In defence of financial globalisation

The argument that a country can be an active participant in global trade but avoid financial globalisation is fundamentally faulty

ILLUSTRATION: BINAY SINHA

The world now falls into one of three camps. There are the people who support both trade and financial globalisation. There are those who want state control and oppose both kinds of freedom. And there are some who think there should be freedom for trade but not for finance. In essence, the fear of financial globalisation is based on three arguments: Exchange rate distortions in recipient countries, the uncertainties associated with the global financial flows, and the loss of autonomy of monetary policy.

As an example, those opposed to financial globalisation point to the recent aggressive monetary tightening by the US Federal Reserve (and many other global central banks) and the consequential problems of developing country economies. When central banks of developed markets increase interest rates, global capital leaves developing countries, which induces currency depreciation and inflation. It is argued that events far away have needlessly rocked the tidy Indian boat.

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When North Korea chooses to not trade with the world, this protects North Korea from global trade shocks. On the other hand, engaging with the world means living with interdependence. The privilege of importing, say, the best global central processing units comes with vulnerability to price fluctuations and supply disruptions.

What would have happened had India remained like North Korea in blocking globalisation? The development of India's biggest industry —information technology (IT) — has been largely facilitated by trade globalisation and funded by foreign capital. When, a now celebrated IT company, did an initial public offering (IPO) in early 1993, the IPO was undersubscribed. The IPO was "bailed out" by a well-known US investment bank, which picked up a substantial equity stake at the offer price. Later, the shares of this company were listed on the NASDAQ stock exchange in 1999 as American depositary receipts. The rest, as they say, is history.

This example was the first of many Indian knowledge entities, relatively light on physical assets, which were able to raise vast amounts of capital. This would not have been possible without financial globalisation. Indian financiers did not understand the Indian IT industry until it was well established. Whether venture capital, private equity or IPO, at each stage of maturity, foreign finance played a significant and disproportionate role in taking risks until a category was well established. Similarly, it's hard to imagine the rise of large-scale renewable energy investment in India without giving a prime role to foreign capital, with overseas ESG funds leading the way.

Let's now turn to the three arguments against financial globalisation.

Argument 1: Should we worry about exchange rate distortions? We need to remember that the exchange rate is one more price and the free market knows how to find the correct price. We should question any official or economist who thinks she knows the correct price for steel, electricity, petrol or an exchange rate. Prices move up and down in all markets, to keep demand and supply in balance.

As in all markets, there are participants who do not like certain levels of price volatility. For them, the financial system offers to sell protection (for a fee). Those who desire the peace and stability of fixed price can get that for a price — by exchanging the variable prices that they face for a fixed price and a fee. These are decisions for each individual or each firm to make, akin to a decision to buy fire insurance. Tapping these markets for risk does require sound thinking in financial economic policy, and there is much to do on this front in India.

Argument 2: On the uncertainties associated with global engagement, financial globalisation is not really different from trade globalisation. Both these come at a price, of a new set of uncertainties, but bring immense benefits alongside them. What is required is better thinking and more capable state institutions on our side, which are able to cope better with this uncertainty.

Argument 3: What about the problem of the loss of autonomy of monetary policy? This is also well understood. Countries like India have adopted inflation targeting to solve this very problem: When the Reserve Bank of India (RBI) organises itself to target 4 per cent Consumer Price Index inflation, this cuts off the pathway of RBI targeting the exchange rate through which overseas developments would interfere with monetary policy autonomy.

Let us glance at the sheer magnitudes of financial capital that now move across the Indian border. In 2021-22, $776 billion came into India and $738 billion left India. These are vast amounts of money, which touch a diverse array of firms and households all across the country. To try to close these down would be hugely disruptive. Similarly, on the current account, there was an inflow of $798 billion and an outflow of $837 billion. Some might hanker for the good old days when India was more like North Korea, but we should appreciate how far we have come.

Why did flows on both the current and the capital account become so big? An old idea in this field is "finance follows trade". Once international trade comes about, this creates the need for financial flows in the form of trade credit, currency risk management, foreign direct investment, etc. Global supply chains and sophisticated production and trade arrangements of multinational companies necessarily require sophisticated financing structures and instruments. It is only a theoretical construct in the minds of some economists, where trade can flourish even when the state interferes with finance.

In the 1960s, mainstream economists thought that they knew what the correct price of steel should be. While that age is long past, many economists continue to think they know what the correct exchange rate should be. Once we get past these notions, the intellectual paradigm for freedom on both the trade and finance side will become well entrenched. Every advanced economy today has very high levels of cross-border freedom. Open financial borders are integral to India's aspirations for growth and prosperity.

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