Finance liberalisation, path dependence and the prospects of an alternative: India

C.P. Chandrasekhar

It is now commonplace to regard India (along with China) as one of the economies in the developing world that is a “success story” of globalisation. This success is defined by the high and sustained rates of growth of aggregate and per capita national income; rapid expansion of (services) exports; substantial accumulation of foreign exchange reserves; and the absence of major financial crises that have characterised a number of other emerging markets. These results in turn are viewed as the consequences of a “prudent” yet extensive programme of global economic integration and domestic deregulation that involves substantial financial liberalization, but includes capital controls and limited convertibility of the currency for capital account transactions. Such prudence is also seen to have ensured that India remained unaffected by the contagion unleashed by the East Asian financial crisis in 1997.

This argument sidesteps three facts. The first is that India had experimented with a process of external liberalization, especially trade liberalization, during the 1980s, that had resulted in a widening of its trade and current account deficits, a sharp increase in external commercial borrowing from private markets and a balance of payments crisis in 1991 (Chandrasekhar and Ghosh 2004; Patnaik and Chandrasekhar 1998). Financial liberalization was partly an outcome of the specific process of adjustment chosen in response to that crisis. Second, India had been on the verge of substantially liberalizing its capital account and rendering the rupee fully convertible, when the East Asian crisis aborted the process. The road map for convertibility had been drawn up by the officially appointed Tarapore Committee, and prudence on this score was the result of the lessons driven home by the 1997 crisis regarding the dangers of adopting that route. Third, even while avoiding full capital account convertibility, India has pushed ahead rapidly in terms of financial liberalization and has in a series of steps substantially opened its capital account. The point to note is that the basic tendency in economic policy since the early 1990s has been towards liberalisation of regulations that influenced the structure of the financial sector.

The source of this tendency were both external and internal. One consequence of the post-1970s expansion of liquidity in the international financial system was the need on the part of international Finance Capital to find new avenues to lend and invest. Having to keep money moving to earn returns, and running out of options within the developed world, *private* international finance that had excluded most developing countries from its ambit because they were perceived to be too risky both economically and politically, chose to target some developing countries that were soon identified as **emerging markets**. Suddenly, flows of private financial capital to developing countries, which till then had access to foreign capital only in the form of limited flows of foreign direct investment and “aid’ from the bilateral and multilateral development aid network, became a possibility, with an implicit message that this was available on demand.

To exploit this option developing countries needed to dilute controls that had been imposed on flows of foreign capital, especially foreign financial capital wanting to enter their equity, debt and insurance markets. With hindsight we know that almost all developing countries chose to exploit this option at different points of time starting in the 1970s in the Southern Cone countries of Latin

America. When India's import substituting industrialisation strategy ran into an impasse in the 1970s, it like many other countries sought to pursue a strategy similar to that adopted by the East Asian, second tier industrialisers. This required attracting foreign investment that used the country concerned as a location for production for the world market. But since such investment was dependent on the decisions made by foreign investors, a strategic adoption of export led development had to be supported also by measures to restructure the capacities of domestic agents and make them internationally competitive. This required substantial liberalisation of trade and foreign investment policies, that would immediately lead to an increase in imports, not least because potential exporters would choose to import the technology, capital goods, intermediates and components needed for export production.

In practice, a policy of trade liberalisation was adopted on the grounds that the competition it would unleash would help restructure domestic economic activity, render firms and other economic agents in India internationally competitive, and put the country on an outward-oriented, export-led growth trajectory. Even if this does prove to be the "ultimate" result of such trade liberalisation (which it normally is not), this cannot be its immediate fall-out. Restructuring domestic capacity takes time as does the process of finding customers and building 'goodwill' in global markets. On the other hand, post-liberalisation, the pent-up demand, especially of the rich, for imported goods that had thus far been curbed with protection would be immediately released. This would lead to a widening of the trade and current account deficit in the balance of payments of the liberalising economy, with foreign exchange expenditures rising much faster than foreign exchange earnings. So access to foreign capital to finance that deficit is a prerequisite for "successful" liberalization that is not aborted by a balance of payments crisis.

Thus, the transition to a liberalised, open economic regime could be stalled by the actual and potential balance of payments difficulties associated with that experiment. It was in this context that the access to foreign capital ensured by the rise to dominance of finance was seen as an opportunity. Ensuring access to foreign capital flows resulting from the accumulated liquidity in the international market required in the first instance relaxation of controls on capital inflows, including inflows of purely financial flows into debt and equity markets. But attracting such inflows also requires attracting the carriers of such capital, viz., the large financial firms such as banks, institutional investors, pension funds and insurance companies. This required relaxation of the terms of entry into and operation in domestic markets of such firms. It also required changing the regulatory framework in keeping with international norms and guidelines, such as those formulated by the Basel Committee. A shift from the 'structural regulation' of the financial sector and financial institutions, to market mediated regulation was the result.

The increase in capital flows into India in the first flush of post-1991 liberalisation was small. Starting from about $100 million, total (portfolio and direct) investment rose to above $3 billion in 1993-94, largely as a result of portfolio flows into India's equity and debt markets. It then rose to about $5 billion a year and remained at that level, till portfolio inflows were disrupted and reversed in the aftermath of the 1997 Southeast Asian crisis. But immediately thereafter, the total bounced back to more than $5 billion by 1999-00. This quantum, however, was seen as unsatisfactory by the government, given its oft-expressed target of ensuring FDI inflows of $10 billion a year.

The shift away from annual inflows in the range of $5 billion a year began in 2003-04. Besides an overall surge in capital flows to all emerging markets, a host of policy measures paved the way for India proving to be one of the favoured investment destination. Rules and caps on foreign investment were relaxed, tax benefits delivered through the external treaty route with countries like Mauritius, and the 'long-term' capital gains tax was abolished in the budget of 2003-04, making India's financial markets virtual tax havens. In 2003-04 aggregate inflows rose to exceed $15 billion. That figure further rose to touch $62 billion in 2007-08 when the global financial crisis broke. While the crises resulted once again in a reversal of portfolio inflows in 2008-09, FDI inflows remained strong at more than $40 billion. Portfolio flows too bounced back taking the aggregate inflow to more than $60 billion in all years till 2013-14, when the "taper tantrum" induced by the fear that the US Federal Reserve would tighten monetary policy and raise interest rates, substantially reduced the *net* inflow of portfolio capital. However, once those fears were quelled aggregate inflows rose to a record $74 billion.

One implication of this post-2003 trend in financial flows was that India was the target of a huge excess of capital inflow into the country when compared to its current account financing needs. If we take the cumulative sum of the excess of the capital inflow relative to the current account deficit, this has increased consistently since the first quarter of 2001-02 to the fourth quarter of 2008-09, and since then has more or less remained near that level and increased further most recently. The result is that India has accumulated a huge stock of legacy foreign finance capital in the forms of footloose investments in its equity and debt markets. And any effort to challenge and/or reverse neoliberal economic policies inevitably leads to the exit of portfolio and "footloose" productive capital, precipitating a crisis of sorts that must be endured if an alternative strategy is to be experimented with. This not only worsens the conditions of the poor, but also gives rise to the view that any attempts at a transition to some form of an alternative to neoliberalism would lead to capital flight and precipitate a crisis, making the alternative impracticable in the new world dominated by finance. This does constitute an important roadblock to the adoption of such strategies. The result is India is stuck in a trajectory of distorted capitalist development. It is to the nature of that development that we turn

The new financial framework shaped by the financial liberalization adopted to attract these flows had many features. To start with, banks extended their activity beyond conventional commercial banking into merchant banking and insurance. Second, within banking, there was a gradual shift in focus from generating incomes from net interest margins (or the difference between deposit and lending rates) to obtaining them in the form of fees and commissions charged for various financial services. Third, related to this was a change in the focus of banking activity as well. While banks did provide credit and create assets that promised a stream of incomes into the future, they did not hold those assets till maturity any more, as they used to in the past in the so-called "originate-and-hold" model. Rather they bundled them into pools, attached those bundles to particular securities eligible for the stream of incomes due from the underlying assets, and sold these securities for a fee to institutional investors and portfolio managers. Banks transferred the risk for a fee, and those who bought into the risk looked to the returns they would earn in the long term. This was the "originate and distribute" model of banking. It meant that those who originated the credit assets tended to understate or discount the risks associated with them. Moreover, since many of the securities created on the basis of these credit assets were complex derivatives, the risk associated with them was difficult to assess. The role of assessing risk was given to private rating agencies, which were paid to grade these instruments according to their level of risk and monitor them regularly for changes in risk profile. Fourth, the ability of the banking system to "produce" credit assets or financial products meant that the ultimate limit to credit was the state of liquidity in the system and the willingness of those with access to that liquidity to buy these assets off the banks. Within a structure of this kind periods of easy money and low interest rates increased the pressure to create credit assets and proliferate risk. Finally, financial liberalization increased the number of layers in an increasingly universalized financial system, with the extent of regulation varying across the layers. Where regulation was light, as in the case of investment banks, hedge funds and private equity firms, financial companies could borrow huge amounts based on a small amount of own capital and undertake leveraged investments to create complex products that were often traded over the counter rather than through exchanges. Credit risk transfer neither meant that the risk disappeared nor that some segments were absolved from exposure to such risk.

These changes made the financial sector an important site for profit appropriation. There are a number of stylised facts that support that argument. The first, is the sheer size of the financial sector and the growing importance of finance in the growth of national income. The second is evidence of financial over-development with the ratio of financial assets to GDP and of financial assets to real wealth rising sharply. And a third is the rising share of financial profits in total corporate profits. All these are indicators of an accelerated expansion of financial activity as the principal site for surplus appropriation.

There have been other significant consequences associated with the rise of finance. One is a change in the mode of appropriation of surplus by Finance itself. In the past Finance acquired a share of the surplus generated in the sphere of production of goods and services. Through investments in or loans provided to these activities, Finance received a dividend, a capital gain when it exited from ownership and interest on credit provided, which after taking out of its costs determined its net profit. In fact, a lot of financial 'investment' was in equity that afforded it control or influence over corporations engaged in production and/or service provision. Dividend incomes rather than capital gains were the main source of return to financial interests that wanted to retain control of profitable real assets. Matters have changed in recent decades. Further, an expansion in the volume of financial transactions allows for periods or episodes of asset price inflation, which when 'marked to market' (or valued at prevailing market prices) in their books seem to be deliver profits and enhance wealth. Not being the result of the sharing or direct appropriation of surpluses generated in the sectors producing commodities and services, this profit and the wealth increase is, at one level, notional. But so long as financial assets are liquid in the sense that they can be easily encashed and the value of money is protected, this wealth amounts to purchasing power and a means of command over real resources.

A second consequence is a tendency for economic activity outside the financial sector to be shaped by finance. Which sectors turn out to be the sunrise sectors in the economy, which firms flourish and which survive and grow, which shut down or are merged or amalgamated with others, and which 'technologies' tend to get showcased are shaped, often unbeknownst to us, by finance. One illustration of this is the growing importance of 'start-ups' In India's 'new' capitalism. Certain firms experimenting with certain technologies are chosen as the target for financial bets. Few of these survive, even if they are extremely well funded with venture capital in their early years. The international experience shows that even those that survive and deliver huge returns to shareholders and generate fortunes for their promoters, like Netscape, AOL and Yahoo did, fade away, unlike a few others like Google and Apple, which survived and became leading firms. Many others of varying sizes merge or are the subject of takeover. But the gains made from the few successes are more than enough to wipe out the losses associated with the many failures.

A third consequence is our perception of technology itself has changed. Technology in the era prior to the Age of Finance was largely a combination of 'hardware' and 'software' that used a certain set of specified capital goods, intermediates and components to undertake a planned production routine to yield a product with a specific design, technical characteristics and use value within a defined organisational framework, like the factory. This allowed us to breakdown technology into segments such as materials technology, manufacturing technology, design technology, and managerial technology. The last was clearly far less of a technology than the others. But technological change could involve improvements in any of these. A feature of technology in recent years is the growing importance of "software" elements and managerial technology in the spectrum. Today's 'technology' majors include the likes of Google (a search engine), Facebook (a social media platform) and Uber (an aggregator). Versions of such companies are present in India as well, displacing software and IT-enabled services firms as the firms of the future. This allows for both the widening of the scope of innovation and an increase in the pace of obsolescence of technologies, providing a constant source of 'NEW, new things' on which Finance can place its bets.

Fourth, the period of the rise of finance has seen a substantial expansion of the service economy and the GDP generated by services. This is because of the specific way in which finance has moulded the use of information technology, allowing it to transform industries delivering products such as goods, media and music, and access to traditional services like commercial taxi services. One often noted feature of contemporary Indian capitalism, is that recent growth in national income has become overwhelmingly dominated by the services sector, and that too by activities that in themselves do not promise much for future growth increases. What needs to be noted is that this is not the result of the observed diversification of national economic activity in the direction of services that occurs at relatively high levels of per capita income after a period of diversification away from agriculture to manufacturing.

Finally, the rise of Finance changes the dynamics of capitalism itself. Some economies still remain exporters, others are the destination for imported profits from foreign investment, and yet others grow on the basis of internal stimuli, in which tax and debt financed public expenditure is replaced with debt financed private expenditure as the principal 'exogenous' stimulus to growth. One cause for this is that for a host of reasons, ranging from its fear that excess borrowing would spur Inflation that would erode the value of the assets or the command over real resources of those holding financial wealth to its desire to rein in States pursuing proactive fiscal policies based on borrowing, which legitimises the State and delegitimises the market to the detriment of finance, capital opposes debt financed spending by governments. As the presence and power of finance increases, therefore, fiscal conservatism becomes the norm and austerity a recurrent policy recommendation.

All of this suggests that the growing dependence on foreign finance capital has distorted India's growth. India's failure, visible from the mid-1960s, to make an expanding and technologically dynamic industrial sector an important, let alone the principal, driver of growth has only worsened in the age of Finance. As per the new series on national accounts with 2011-12 as base, over the entire four-year period starting 2012-13, services of various kinds accounted for as much as 68.7 per cent of total GDP growth. Manufacturing provided for only around 18 per cent, slightly less than the service activities comprising trade, repair, hotels and restaurants. What is more startling is that some of the biggest contributions to GDP growth came from finance, insurance and real estate (FIRE - 30.9 per cent) and public administration and defence (12.5 per cent). Indeed, these two sectors together accounted for 43 per cent – or nearly half – of all estimated increases in economic activity in the past four financial years. Over 2015-16, this FIRE sector accounted for ahuge 21.6 per cent of total GDP (or Gross Value Added at Basic Prices, as the new series describes it). This is problematic, because expansion in these sectors is not suggestive of a good foundation for future stable growth.

All of thes e are tied to the inflows of foreign financial capital and the financial liberalisation that presedes and follows that process. The growing presence of foreign financial capital is disconcerting not just because such flows are in the nature of “hot money” which renders the external sector fragile, but because the effort to attract such flows and manage any surge in such flows that may occur has a number of macroeconomic implications. Most importantly, inasmuch as financial liberalization leads to financial growth and deepening and increases the presence and role of financial agents in the economy, it forces the state to adopt a deflationary stance to appease financial interests. Those interests are against deficit-financed spending by the state for a number of reasons. First, deficit financing is seen to increase the liquidity overhang in the system, and therefore as being potentially inflationary. Inflation is anathema to finance since it erodes the real value of financial assets. Second, since government spending is “autonomous” in character, the use of debt to finance such autonomous spending is seen as introducing into financial markets an arbitrary player not driven by the profit motive, whose activities can render interest rate differentials that determine financial profits more unpredictable. Third, if deficit spending leads to a substantial build-up of the state’s debt and interest burden, it may intervene in financial markets to lower interest rates with implications for financial returns. Financial interests wanting to guard against that possibility tend to oppose deficit spending. Finally, the use of deficit spending to support autonomous expenditures by the state amounts to an implicit legitimisation of an interventionist state, and therefore, a de-legitimisation of the market. Since global finance seeks to de-legitimise the state and legitimise the market, it strongly opposes deficit-financed, autonomous state spending (Patnaik 2005).

Efforts to curb the deficit inevitably involve a contraction of public expenditure, especially expenditure on capital formation, which adversely affects growth and employment; leads to a curtailment of social sector expenditures that sets back the battle against deprivation; impacts adversely on food and other subsidies that benefit the poor; and sets off a scramble to privatise profit-earning public assets, which render the self-imposed fiscal strait-jacket self-perpetuating. All the more so since the finance-induced pressure to limit deficit spending is institutionalised through legislation like the Fiscal Responsibility and Budget Management Act passed in 2004 in India, which constitutionally binds the state to do away with revenue deficits and limit fiscal deficits to low, pre-specified levels.

Accompanying this is evidence from the demand side that indicates that the combination of financial liberalization and the large financial inflows that followed it did create a new regime of accumulation in India. The inflow of foreign capital had as its counterpart an increase in the overhang of liquidity in the domestic economy. Based on that overhang, a liberalized banking system has been creating new credit assets at a rapid rate. The ratio of bank credit outstanding to GDP, which had remained at around 22 per cent for a decade starting 1989-90, began to rise after 1999-2000, doubled by 2005-06 and is currently well above 50 per cent. India's has been witnessing a credit boom during its high growth years.

There were also significant changes in the sectoral distribution of credit. Overall there were two sets of sectors that gained in share. The first comprised of retail advances, covering housing loans, loans for automobile and consumer durable purchases, educational loans, and the like. The share of personal loans increased from slightly more than 9 per cent of total outstanding commercial bank credit at the end of March 1996 to close to a quarter of the total more recently. The second area of change was the distribution of credit going to industry, which at around 40 per cent of total bank credit outstanding was still substantial. The share of infrastructural lending in the *total advances of scheduled commercial banks to the industrial sector* rose sharply, from less than 2 per cent at the end of March 1998 to 16.4 per cent at the end of March 2004 and as much as 35 per cent at the end of March 2015. That is, even as the volume (though not share) of lending to industry in the total advances of the banking system has risen, the importance of lending to infrastructure within industry has increased hugely. Sectors like power, roads and ports, and telecommunications have been the most important beneficiaries. For commercial banks, which are known to prefer lending for short term purposes, this turn to lending to infrastructure was a high risk strategy.

These changes initially spurred growth because of the demand increases it financed. But soon it was clear that this trajectory was one that involved driving growth at the expense of financial stability, since many of these projects and loans were not viable and turned non-performing. According to the end-June 2016 edition of the Reserve Bank of India's (RBI's) biannual *Financial Stability Report*, gross non-performing assets (GNPAs) of the scheduled commercial banks (SCBs) rose sharply from 5.1 per cent of gross advances at the end of March 2015 to 7.6 per cent at the end of March 2016. Thus, the problem is not just the volume of bad assets, but the rapid growth in such assets. According to answers to two questions (Nos. 1759 and 2526 of August 2016) in the upper house of the Indian parliament, while the total GNPAs of public sector banks stood at Rs. 4,768 billion at the end of March 2016, the non-performing assets that were reported by them in the second half of financial year 2015-16 alone amounted to Rs. 2,770 billion. Figures obtained by *Reuters* through a Right to Information application indicate that stressed assets on the books of the banks had risen from Rs. 8060 billion at the end of December 2015 to Rs. 9220 billion at the end of June 2016. That would suggest that the value of loans that could turn bad is still on the rise.

Even ignoring this trend, the rise in non-performing assets due to reclassification is not without implications for the health of India's predominantly public banking system. Once assets are recorded as non-performing, banks need to write off loss assets. They must also provide for the implicit decline in the value of doubtful and sub-standard assets. That adversely affects the profitability of banks. Even though much less than the RBI mandated 70 per cent of NPAs have on average been provided for by Indian SCBs, the return on assets (RoA) and the return on equity (RoE) of the group fell between end-March 2015 and end-March 2016, from 0.8 to 0.4 per cent in the case of the former and from 9.3 to 4.8 per cent in the case of the latter. Underlying this profit squeeze was an 86 per cent year-on-year growth of risk provisions and a 27.3 per cent increase in write-offs, which together contributed to a 43 per cent fall in profits after tax. Given the uneven distribution of this hit across banks, 21 SCBs accounting for 37 per cent of the total assets of all SCBs recorded negative RoA values over financial year 2015-16.

The question that arises, therefore, is the manner in which the government, the RBI and the banks are aiming to address this problem. One option would be for the banks to treat the write-offs as merely "technical' and then try and recover as much of the value of these assets as possible, to strengthen their financial position. However, the experience here has been disappointing. Not only has total NPA reduction been flat between 2014-15 (Rs. 1,270 billion) and 2015-16 (Rs. 1,280 billion) when the sum of declared NPAs was rising, but much of this reduction has been the result of compromises or write-offs, which yield the bank little or nothing. NPA reduction is reported under three heads (actual recoveries, 'upgradation' or transformation of NPAs into paying assets, and compromises/write-offs). Write–offs involve a complete loss for the banks. According to Finance Ministry figures the share of write-offs in the NPA reduction of the public sector banks rose from an already high 41 per cent in 2014-15 to 46 per cent in 2015-16.

This is also a course for concern since NPAs are often a reflection of wilful default. In the fourth round of what has become a periodic exercise, the All India Bank Employees Association (AIBEA), the "oldest and largest" trade union in the industry, has released a list of 5,610 wilful defaulters on debt they owe commercial banks. The official listing of suit-filed accounts of wilful defaulters disseminated through the Credit Information Bureau (India) Ltd, reports 6,081 cases involving loans totaling Rs. 59,518 crore as of March 31, 2016.

The Reserve Bank of India (RBI) defines a wilful defaulter as one who has diverted bank loans to activities other than one for which they were originally taken, siphoned funds out with no corresponding assets of any kind to show in the books of the company or who has not repaid loans despite having adequate resources to meet commitments. Thus, the crucial issue here is not default *per se*, but default that is intentional, deliberate and calculated. This makes wilful default a criminal offence. A default that results from a wrong investment decision, sheer mismanagement or unexpected changes in the business environment of a firm that does not have the liquidity to meet payments commitments would not fall in the "wilful" category.

Despite this restricted definition, wilful defaults are large. The total default in the 5,610 accounts revealed by the AIBEA adds up to Rs. 58,792 crore. This amounts to around 11 per cent of total non-performing assets in the banking system at the end of March 2016. As many as 4,738 of these accounts accounting for Rs. 47,351 crore of wilfully defaulted loans are with the public sector banks (including the State Bank of India group). In an answer to a Parliamentary question in the Lok Sabha in December 2015, Finance Minister Arun Jaitley reported that in the case of loans of Rs.25 lakh and above from public sector banks alone, the number of cases of wilful default had risen by 44 per cent from 4929 at the end of March 2013 to 7265 at the end of September 2015, and the sum involved by a huge 150 per cent from Rs. 25,804 crore to Rs. 64,335 crore. Clearly, the credit boom during the years after 2004 has been exploited by a set of unscrupulous borrowers, who could avoid scrutiny because of the relaxation in scrutiny that is associated with a post-liberalisation debt spiral.

What is noteworthy about the numbers released by the AIBEA is that the top 106 borrowers (1.9 per cent of the total) responsible for wilful default on loans equal to or exceeding Rs. 100 crore each, together accounted for Rs. 23,093 crore or close to two-fifths (39.3 per cent) of the total sum in default as per this list. Clearly, the NPAs in the books of banks and the manner in which they are being addressed points a new form of primitive accumulation in India in the Age of Finance.

All of this points to the almost moribund nature of the new capitalism being shaped in India because of increased dependence on foreign finance. In the 1950s, there was near unanimity that winning a degree of autonomy vis-à-vis foreign capital was a prerequisite for consolidating India's political freedom. Today, many see recognition by foreign capital as a favoured investment destination as a measure of the country's economic success. But turning moribund and losing sovereignty at the expense of the working people seems to be the real consequence of the accumulated presence of foreign (especially financial) capital in the country since liberalisation.

The implication of this that an alternative development strategy that revives Indian manufacturing, ensures more jobs in industry and services and increases the State's contribution to social development and the reduction of social deprivation has to be based on reduced capital inflow and a resulting reduction in the influence of foreign finance on the development process. This requires capital controls. Hence, unless governments overcome the fear of tightening capital controls because of the short term impact in terms of capital flight, the prospects of an alternative will remain dim.