FINANCIAL CRISES, RESERVE ACCUMULATION, AND CAPITAL FLOWS

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I

The end of the *dirigiste* era has brought in its wake a process of liberalization of financial flows into and out of most third world economies. This process began early in some parts and later in others; and it has proceeded to different extents in different countries. Nonetheless it is a fact of life over much of the third world. Any such liberalization brings third world assets into the ambit of portfolio decisions of first world wealth-holders. This has certain implications, one of which is the unleashing of financial crises in the third world. Let us first look at a simplified picture of the financial crisis.

The introduction into the portfolios of first world wealth-holders of some of these assets that were hitherto inaccessible to them, is likely to entail an improvement in these portfolios. Hence their demand for these assets will go up, through an *ex ante* reduction partly in their demand for money, and partly in their demand for other non-money assets. This will have an impact on the prices of the third world assets, and a new stock equilibrium will be established, where, under standard assumptions, the returns at the margin, or what Kaldor (1964) had called the "own rates of money interest", from each of the assets belonging to this augmented universe and entering into to the wealth-holder's portfolio, is equalized for each wealth-holder.

A sufficient condition for such a new equilibrium to come about, if we follow Keynes, is that the elasticity of price expectation must be less than unity for all assets for all wealth-holders, even though the expectations themselves may be divergent among them. This divergence of expectations played a crucial role in Keynes' analysis. It meant a division of the wealth-holders into "bulls" and "bears", which explained both how asset transactions actually took place, and also how equilibrium was established, through a shifting of the line demarcating the two. But it precluded any notion of a "representative wealth-holder", such as was invoked in the analyses of Kalecki (1954), Kaldor (1964) and Hicks (1946). In what follows however, since our concern will be with examining equilibrium conditions, and not with the process through which equilibrium is arrived at, we shall invoke the notion of a "representative wealth-holder", which, as Kahn (1972) had pointed out, assumes a "dense concentration at the margin". But we shall distinguish between the "representative wealth-holder" from the first world and the "representative

wealth-holder" from the third world.

While inelasticity of price expectations in the asset market is a sufficient condition for equilibrium, it is obviously not a necessary condition. Even with unit elastic price expectations, equilibrium can still come about through what Keynes had called the "minor influence" of variations in the "own rates of own interest"[1]. Likewise the principle of increasing risk (Kalecki 1954) may be invoked as an equilibrating mechanism, since it works in favour of a diversified portfolio. But these other equilibrating forces, in the absence of inelastic price expectations, are likely to be too weak in practice to bring about a meaningful stock equilibrium. We can therefore, without much violence to reality, ignore the fact of inelastic price expectations not being a necessary condition in the analysis that follows. Of course, when we say elasticity of price expectations, we refer, in the case of first world wealth-holders, to the elasticity of *dollar price expectations*, i.e. we aggregate the price expectations in the foreign exchange market as well as in the asset markets.

While inelastic price expectations ensure a stock equilibrium, there is no reason why the sequence of stock equilibria should exhibit a pattern that includes a financial crisis. To understand the occurrence of a financial crisis *as a systemic phenomenon*, rather than just a massive erratic shock, we have to go beyond the mere existence of stock equilibria. Thus, in the absence of inelastic expectations, we have no stock equilibrium; but in the presence of inelastic price expectations, while we have stock equilibria, we have no systemic explanation as yet for a financial crisis.

The matter can be put differently. One can understand a financial crisis arising from *elastic price expectations*, i.e. as an expression of the fact that no equilibrium exists and the economy hurtles in a particular direction; but to understand a financial crisis in the context of a sequence of stock equilibria, which are ensured by inelastic expectations, requires additional theoretical construction. A possible construction is the following one.

We can visualize each wealth-holder revising expectations (or, alternatively, acting upon revised expectations) only at discrete intervals. The gap between two successive dates when the wealth-holder revises expectations, is our "period", and we can assume for convenience that all wealth holders behave identically in this respect. We can imagine all wealth-holders making their portfolio choices at the beginning of each period, on the basis of a given expected price which each wealth-holder has for the end of the period. No matter what the actual asset prices that emerge from their choices, this end-of-period expected price remains unchanged for each. But the expected price *for the end of the next period* is influenced by the actual asset prices ruling in the stock equilibrium of the current period. We thus have inelastic (in fact, zero-elastic) asset price expectations *during the period* which ensures a stock equlibrium. But we have the feedback effect of the current equilibrium price on the next period's expected price, which makes possible a dynamic sequence of stock equilibria.

[1] For a discussion of "own rates of own interest" see Kaldor (1964).

This construction is by no means far-fetched or unrealistic. It merely presumes that people take time to adjust their expectations in response to actual price movements, that they want to "wait and watch" and "look around" before revising their expectations about the future. On the basis of this premise, we can understand financial crises arising in the context of a sequence of stock equilibria in the following manner.

When wealth-holders do revise their expectations, there are two different considerations they reckon with: if prices are rising, then they normally expect this momentum to continue for some more time; as against this, when prices have gone "too high" or "too low", then they expect some rectification to occur in the form of counter-acting price declines or increases. Denoting the expected price at the end of period t by p^e_t and the actual price during period t by p_t, the price expectation formation rule can be given simply as:

$$p^e_{t+1} = p_t . (a.p_t / p_{t-1} - b.p_t / p^*).. \qquad (E)$$

where p* is the "normal price" according to the conception of a particular wealth-holder (it may differ across wealth-holders, but, being based on historical experience, is not too dissimilar across them, which fits in with the "representative wealth-holder" assumption), relative to which the asset price in any period is considered "too high" or "too low".

For depicting stock equilibrium let us make the most simple assumption that there is only one asset in the third world economy which has a perpetual life, so that its rate of return is simply the reciprocal of its price. And that first world wealth holders compare this asset to some representative first world asset with a rate of return r*. The equilibrium condition for a representative first world wealth-holder then can be written as:

$$r^* = 1/ p_t + p^e_t/p_t - 1 - \rho..... \qquad (F)$$

where ρ is the marginal risk premium required to compensate the wealth-holder for holding the third world asset as compared to the first world asset.

Now the anatomy of a financial crisis according to the above conception can be understood as follows. Let us start from a situation where, for simplicity, the expected and actual prices of the third world asset are equal and hence equal p*. Starting from this situation, if first world wealth-holders get access to this asset, then its price increases and we have a series of stock equilibria through which its price keeps rising. But as long as a>b, a time will come when the expected price for the asset will be such that it no longer appears attractive relative to the first world asset. Its price increase will first slow down and then come to a stop. But by the time that happens, the rate of return it earns has become lower than r* (provided a is sufficiently larger than b), and hence there will be a reverse shift away from the third world to the first world asset (this shift in fact will begin much earlier), which will bring down the price of the former and start a downward price spiral that constitutes the essence of a financial crisis.

All this can be refined. The idea of an automaticity about the crisis coming to an end, which the above model implicitly suggests, can be abandoned. The downward price movement can be made, as indeed it should be, sudden, sharp, and without any obvious restraints (since expectations are likely to turn elastic over a whole range of prices, when the prices are declining). But this model can illustrate the argument I wish to make.

II

The rise in the dollar prices of the third world assets consists of two parts: a rise in the dollar value of the local currency, and a rise in the local currency value of the assets. Before the economy opened itself up to financial flows, the first of these considerations did not figure in anyone's calculations. There was a stock equilibrium in the economy with the "own rates of money interest" being equal (calculated in local currency) across all assets for the representative domestic wealth-holder. If one of these, say the deposit rate, is fixed, then all the others must adjust to it in equilibrium. Now, suppose after the economy has got "opened up", banks continue to accept any amount of deposits at the same (fixed) interest rate. Then the same own rates of money interest in local currency must prevail in a stock equilibrium after the "opening up" as the ones that prevailed before. But, for this new stock equilibrium to prevail, it is necessary not only that there should be inelastic price expectations in the markets for local currency assets, but also that there should be inelastic price expectation in the foreign exchange market. If price expectations are elastic with regard to the local currency price of the asset, then there would be no equilibrium to start with, even prior to the opening of the economy to financial flows. But in addition, after the economy is "opened up", a stock-equilibrium cannot exist in the absence of inelastic price expectations in the foreign exchange market. *Thus, inelastic expectations with regard to the dollar value of the third world currency is a condition for the existence of a stock equilibrium in a third world economy "opened up" to financial flows.*

Now, suppose the government wants to avoid financial crises. The most obvious way in which it can intervene is by stabilizing the dollar value of the local currency. This is because, unlike other assets, the supply of local currency is within the powers of the Central Bank, and hence (whether directly or indirectly) of the government, and can be augmented at will. The Central Bank can simply buy dollars at the going exchange rate and hold them as foreign exchange reserves when the demand for local assets by first world wealth-holders increases.

Let us look at the implications of this. If we denote the "own rates of money interest" (in local currency) on local currency assets before and after "opening up" by ε (which does not change for reasons just discussed), then, with the exchange rate remaining unchanged through Central Bank intervention, the condition for a new stock equilibrium will be

$$r^* = \varepsilon - \rho \ldots \qquad \text{(G)}$$

But, *ex hypothesi* the reason why first world wealth-holders wanted to move into the third world economy's asset in the first place was that the r.h.s. in (G) exceeded the l.h.s. An equilibrium can be reached only if this inequality is converted into an equality by the very process of the increase in the *ex ante* demand for the third world economy's asset. But the only equilibrating factor in (G) is ρ, the marginal risk-premium, which represents compensation for foreigners against two kinds of risk: the foreign exchange risk and the risk associated with the asset market (compared to the risk of holding the first world asset).

The very stabilization of the exchange rate however *actually reduces* the first kind of risk, while the second kind of risk remains unchanged. (As for the principle of increasing risk, it becomes relevant in the present context only if there are substantial increases in the actual holding of local currency assets by foreigners. With ε remaining unchanged, there is no reason why such substantial transfers of local currency assets should occur at all from domestic to foreign owners). Hence Central Bank intervention reduces the value of ρ, if anything, and allows little scope for ρ to increase as the foreigners' demand for local assets increases. *The attempt to eliminate financial crises therefore prevents the existence of a stock-equilibrium altogether.* Looking at it differently, inelastic price expectations are a condition for stock-equilibrium only when *prices are allowed to move around*. But if there is a restriction on price movements, then even though this may itself ensure inelastic expectations, it cannot ensure the existence of a stock- equilibrium.

The prevention of crises through government intervention in short entails that no mechanism to arrest the rising demand for the local asset remains. True, we have assumed so far that the asset that "rules the roost" among local currency assets, and to whose rate all other rates are tethered, sees no shift in its rate of return[2]. If this asset happens to be bank deposits, then, it may appear, that this assumption loses its rationale, and that variations in the deposit rate can be a policy instrument for achieving a stock equilibrium. But, even assuming that the correct deposit rate for bringing about an equilibrium can be accurately estimated, monetary policy is not free to fix the deposit rate anywhere it likes, since it must *inter alia* cover the minimum lenders' risk[3]. In other words, the deposit rate may be ostensibly what "rules the roost" (if it does), but underlying it will be something more solid. The conclusion that government efforts to overcome financial crises negate the possibility of a stock equilibrium itself, therefore, remains valid.

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[2] Kaldor (1964) had raised the whole question of why money "ruled the roost" among all the assets, in the sense that the yield on money determined the vector if own rates of money interest on all other assets.

[3] The question may be asked: if the opening up of third world assets to first world wealth-holders makes them demand these assets, and if among assets in each place the one that "rules the roost" is tethered to the minimum lending risk, then this must presuppose that the lending risks are higher in the third than in the first world. This is an entirely plausible supposition, since the higher level of development of the institutions of capitalism will normally be associated with lower lenders' risk.

Crises, Marx had said, are a way of resolving, forcibly and temporarily, the contradictions of capitalism. Of course Marx often tended to look at crises in purely cyclical terms, i.e. assumed an automaticity about recovery from the downturn, much the way we have assumed above. There is in fact no such automaticity. Even so, a crisis is a way of rectifying, no doubt in a most explosive and painful manner, the unrestrained movements of the economy, or of particular markets, in particular directions. In the simple model sketched above, a financial crisis was the mechanism for preventing an unrestricted explosion of the demand for the third world economy's asset. In the absence of crises, there is nothing to prevent such an unrestricted explosion of demand.

The fact that the above model holds the occurrence of financial crises as the factor responsible for arresting the unrestricted explosion of demand for financial assets, may not be obvious at first sight. It may appear as if the restraint on demand for the asset arises *spontaneously* because its price at some point begins to look as if it is "too high". *But the reason that wealth-holders get panicky when they think that the price has become "too high" is their fear of an impending financial crisis.* In other words, it is the fact of financial crises that acts as an equilibrating mechanism[4]. It ensures that the "across-periods" elasticity of price expectations ultimately comes down to levels where demand tapers off. This in turn produces an actual financial crisis, which again keeps the fear of financial crises alive in the minds of the wealth-holders. *In short, a crisis-free capitalism, including a financial crisis-free capitalism is a chimera*. But the fact that capitalism cannot be made crisis-free is not an argument for living with crises, or tolerating or welcoming them; it is an argument for going beyond the existing capitalism.

III

The building up of foreign exchange reserves is not just for preventing financial crises. It is also a measure for preventing unemployment and immiserization which would follow the inflow of foreign currency into a third world economy for asset acquisition, if its currency price were perfectly flexible. When third world assets are opened up to first world wealth-holders, if the l.h.s. of (F) above is lower than the r.h.s. for some wealth-holders in the initial situation, then the demand for such assets will increase. This, *in the absence of government intervention*, will raise their price until, with inelastic (or zero-elastic, as we have been assuming) expectations, the r.h.s. gets lowered to establish equilibrium. Since, in the case of local currency denominated bank deposits, there is no increase in the local currency price of the asset, the rise occurs in the price of the local currency itself in terms of foreign exchange.

But here we come to a striking conclusion. *While the condition for stock equilibrium remains unchanged, the process of attaining stock-equilibrium, involving*

[4] One is reminded here of Dennis Robertson's (1937) remark about "the dying embers of liquidity preference" having to be periodically stoked through falls in bond prices. Likewise the runaway demand for third world financial assets has to be periodically curbed through falls in the prices of these assets. The difference between the two cases however consists in this: the memory of these falls produces actual falls, *which in turn perpetuate this memory*.

fixed-rate local currency assets, necessarily impinges on flow magnitudes as well, as in the case of Keynes' bond market. In other words, this process of impinging on flow magnitudes does not alter the conditions for stock equilibrium, but it occurs nevertheless. The rise in the price of the local currency (in terms of foreign exchange) which must occur for stock equilibrium, simultaneously results in imports out-competing domestic production both in the domestic and in the international market. In sectors like industry which are prone to output adjustment, this gives rise to reduced output along with reduced price, and hence unemployment. In sectors like agriculture where short-period output adjustment does not occur, it results in reduced price and hence increased immiserization of the peasants. Currency appreciation in short brings hardships in the form of unemployment and immiserization, to prevent which the Central Bank intervenes by holding foreign exchange reserves at a particular exchange rate.

Approaching the issue from another angle, we can distinguish between four different notions of "equilibrium exchange rate": that exchange rate which best serves the employment objective (i.e. makes the economy "competitive" without inviting retaliation); that exchange rate which best serves the objective of inflation-control (the NAIRE or Non-Accelerating Inflation Rate of Exchange rate[5]); that exchange rate which clears the foreign exchange market; and that exchange rate which attains stock-equilibrium.

The third of these, which is the commonest meaning given to the term "equilibrium exchange rate" is actually meaningless. The concept of an exchange rate that "clears" the foreign exchange market has no meaning, exactly for the same reason that the concept of an interest rate that equalizes "savings" with "investment" has no meaning, namely that it presupposes some given level of income. For every level of income there is a separate "equilibrium" exchange rate in this sense. Let us therefore look at the other three concepts. The economy can be in equilibrium in the sense of being in a state of rest, without either inviting retaliation from rivals or experiencing accelerating inflation, only when the "stock equilibrium exchange rate" exceeds the other two, and prevails. The state of equilibrium of the economy can then be captured by

$$r^* = \varepsilon + (p^e / p) - 1 - \rho \ldots \qquad \text{(H)}$$

$$Y = f^{-1}(p)$$

where ε refers to the rate of return on the fixed rate local currency asset (such as bank deposits), p is the price of the local currency in terms of foreign exchange, ρ the differential marginal risk premium associated with holding the fixed-rate local currency asset as compared to the foreign asset, and Y the level of income. *What this shows is that the exchange rate is determined by the stock equilibrium, while the foreign exchange market is "cleared" at this exchange rate through income (and hence employment) adjustment (with given levels of domestic investment, and given ratios of consumption,*

[5] The concept of a Non-Accelerating Inflation Rate of Exchange is discussed in Patnaik and Rawal (2005).

tax revenue and fiscal deficit to income).

It follows from this that when the stock equilibrium entails a rise in the exchange rate, income and employment must shrink. This rise can be prevented if the Central Bank intervenes to stabilize the exchange rate by holding reserves. The holding of reserves therefore becomes necessary not just for preventing a future financial crisis, of the sort we have been discussing so far, but also for preventing a drop in the level of employment in the economy and in the levels of income of the peasants.

The problem with stabilizing the exchange rate and the associated measure of holding reserves, however, is that *it makes things worse over time*. Since ε in (H) is given, and since the stock equilibrium before "opening up" must have ensured that the "own rate of money interest" on all assets equalled ε, the fact that foreigners wish to hold local currency assets after "opening up" implies that ε exceeds $(r^* + \rho)$. Under these conditions however exchange rate stabilization makes it impossible to attain a stock equilibrium after "opening up", since no equilibrating mechanism now exists. *It follows then that exchange rate stabilization makes it impossible to achieve a stock equilibrium.*

We have not till now discussed either the disequilibrium behaviour of the system or the process through which equilibrium is reached. We have talked of foreigners' demand for local assets raising their prices, but we have said nothing about the actual financial flows. Strictly speaking, from an examination of equilibrium conditions we can not jump to any theoretical conclusions about the magnitude of actual financial flows. But it is plausible to assume that the magnitude of financial flows into an economy will be linked to the magnitude of the foreigners' demand for its assets. It follows that since the excess demand for the economy's assets is not eliminated in this case, foreign exchange reserves keep piling up. And since with the piling up of reserves the marginal risk premium associated with holding the local currency declines further from the already low level to which the stabilization of the exchange rate had brought it down, the excess demand for the local currency asset will keep increasing and reserves will keep piling up over time even faster.

Let us look at this disequilibrium behaviour briefly. The fact that the economy does not "explode" in a situation of perennial excess demand, is because in practice only a certain finite amount of financial inflows occurs in any period notwithstanding this excess demand, which affects domestic asset prices but keeps them within bounds. Even within this overall disequilibrium however, portfolio adjustments made by *domestic wealth-holders will ensure that all "own rates of money interest" in local currency terms equal* ε. This will happen through an increase in their prices relative to their expected prices. The sequence of such states of rest across periods (they cannot strictly be called "stock equilibria") can still generate a domestic financial crisis, in the form of a sharp drop in the price of some local currency assets, for exactly the same reasons as were discussed earlier.

When such a drop occurs, foreigners will not be unaffected by it. In other words it will also entail a reduction in demand for the local currency itself. But even if there is no

foreign exchange crisis, because the reduced demand for the local currency is handled through the decumulation of foreign exchange reserves, the collapse of the price of some local currency assets will have serious adverse consequences.

Central Bank intervention, in the form of holding foreign exchange reserves, to prevent financial crises, in a world with free financial flows, therefore is ineffective in two senses. It prevents first of all the achievement of a stock equilibrium altogether. Secondly, even within this overall disequlibrium, it still cannot prevent the occurrence of financial crises. *The most it can do is to prevent domestic financial crises from spilling over into foreign exchange crises*, but even that is achieved at the cost of compounding the problem of instability over time. Of course, this does not mean asking for a removal of Central Bank intervention. On the contrary, such intervention is essential in a regime of free financial flows for preventing increased unemployment and immiserization. But it is the regime itself that needs transcending. One can go further. Since this regime represents the latest phase of existing capitalism, transcending this regime means transcending existing capitalism.

Putting it differently, crises, though painful, play a certain role under capitalism. The prevention of crises, by foreclosing this role, creates instability in a different way, by undermining the *modus operandi* of the system. To say this, echoing Marx, is not to plead for an acceptance of crises; it is to plead against the acceptance of capitalism as we have known it, since this knowledge has shown that "crisis-free capitalism" is a chimera. This does not of course mean that we should not demand intervention against crises, but we should do so without any illusions, and only as part of a process of going beyond existing capitalism.

IV

The accumulation of reserves by several third world economies is often seen as a factor reducing global demand. This is not true. A distinction must be drawn here between reserve accumulation that is accompanied by a current account surplus and reserve accumulation that is unaccompanied by such a surplus. The cases of China and India belong respectively to these two categories. *In the case of the latter, reserve accumulation, as already discussed, has an expansionary consequence on the level of aggregate demand of the reserve accumulating economy,* for in its absence there would be a currency appreciation causing domestic unemployment. But since such an appreciation would be accompanied by a corresponding increase in the aggregate demand of those countries whose currencies have depreciated relatively, the level of world aggregate demand would remain unchanged. In short, the level of world aggregate demand is unaffected whether or not there is reserve accumulation of this sort.

Even in the case of the former, reserve accumulation *per se* cannot be said to have caused a decline in world aggregate demand. If China for instance decided not to accumulate reserves but to let her currency appreciate, then there will be a decline in the level of aggregate demand in China which will be accompanied by an increase in the aggregate demand of countries currently out-competed by China, notably the US. In

principle, there is no reason to believe that the level of world aggregate demand will change on account of China's reserve decumulation. It is only if reserve decumulation in China is accompanied by a corresponding increase in some other item of aggregate demand that we can expect an increase in the level of world aggregate demand. If for instance, the Chinese economy instead of running current account surpluses decides to enlarge domestic absorption through enlarged government expenditure while keeping the exchange rate unchanged, then there will be an increase in world aggregate demand. But then this has nothing to do with reserve decumulation *per se*: all that it says is that the level of world aggregate demand goes up if the domestic absorption of one particular country goes up without that of any other country reducing, which is but a truism.

The conclusion in both cases that the level of world aggregate demand remains unchanged in the event of a decumulation of reserves through an appreciation of the exchange rate, assumes that the economy, whose currency has depreciated relatively and which experiences an increase in aggregate demand as a consequence, is unconcerned with the associated increase in its domestic prices. If the price effects of an expansion of its aggregate demand entail high social resistance, as might be expected in the case of the US perhaps, which has a restraining effect on the magnitude of its demand expansion, then *reserve decumulation on the part of the "emerging market economies" through an appreciation of the exchange rate has a contractionary effect on world aggregate demand.* It follows that the accumulation of reserves through Central Bank intervention in keeping the exchange rate fixed, makes the level of world aggregate demand no lower than it otherwise would have been; but it invariably has a net expansionary effect on the level of aggregate demand of the reserve accumulating economy itself, compared to what it would be if reserves did not accumulate and the exchange rate was allowed to appreciate.

The concern with the accumulation of reserves represents however a refracted perception of something altogether different. While such accumulation has no effect *per se* on the level of world aggregate demand (except for the fact that its substitution by larger domestic absorption would be beneficial for all, which is a very different proposition), it does undermine the position of the leading capitalist economy, by accumulating claims against it. Throughout the history of capitalism, the diffusion of industrial capitalism from the core to "newly industrializing countries" has been accompanied by the leading capitalist power of the time running a current account deficit visavis the "newly industrializing economies", thus offering them space in its domestic market. But this never caused any net accumulation of claims against the leading capitalist power because it always had access to a drain of surplus from colonies, in addition to having the colonial markets "on tap", which more than paid for its current account deficits visavis the "newly industrializing countries". Its currency therefore was never under pressure even as it ran current account deficits against the NICs of the time. The fact that the leading capitalist power of today finds its currency under pressure and itself becoming a heavily indebted nation, is because the possibilities of colonial drain no longer exist, though misadventures for resurrecting the system of colonial drain, especially from oil-rich third world countries, have not been given up[6].

[6] The arguments of this paragraph have been developed at length in Patnaik (2005).

V

The proposition advanced above that Central Bank intervention for stabilizing the exchange rate, in order to prevent unemployment through exchange rate appreciation, and future financial crises, has the effect of making things worse over time, is borne out by the Indian experience. It was argued earlier (in section III) that even within the overall stock- disequilibrium that characterizes a situation of Central Bank intervention to stabilize the exchange rate, the "own rates of money interest" in local currency (in Kaldor's terminology), will be equal to ε and to each other. Since this comes about through movements of actual asset prices relative to their expected prices, and hence entails significant movements in actual asset prices, it does not prevent financial crises. (In India's case it is the stock market crisis that is pertinent). Government intervention in India therefore has taken the form of *both* stabilizing the exchange rate *and* keeping the stock market boom going, through selective interventions by way of "liberalization" and fiscal incentives.

But the very logic of a combination of a stock market boom and stabilized exchange rate has meant a continuous shift of foreign demand towards the local currency assets and hence towards the local currency as well This has saddled the Reserve Bank of India with burgeoning reserves which have in the course of three years climbed to $200 billion. And precisely because such large reserves make the rupee less vulnerable to collapse, the marginal risk premium associated with holding the rupee has gone down, thereby further stimulating financial inflows and hence adding to reserves.

This situation of disequilibrium would not matter, except for the fact that there is a massive difference between the rate of return earned by those who are bringing in financial inflows and the rate of return earned on the reserves. If a minimum of 20 percent is taken as the rate of return, inclusive of asset price appreciation, for those who bring in financial inflows, then, given the fact that the reserves earn no more than about 1.5 percent on average, the annual loss owing to this difference comes to about 6 percent of the GDP of the country. In other words, the country, as it were, is borrowing dear to lend cheap, to an extent where its annual loss at present amounts to 6 percent of the GDP. This is not to say that 6 percent of the GDP is being actually drained out of the country every year. But the fact that it is not being actually drained out now, only implies that the size of the drain will be even larger in future.

The so-called "sterilization" operations, meant ostensibly to control money supply, are really a means of preventing damage to the banking system under the weight of this loss. Precisely because we are in a disequilibrium situation where financial inflows continue to occur, and foreign exchange reserves continue to get built up, the magnitude of reserve money increases sharply which finds its way into the banks and far outstrips the demand for credit from "worthwhile borrowers". Banks' profits are threatened by this discrepancy, and the Reserve Bank steps in to shore up these profits by putting income earning government securities into the banks' portfolio. The Reserve Bank's doing so however means a substitution of foreign exchange reserves for government securities in

its own asset portfolio, with the former earning much lower rates of return than the latter. This therefore lowers the Reserve Bank's profitability, and hence reduces a whole range of development finance activities which the Reserve Bank uses its profits for promoting. In short the Reserve Bank is taking upon itself the losses that the commercial banks would otherwise have incurred owing to this disequilibrium situation.

Many in India, in a throwback to mercantilism, have applauded the accumulation of reserves, deeming it to be a great success for the neo-liberal policies. For reasons just discussed, nothing could be further from the truth. Very recently the Reserve Bank has allowed an increase in the dollar price of the rupee (partly perhaps to control incipient inflationary pressures), but the effects of this move are already apparent in the form of lower export prices for the already hard-pressed peasants.

What the Indian case clearly demonstrates is that measures aimed at avoiding financial crises push the economy into a perennial disequlibrium. This choice between the devil and the deep sea may well be avoided in the first instance through the imposition of capital controls, but such controls will in turn bring in their train a whole range of further developments, the cumulative impact of which will be a shift in the balance of class forces that underlies contemporary Indian capitalism, provided there is no sudden panic-stricken or externally-imposed change of course in between.

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