments by corporates in industrial securities as compared to the share in financial securities, deployment of short term finance brought in by the FIIs for speculation in commodities, stocks and real estates, loss of autonomy in monetary policy in the face of volatile as well as excessive inflows of flight capital, and, finally, the related instabilities, in exchange rates, credit markets and even in official reserves.

Faith in the neo-liberal doctrine of monetarism has thus oriented policy making in India which has tacitly accepted the related compulsions by foregoing other goals like growth of the economy or distribution as of concern. With a transformation like the one above India provides a

classic case, of a tacit compliance which came without compulsions (as could be identified in situations like an urgency to fetch conditional official loans to avoid an imminent bankruptcy) which happened in Greece and some other South European countries. The change was more subtle, with a silent acceptance by the ruling elite in the country to the “order” which falls in line for an entry to the lucrative arena of global finance for rentiers all over the world.

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