PSL Quarterly Review, vol. 67 n. 271 (2014), 423-450

Economic policy in India: for economic stimulus or for austerity and volatility?

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1. Introduction

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 that 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 goals 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 that 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 *necessarily* creates an equivalent level of additional savings at any given interest rate,[1] either by increasing

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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 'forced savings' by depressing the real wage, and hence 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 credit, see 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, with their claim that it generates inflationary consequences with 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, denies possible output expansions. Moreover, the argument ignores 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

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"Religious pluralism, cultural differences and social and institutional stability – what can we learn from India?" held at the Department of Political Sciences of Sapienza University of Rome, 9-10 June 2014. We thank Professors Tito Marci and Cristina Marcuzzo for the invitation as well as for their comments on the paper. We also offer our thanks to the other participants and to Professor Julio Lopez in particular for offering comments as a discussant. Finally, the comments from one referee of *PSL Quarterly Review* were of considerable help in improving the paper.

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

[2] See Hicks (1937).

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 (Pasinetti, 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 and Bank of International Settlements), 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, 2012).

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.

2. Monetarism in action: the 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.

[3] As for growth of GDP in the emerging economies, India, along with China and three more countries (Brazil, Russia and South Africa, together known as the BRICS countries),

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 (Reserve Bank of India, *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 allowed to FDI, free access of (foreign indirect investment or 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.

2.1. De-regulated 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

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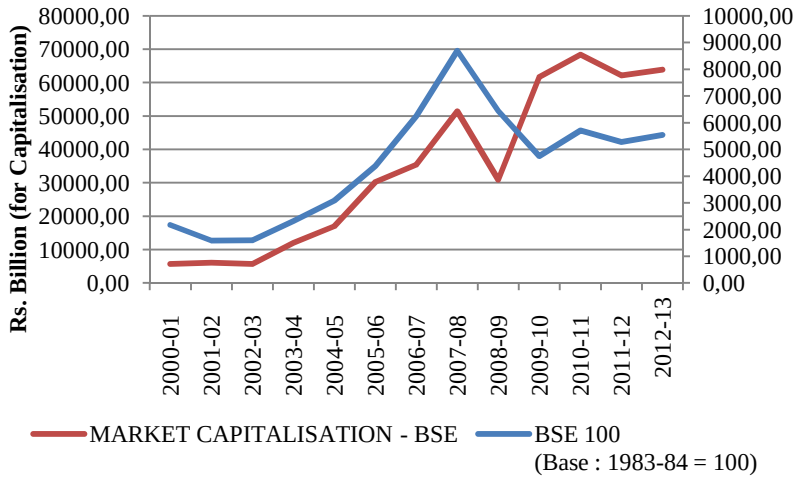
have consistently maintained growth rates much higher than those in the rest of world including the advanced economies. The BRICS countries have also maintained an impressive performance in terms of net FDI inflows, as recorded by the $425bn total FDI inflows on average during 2011 and 2012. Of the above, China alone accounted for nearly $200bn. See http://www.data.worldbank.org/.

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 (see 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 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 capitalisation*



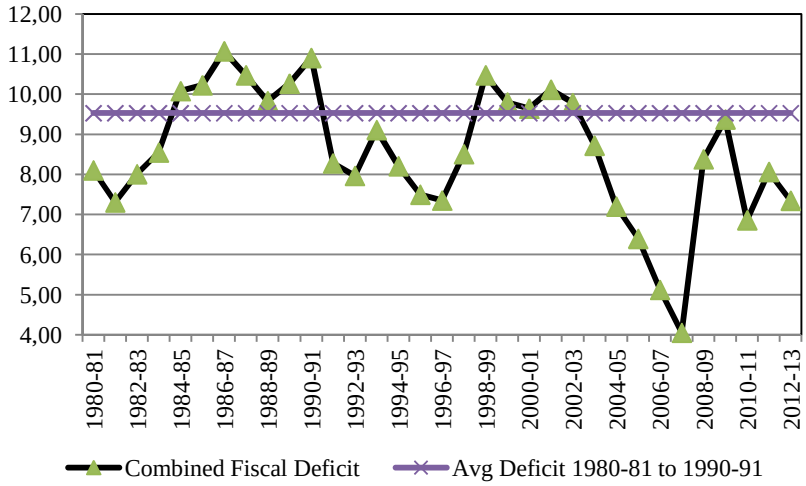
Source: Reserve Bank of India, *Handbook of Statistics on Indian Economy*.

2.2. 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.

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 2002-2003 to 2007-2008, 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 also in a large number of other countries between 2007-2008 and 2009-2010. 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 2009-2010 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 2010-2011.

Chart 2 – *Share of combined (centre and state) fiscal deficit in GDP*



Source: Reserve Bank of India, *Handbook of Statistics on Indian Economy*..

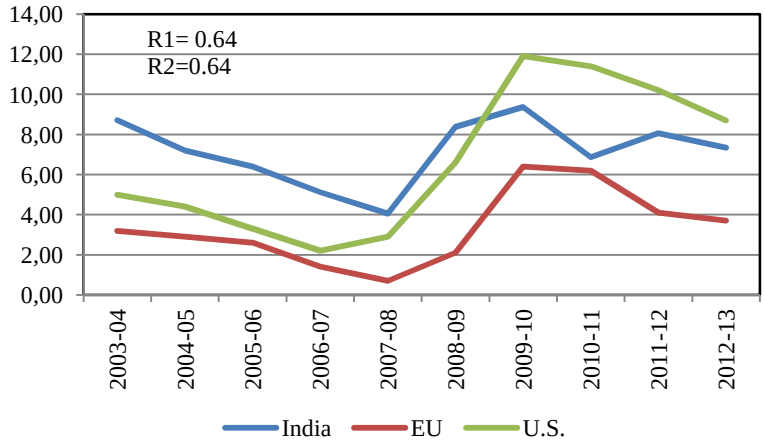
With the IMF providing the directive to cut fiscal deficits, the withdrawal of fiscal stimulus in 2010-2011 returned in India at roughly the same time as similar actions occurred in the US and in the EU. In fact, as reflected in chart 3, the fiscal deficit in India followed the same trend as those in 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 2012-2013 budget of the central government, which indicates an attempt to continue the restraint (chart 4).

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

[4] Fiscal deficit - interest payments = primary deficit.

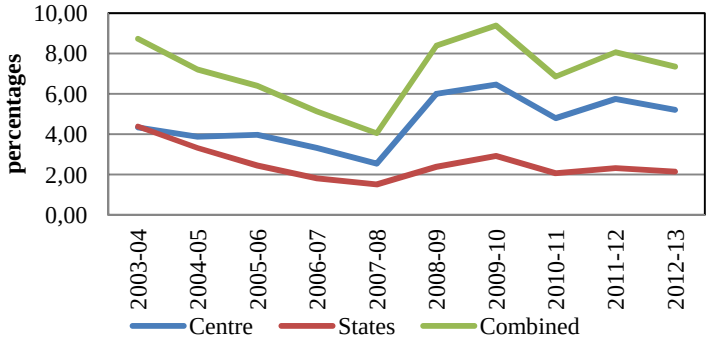
the market continuously increased the interest bill which soon became the largest component of expenditures in the fiscal budget (see charts 4, 5 and 6). As a result, the expenditures in the budget under other heads, and especially on capital expenditures and subsidies, turned out to be small as compared to interest payments.

Chart 3 – *Share of fiscal deficit in GDP for India, EU and U.S.*



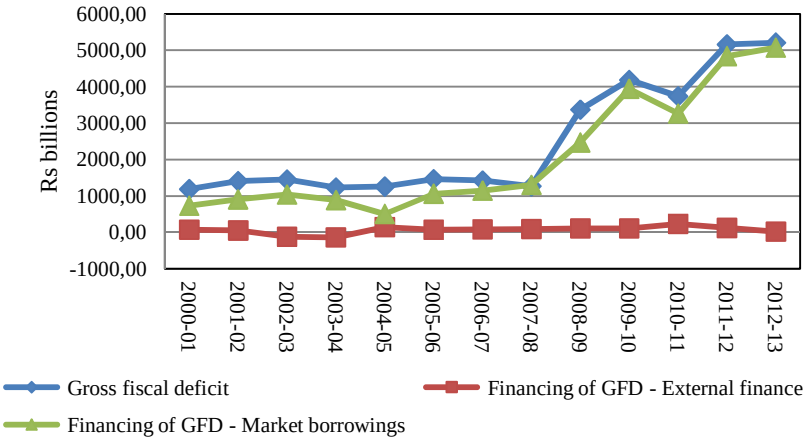
Source: Reserve Bank of India, *Handbook of Statistics on Indian Economy* and OECD, various publications.

Chart 4 – *Fiscal deficits as ratio of GDP*



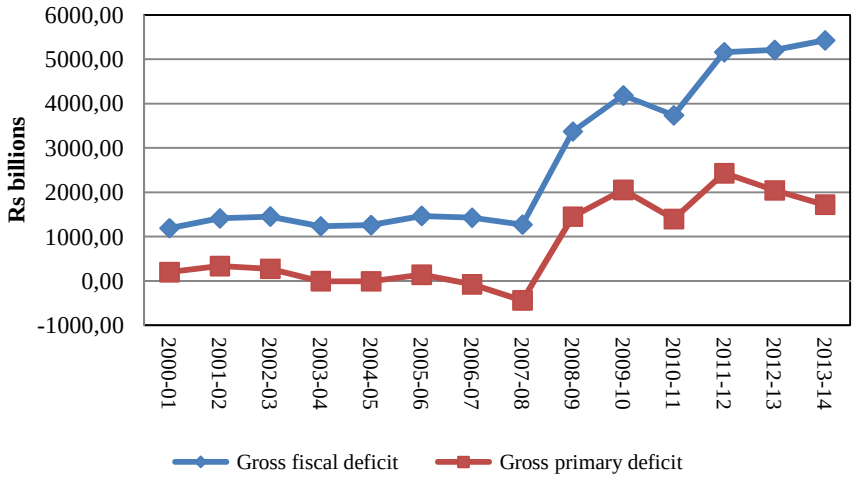
Source: Reserve Bank of India, *Handbook of Statistics on Indian Economy*.

Chart 5 – *Financing of gross fiscal deficit in central budget*



Source: Reserve Bank of India, *Handbook of Statistics on Indian Economy*.

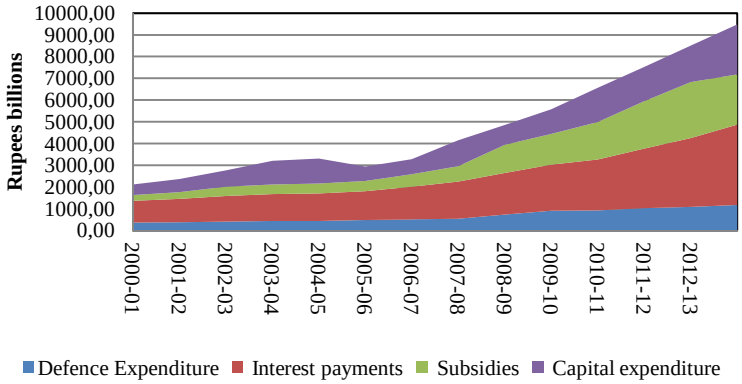
Chart 6 – *Gross fiscal and primary deficits*



Source: Reserve Bank of India, *Handbook of Statistics on Indian Economy*.

The temporary rise in subsidies, especially in terms of the stimulus administered between 2007-2009 and 2009-2010, 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 expenditures[5] for the social plus the rural sector (as in the budget). The rate, with the exception of a single year 2008-2009, failed to increase beyond the level attained in 2003-2004, the year when the FRBMA actually started (see chart 7). It is notable that despite the short-lived phase of a fiscal stimulus during 2008-2009 and 2009-2010, 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*

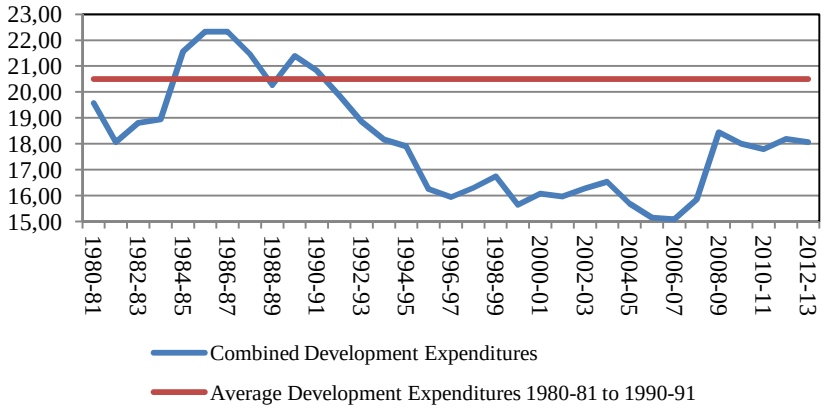


Source: Reserve Bank of India, *Handbook of Statistics on Indian Economy*.

[5] Rural Expenditures comprise expenditures on agriculture and allied services, fertilizer subsidy and power, irrigation and flood control. Social Sector Expenditures comprise of expenditures comprised of the items under the heading "Social and Community Services" in *Indian Public Finance Statistics*. Real Expenditures are calculated by deflating social and rural expenditures with a GDP Deflator. The GDP Deflator is calculated in the following manner: 100*(*GDP at Market Price*/*GDP at Constant Price*).

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 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.

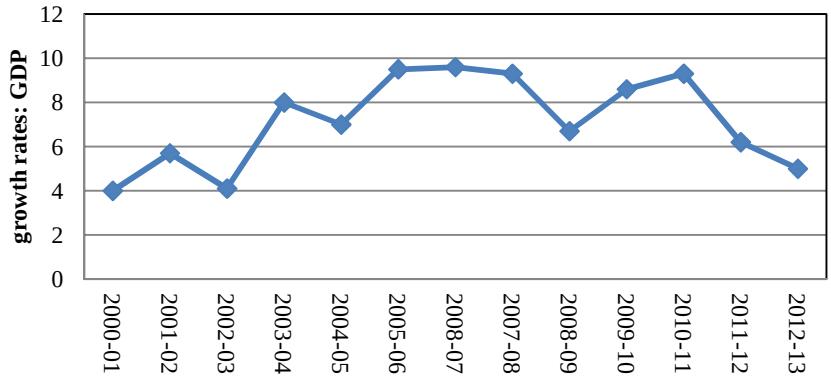
Chart 8 – *Share of combined development expenditures in GDP*



Source: Reserve Bank of India, *Handbook of Statistics on 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 offshore 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*



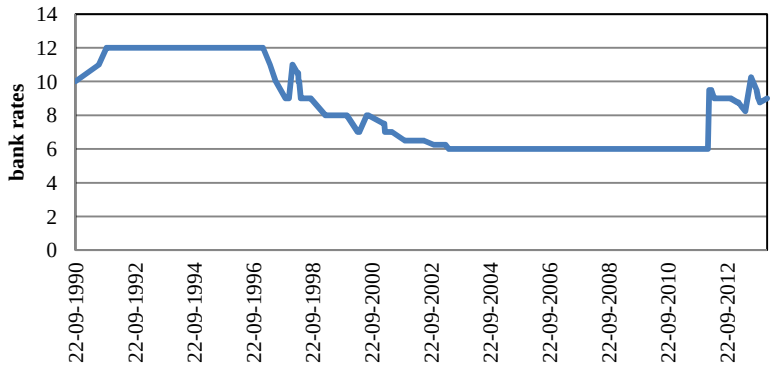
Source: Government of India *Economic Survey* 2012-13.

2.3. 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.

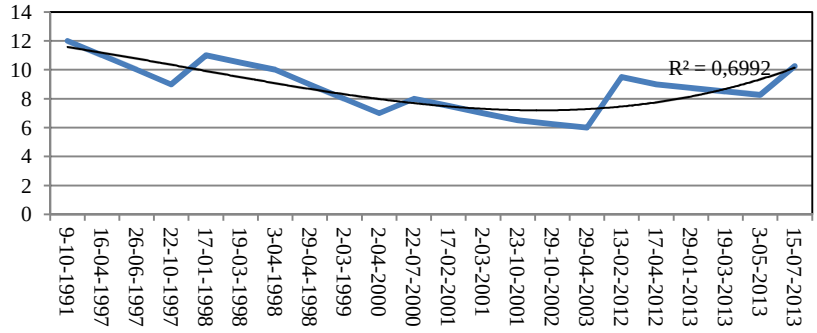
Thus, notwithstanding its proven inadequacy in controlling prices, monetary policy in India has continued to be conditioned by the norms of inflation targeting. This often necessitated a stop-go rhythm in its interventions in the credit market. The tools that were used included frequent adjustments, 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 Statistics on Indian Economy*.

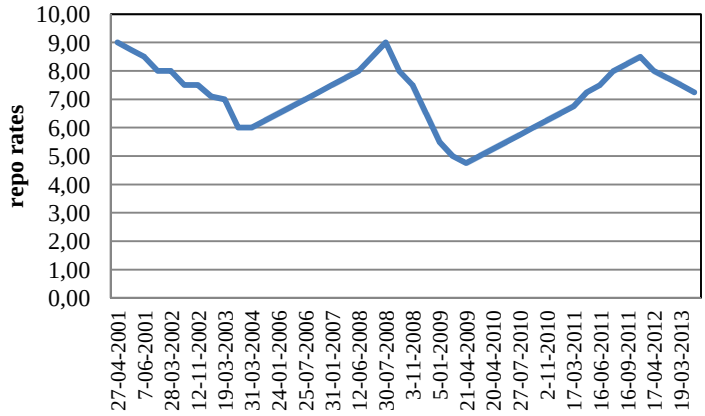
Chart 10b – *Bank rates*



Source: Reserve Bank of India, *Handbook of Statistics on 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 market[6] (see chart 11).

Chart 11 – *Repo rates*



Source: Reserve Bank of India, *Handbook of Statistics on Indian Economy*.

In 2000, an auction system of repos and reverse repos was introduced, to draw out as well as to inject liquidity into the market. Use also was made of the Monetary Stabilisation Scheme (MSS) which included measures like

[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.

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.

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:

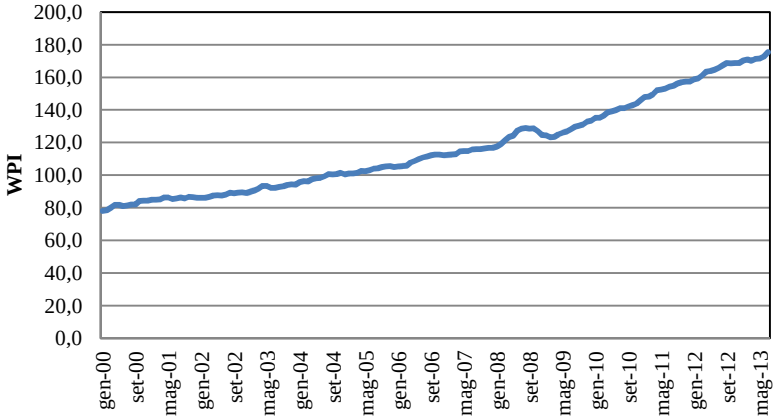
Phase I: 2003-08	High domestic growth; Rising inflation	Repo rate raised from 6 to 9 percent	CRR raised from 4.5 to 9 percent
Phase II: 2008-10	Growth drops with global financial crisis	Repo rate reduced from 9 percent to 5.25 percent	CRR was reduced from 9 percent to 5.75 percent
Phase III: 2010-12	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: 2012-13 and 2013-14	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
11 November 2013[7]		Repo rate raised from 7.50 percent to 7.75 percent	

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

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

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: Reserve Bank of India, *Handbook of Statistics on Indian Economy*.

2.4. Financialisation 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

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

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 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 liberalized capital inflows.

Between "austerity" measures to target inflation and the liberalized 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 capitalization as well as the rising stock prices, as observed in the Bombay Stock Exchange (BSE), provide an indication of the same pattern (see chart 12).

2.5. Financialisation and corporate investments

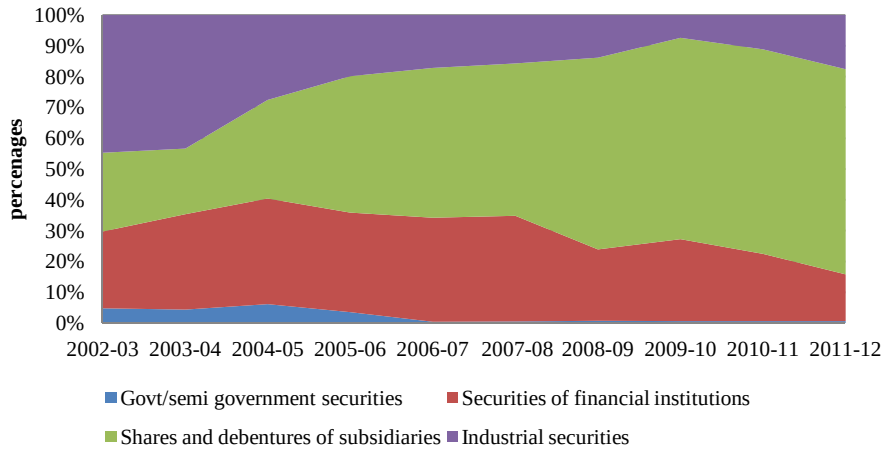
Financialization in combination with austerity measures provided a strong impetus to hold financial assets, both with good returns and prospects for capital gains. Tendencies of this can be identified in the pattern of investments by the corporate sector. As pointed out in connection with large corporates 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) (see also van Treeck, 2008 and Organhazi, 2008 on this point). 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 (chart 13). 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*

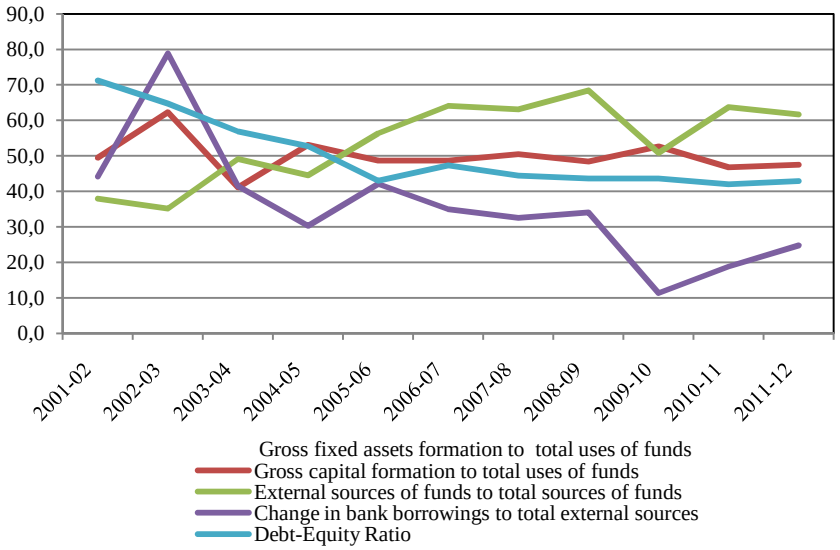


Source: "Survey of Non-Financial Public Limited Companies" in Reserve Bank of India Bulletins, various issues.

3. 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

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.

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", causes monetary policy[9] to lose autonomy in its choice of 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 the 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

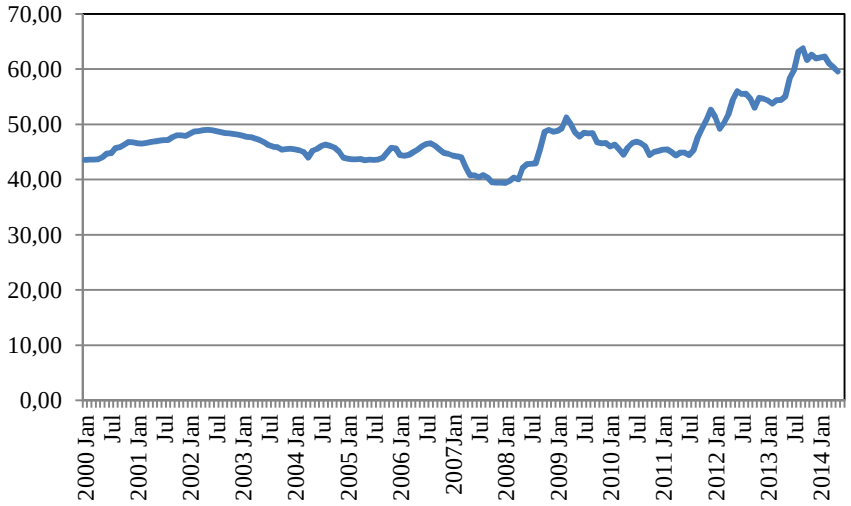
[9] See a more detailed analysis in Sen (2014).

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 that 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 $1 (US) in August 2013 to Rs. 68.3 on 28 August 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 competiveness of Indian goods in the domestic and overseas markets. The successive changes in these rates can be noticed from chart 15 below.

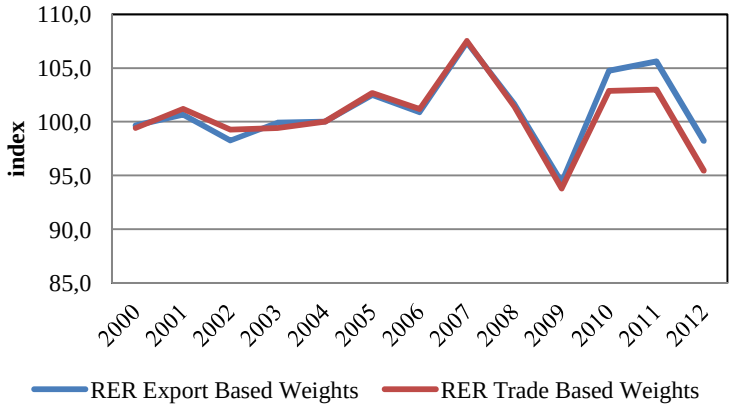
Successive rounds of deregulation of the capital account, which generated steady inflows of short-term capital to the country since the early 1990s, restrained monetary authorities from having full sway over what could otherwise be considered as appropriate from the perspective of domestic output growth, 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 competiveness 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), on which trading has been officially sanctioned since

Chart 15 – *Rupee-US$ nominal exchange rate*



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

Chart 16 – *Real effective exchange rate indicies of Rupee: 2004 =100*



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

2003. Trade in derivatives (especially currency futures) had a major presence in these transactions, both in stock markets as well as on the MCX.[10]

As for the other implications of tight monetary policy, the measures have contributed to a steep climb in bank rates over time and to the curtailing of credit, especially for the sensitive sectors like the poor and the small and medium-sized enterprises (SMEs). In particular, compliance with the Bank of International Settlements (BIS), which instituted the globalized norms for risk-adjusted credit, has intensified financial exclusion, especially for the poor and SMEs 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 the 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 than when compared to the fiscal deficit. However, expenditure in the primary budget, which includes defence (subject to strategic concerns), could be squeezed with reductions made in the remaining two areas, namely capital expenditure and subsidies. It may be pointed out that per capita growth rate (in real terms) of expenditures in the social and rural sectors actually fell (as a percentage of GDP) from 25% to (-) 2.5% within a year between 2008-09 and 2009-10, followed by reduced levels at 5.5% of GDP in 2011-12.

3. Concluding observations

This paper has dwelt on limitations of monetarism, both at the 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

[10] See Sen (2011a).

[11] For details of the impact of Basel II norms on credit supplied to the poor, see Sen (2011b).

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. As compared to Greece, one of the countries in southern Europe worst-hit by the crisis, 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 in the aftermath of the global financial crisis. This has prompted donors including the IMF and the international financial community (backed by the European Central Bank and the rich countries of the eurozone) to enforce strict fiscal and monetary discipline in the country. The multiple compulsions faced by the Greek authorities included first the rules of 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 mindset of those who controlled policies, with a leap in the direction of neoliberal strategies which gave free rein to global finance. As a consequence the latter enjoyed 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) and tax concessions on capital gains and for corporates as well as households. Thus the Indian state was found to be in a collaborative mood, or even a predatory one, eager to facilitate the above transformations. Little was done to arrest the related consequences in the

economy which included 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 policymaking in India which has tacitly accepted the related compulsions by foregoing other goals like growth of the economy or distribution of wealth as if they were of no concern. With a transformation like the one above India provides a classic case of tacit compliance which came without the compulsions (as could be identified in situations like an urgency to fetch conditional official loans to avoid an imminent bankruptcy) present in Greece and some other South European countries. The change was more subtle, with the silent acceptance by the ruling elite in the country of the "order" which falls in line for entry to the lucrative arena of global finance for rentiers all over the world.

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