

# **Managing Current Account Deficit: Cross Country Experience From Developing Countries**

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## **Managing Current Account Deficit: Cross Country Experience from Developing Countries**

### **1. Introduction**

Definitionally, a current account deficit would mean that the country is importing more goods and services than it is exporting. This can be financed by capital inflows or drawdown of foreign exchange reserves. Since, the current account can be expressed as the difference between national savings and investment, a current account deficit would be reflective of a low level of national savings relative to its investment. Interestingly, in a world with completely flexible exchange rate, there cannot be any prolonged period of CAD. After all, if a country has CAD, its exchange rate vis-a-vis its trading partner will depreciate and consequently its exports are cheaper and its imports are expensive so as to bridge the gap in the current account balance.

However, all over the world, instance of imperfect flexibility in exchange rate is quite common and from a purely mercantilist point of view, a current account deficit is often associated with a country's weaknesses on trade front vis-a-vis its trading partners – a view gets acceptance in political parlance. Thus, it becomes quite expensive for any country to withstand ant prolonged CAD – both economically and politically.

It is in this context that the present research report will make an attempt to understand the causes of CAD, and in its light narrate the experiences of select countries and suggest the course of actions in the Indian policy space.

The rest of the paper is organized as follows. Section 2 is devoted to principles of CAD management and Section 3 takes up the sample of countries. Sections 4 and 5 are devoted to country experiences of select Latin American and Asian economies, respectively. Both longer-term trends and recent experience of Indian BoP is taken up in Section 6. In lieu of presenting the concluding observations, section 7 discusses future lessons for India.

## **2. Principles of CAD Management**

An interesting unresolved issue in this context is the relationship between current account balance (CA) and capital account balance (KA). The balance of payments (BOP) equilibrium condition can be written as:  $CA + KA - \Delta R = 0$ , where  $\Delta R$  is the change in forex reserves (with  $\Delta R < 0$  implying reserve accumulation and  $\Delta R > 0$  implying drawdown of reserves). Of course, with full flexibility of the exchange rate and in a reserve currency issuing country the importance of  $\Delta R$  would be minimal. The typical Indian case (for most of the years since 2000) may be characterised as:  $CA < 0$ ,  $KA > 0$  and  $\Delta R < 0$  with some two-way flexibility of the exchange rate. The relationship between CA and KA is complex and conceptually, there are elements of simultaneity in their relationship. Hence it would be erroneous to ascribe the causality from CA to KA or other way round. While the exchange rate, global growth, domestic growth, terms of trade and exports and imports restrictions can all influence CA, major determinants of KA would include factors such as, country-risk adjusted return, domestic and global growth, and restrictions on inward and outward foreign investment.

Is large and persistent CAD current account deficit a cause for concern? Are these countries living beyond their means? The traditional arguments run as follows. First, countries with persistent CAD could be on a path to insolvency, building up excessive net foreign debt, raising the prospects of default and/or a sharp reversal in capital flows, which might force an abrupt and costly adjustment. Second, large deficits and rising indebtedness could leave countries more vulnerable to adverse external shocks (including a change in sentiment of foreign creditors). Third, it could reflect the extent of competitiveness of the country and could

reflect underlying saving-investment pattern. Thus, in the conventional wisdom national authorities should take appropriate policies to reduce CAD.

There is, however, a diametrically opposing argument that, so long as markets are efficient, current account deficits reflect the optimal decisions of borrowers and lenders. Therefore, policy intervention to reduce deficits is not only unwarranted but could reduce welfare. Moreover, policies that attempt to rein in deficits may be ineffective, while policies to improve market efficiency and enhance welfare could lead to higher current account deficits.

Interestingly, in some quarters the “Lawson doctrine” (named after Nigel Lawson, the British Chancellor of the Exchequer in Margaret Thatcher’s cabinet during the 1980s) is quite popular. As per this doctrine, as long as the current account deficit reflects the saving – investment imbalances of the private agents, it is not alarming (perhaps in line with the Ricardian equivalence); however, when it is accompanied by fiscal deficit, CAD is bad.<sup>1</sup> Admittedly, this notion springs primarily from a philosophy of fiscal fundamentalism and hence may not have much relevance. Of course, if the fiscal deficit is largely financed by sovereign borrowing in the global market (denominated in a foreign currency) and is subscribed by foreign entities then such fiscal deficit can be linked to capital inflows. To the extent surplus in capital flows (via sovereign debt) can induce an economy to undertake a CAD, the two deficits

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<sup>1</sup>As per Ricardian equivalence, it will not matter for a rational and altruistic individual whether government finances happen through debt or taxation. After all, when a rational altruistic representative individual has a strong bequest motive, her utility will not only depend upon her current consumption but consumption of all the future generations. In such a situation, the individual will be indifferent between the situations of debt-financed and tax-financed government expenditure. After all, in such a situation the individual would view debt as equivalent to future taxation on the subsequent generations. But as far as the saving-investment imbalance of the private individual is concerned, rationality would mean that this imbalance is an outcome of the individual’s inter-temporal optimization decision and one need not worry about it.

can be interlinked.<sup>2</sup> The empirical literature has, however, mostly concluded that the link between the FD and CAD is weak or non-existent (Bussière and others, 2010).

Thus, in the traditional wisdom a persistent CAD is perhaps indicative of economic malaise in a country and calls for policy interventions. What then are the options for managing CAD? One can in fact think of a flow chart (Figure 1) giving some sequential choice of policy options. First and foremost, the policy maker needs to ask the question: Is the exchange rate near equilibrium? If not, the country can allow exchange rate depreciation so as to wipe out the CAD. However, if for some reason, exchange rates regime of the country does not allow its downward movement then the country needs to have conscious attempt to reduce trade balance via encouraging exports, discouraging non-essential imports or easing domestic supply constraints. Besides, if the country has a significant Diaspora, then remittances could be encouraged. Finally, such deficit in current account could be counterbalanced by capital inflows – either from foreign investment (direct or portfolio) or from foreign loans (commercial or Sovereign).

Interestingly, there is no established hierarchy of policy choices. Faced with the problem of persistent CAD, a country can adopt all these policies simultaneously, depending upon its objective condition. Illustratively, when Indian CAD reached 5 percent of GDP in mid 2013, a barrage of measures were undertaken, such as, restrictions on gold imports or opening a line of credit on oil marketing companies.

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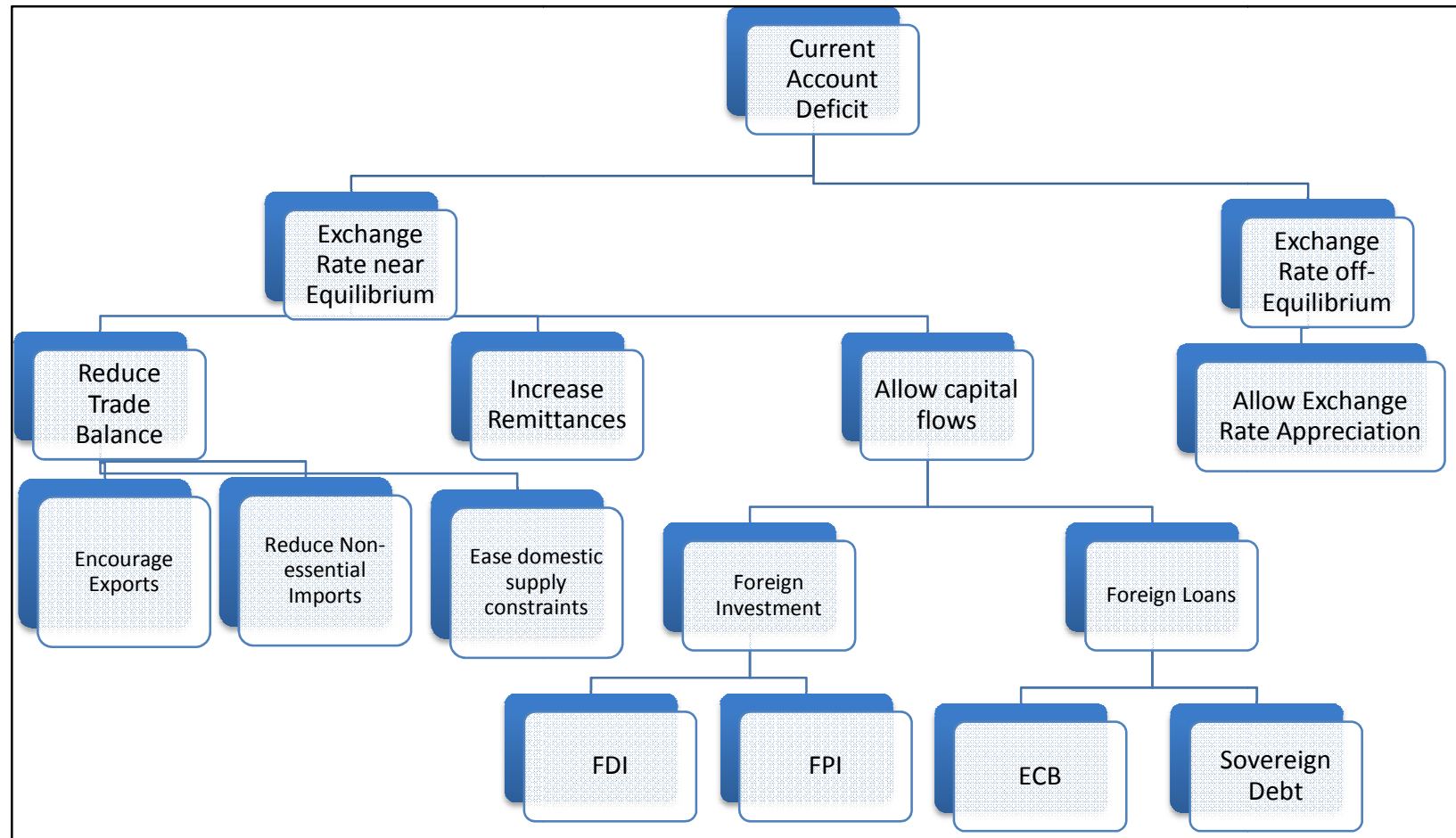
<sup>2</sup> Parenthetically, one may note that in some sense, this is the situation in a number of Euro area crisis countries

At this juncture, a caveat is in order. The inability of a country to incur persistent CAD is valid in case of a non-reserve currency issuing economy. For a reserve-currency issuing economy the logic gets topsy-turvy. Illustratively, for the US, continuation of huge CAD has been on the strength of U.S. dollar. This phenomenon that has been termed as an “exorbitant privilege” by Barry Eichengreen, who went on to say:

“Insofar as foreign banks and firms value the convenience of dollar securities, they are willing to pay more to obtain them. Equivalently, the interest rate they require to hold them is less. This effect is substantial: the interest that the United States must pay on its foreign liabilities is two to three percentage points less than the rate of return on its foreign investments. The U.S. can run an external deficit in the amount of this difference, importing more than it exports and consuming more than it produces year after year without becoming more indebted to the rest of the world. Or it can scoop up foreign companies in that amount as the result of the dollar’s singular status as the world’s currency.

This has long been a sore point for foreigners, who see themselves as supporting American living standards and subsidizing American multinationals through the operation of this asymmetric financial system. Charles de Gaulle made the issue a *cause célèbre* in a series of presidential press conferences in the 1960s. His finance minister, Valéry Giscard d’Estaing, referred to it as America’s “exorbitant privilege.” (Eichengreen, 2011; p.4).





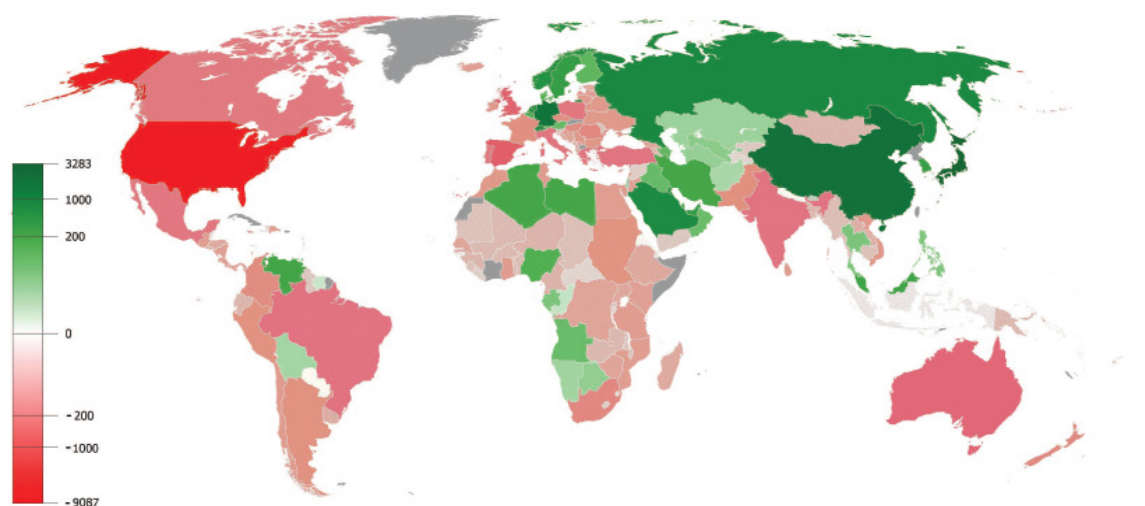
**Figure 1: Policy Options for financing Current Account Deficit**

### 3. Sample of Countries

#### *Taxonomy of Developing versus Developed Country*

Of the 184 member countries of the IMF for which data are available, in 2011, 127 countries have CAD and rest 57 countries have CAS. Of these 127 countries, if we define significant countries as one whose share is more than 0.5 percent of the global GDP, then we are left with 9 EMs, viz., Colombia; Egypt; South Africa; Argentina; Poland; Turkey; Mexico; Brazil; and India. Of these countries, we have focused our attention to comparatively bigger countries and those which faced a crisis-like situation out of unsustainable CAD viz., Argentina; Mexico; Brazil; and India. However, apart from these countries, for historical reasons we went back to the period of 1980's and 1990's and have taken three more countries in Asia those were affected by the East Asian crisis, viz., Thailand, Malaysia and Indonesia.

**Chart 3.1: Cumulative Current Account Balances Around the World: 2008-2012**



Note: The graph shows for each country the sum of current account balances in billions of U.S. dollars between 1980 and 2012.

Source: International Macroeconomics/ Stephanie Schmitt-Groh and Martin Uribe, 2014.

Thus, in order to have policy messages that are relevant for India, we choose to drop Colombia, Egypt, Poland, Turkey and Chile. We also neglected South Korea as it is part of OECD and is treated as an advanced country in IMF classification.

In sum, our sample countries comprise of the followingsix large (relatively speaking) economies:<sup>3</sup>

- 1) Argentina;
- 2) Brazil;
- 3) Mexico
- 4) Thailand;
- 5) Indonesia; and
- 6) Malaysia

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<sup>3</sup>We, thus, neglect smaller economies like Chile or economies with which India has little commonality like Poland or Turkey. I am indebted to an anonymous referee for inputs on selection of countries.

## **4. Experience of Select Latin American Countries**

### **4.1 Some General Trends**

As far as Latin American countries are concerned, two key features may be noted at the very outset. First, many of these countries are commodity exporters – iron ore, crude petroleum, copper, sugar, and banana. Second, it may not be an exaggeration to note that with increasing financial and capital account liberalization, an increasing trade / current deficit was found to be feasible to be serviceable. However, since capital flows followed boom-bust cycles in most of these countries, currency and financial sector crises also became increasingly frequent, in these countries. Latin America, especially in the Southern Cone countries<sup>4</sup> had followed this pattern of liberalization and crises since the late 1970s (French-Davis and Griffith-Jones, 2011). Thus the period under consideration 1980 – 2013, these countries were affected initially by the Latin American debt crisis of the 1980s, followed by the Mexican peso crisis and finally the global financial crisis and the great recession since 2007.

In the early 1980s, most of the Latin American countries faced massive balance of payments problems due to the rise in international interest rates and the interruption in access to foreign finance. Consequently, most of the countries reoriented their macroeconomic policies and resorted to significant devaluations. They also oriented their monetary and fiscal policies towards the management of fiscal and external disequilibria (Frenkel and Rapetti, 2011). Subsequently, the change in the international financial conditions had begun around 1989 and since then Latin American countries experienced had another turning point. Capital

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<sup>4</sup>Comprising Argentina, Chile, Paraguay, Uruguay, Southern Brazil and the Brazilian state of São Paulo.

inflows to the region peaked in 1993 and then fell in 1995 as a consequence of the Mexican crisis; it grew again until the eruption of the Asian and Russian crises in 1997–8. During the first decade of 2000, number of Latin American countries intervened significantly in the forex market so as avoid substantial NER depreciations. Between 2004 and 2008, Latin American economies experienced unprecedented surge in capital flows.

Interestingly, as far financing the current account deficit by capital inflows is concerned, the links of these countries with international capital markets were largely severed as a result of the debt crisis in 1980s. After all, most these countries had Sovereign debt. However, the region enjoyed an expansion of capital flows during 1991–4, from mid-1995 to 1997, in the mid-2000s, and again from mid-2009. It is interesting to note what two commentators went on to say:

“At the beginning, these surges, especially in the early 1990s, were most welcome because they overcame a binding external constraint that was contributing to low investment levels and to a severe economic recession in the region; but they later became excessive, and contributed to the vulnerability that was revealed when the Asian crisis hit Latin American Countries. On the four occasions, these increasing inflows generated an unwelcome and distorting effect on real macroeconomic balances (French-Davis and Griffith-Jones, 2011).

In fact, it is well-documented that that these Latin American economies suffered from five types of vulnerabilities, viz., (i) high external liabilities, with a large short-term share; (ii) significant current account deficits; (iii) appreciated exchange rates and currency mismatches;

(iv) high prices of domestic financial assets and real estate; and (v) sizable increases in money supply as counterpart of the accumulation of international reserves (French-Davis 2006).

In terms of episodes, the period 1977-2003 was marked by current account deficit (Table 4.1). This was primarily financed by net capital inflows with portfolio investment being predominant during 1992-94 and 1996-97. During the first decade of the 21<sup>st</sup> century, however, current account balance turned into a surplus reflecting the commodity boom.

**Table 4.1: Latin America: composition of financing of Current Account**

	Percentage of trend GDP	1977– 81	1982– 90	1991	1992– 4	1995	1996– 7	1998– 2003	2004– 6	2007	2008	2004– 8
1	Current account	-3.9	-1.3	-1.4	-3.0	-2.3	-2.9	-2.1	1.2	0.5	-0.8	0.7
2	Trade balance	-1.5	2.4	0.4	-1.5	-0.7	-1.2	-0.7	2.2	1.4	0.4	1.7
3	Net capital inflows	4.6	1.5	1.9	3.6	1.7	4.5	1.6	0.1	3.0	1.6	1.0
4	Net FDI	0.8	0.6	0.9	1.1	1.6	2.8	2.9	1.5	2.5	2.5	1.9
5	Portfolio	0.2	0.0	1.3	3.9	0.2	2.1	0.1	-0.1	1.8	-0.3	0.3
6	Other capital	3.5	-1.8	-0.4	-1.2	0.4	-0.1	-1.1	-1.1	-1.0	-0.6	-1.0
7	Reserves accumulation	0.7	0.0	1.4	0.9	1.4	1.1	0.0	1.1	3.5	0.9	1.5
Source: French-Davis and Griffith-Jones, 2011												

With this background, let us now turn to each of the major Latin American countries in our sample.

## **4.2 Argentina**

Argentina had a turbulent political history till recently. In fact, until the 1980s, military regimes had a tendency of coming back, so much so that, "Between 1916 and 1989, there were no transfers of power from a democratically elected president to a democratically elected president of another party" (Saxton, 2003).

To put the things in perspective, it may be noted that President Menem initiated a series of economic reforms during 1989-1994. A cornerstone of the macroeconomic policies was the Convertibility Law (with effect from April 1, 1991), which ended the hyperinflation by establishing a pegged exchange rate with the U.S. dollar.<sup>5</sup> Argentina was badly hit by Mexico's currency devaluation of December 1994—the so-called tequila crisis and Argentina suffered a sharp recession in 1995. Around this time, the government strengthened the financial system by large-scale privatization of banks owned by provincial governments, which was doing badly.

The period 1995-1998 witnessed an overly optimistic view of Argentina's growth potential. This resulted in some sort of "deflected attention from the underlying public sector debt dynamics that resulted in the federal government's financing needs doubling between 1995-1998 to about US\$20 billion" (Saxton, 2003). Interestingly, Private creditors held

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<sup>5</sup>The exchange rate was initially 10,000 Argentine australes per dollar; on January 1, 1992 the peso replaced the austral at 1 peso = 10,000 australes = US\$1. In fact, Argentinians started using dollars freely, and the country developed a "bimonetary" system in which usage of dollars in loans and bank deposits became widespread (Saxton, 2003).

more than 70 percent of Argentina's sovereign debt; the remainder was held by official creditors, mainly the IMF. This financing pattern made the Argentine economy extremely vulnerable and the economy slipped into a prolonged recession since 1998.<sup>6</sup> Consequently, spreads on Argentina's sovereign bonds rose by some 250 to about 750 basis points above US Treasuries between July-December 1998. The period 1999-2000 was marked by negative growth (Table 4.2).

**Table 4.2: Argentina: Select Macroeconomic Indicators**

	Current Account Balance	GDP Growth	Investment	Savings	Inflation	Volume of imports of goods & services	Volume of Imports of goods	Volume of exports of goods & services	Volume of exports of goods	Govt Deficit (% of GDP)	Govt gross debt
Units	(% of GDP)	(%)	(% of GDP)	(%)	(%)	(% change)	(% change)	(% change)	(% change)	(% of GDP)	(% of GDP)
1980	-1.2	0.7	25.2	23.2	100.8	41.5	67.8	43.2	33.2	n/a	n/a
1981	-3.4	-5.7	22.6	20.4	104.5	-8.2	-20.5	5.2	7.9	n/a	n/a
1982	-3.5	-3.1	21.7	19.4	164.8	-42.6	-24.7	3.9	6.7	n/a	n/a
1983	-2.3	3.7	20.8	19.0	343.8	-6.9	-28.5	2.6	5.6	n/a	n/a
1984	-2.1	2.0	19.9	18.2	626.7	4.7	14.2	-2.6	8.1	n/a	n/a
1985	-1.1	-7.0	17.5	19.3	672.2	-13.0	-19.0	15.6	2.6	n/a	n/a
1986	-2.7	7.1	17.4	18.1	90.1	18.5	17.5	-10.0	-12.7	n/a	n/a
1987	-3.9	2.5	19.5	16.2	131.3	11.4	13.3	-3.5	-9.6	n/a	n/a
1988	-1.2	-2.0	18.6	17.4	343.0	-9.2	-15.3	18.7	20.4	n/a	n/a
1989	1.3	-7.0	15.5	16.8	3079.5	-16.4	1.0	7.5	34.6	n/a	n/a
1990	3.3	-1.3	14.0	17.3	2314.0	-0.7	-24.7	16.8	4.8	n/a	n/a
1991	-0.2	10.5	14.6	14.4	171.7	75.6	104.5	-5.1	-0.3	n/a	n/a
1992	-2.8	10.3	16.7	13.9	24.9	66.5	76.7	2.1	5.2	n/a	n/a

<sup>6</sup>Several other factors contributed to the downturn, including a cyclical correction, political uncertainties, and financial contagion from Russia's August 1998 debt default and Brazil's 1999 devaluation of the real.



**Table 4.2: Argentina: Select Macroeconomic Indicators**

	Current Account Balance	GDP Growth	Investment	Savings	Inflation	Volume of imports of goods & services	Volume of Imports of goods	Volume of exports of goods & services	Volume of exports of goods	Govt Deficit (% of GDP)	Govt gross debt
1993	-3.4	6.3	19.7	15.7	18.5	13.4	13.4	2.4	2.4	n/a	30.1
1994	-4.3	5.8	20.0	15.6	4.2	26.7	26.7	17.4	17.4	n/a	31.8
1995	-2.0	-2.8	18.6	18.0	3.4	-11.5	-11.5	25.6	25.6	-2.3	34.4
1996	-2.5	5.5	19.6	15.6	0.2	19.5	19.5	6.4	6.4	-3.1	36.4
1997	-4.1	8.1	20.8	15.2	0.5	30.0	29.9	15.1	15.1	-2.1	35.4
1998	-4.8	3.9	21.0	15.1	0.9	9.9	9.5	12.7	12.8	-2.0	38.2
1999	-4.2	-3.4	17.8	13.8	-1.2	-16.0	-15.9	-2.1	-2.2	-4.1	43.5
2000	-3.1	-0.8	17.5	13.1	-0.9	-2.4	-2.4	1.9	1.9	-3.6	45.6
2001	-1.4	-4.4	15.6	12.8	-1.1	-16.6	-17.2	6.1	6.2	-6.0	53.6
2002	9.0	-10.9	10.8	20.9	25.9	-53.6	-53.2	0.2	0.0	-15.9	165.0
2003	6.4	9.0	14.1	21.4	13.4	48.9	49.8	5.0	5.2	-4.4	139.4
2004	1.8	8.9	18.6	20.9	4.4	51.2	50.4	0.0	-0.1	-2.9	127.0
2005	2.6	9.2	20.8	24.0	9.6	18.3	18.4	11.2	11.2	-1.8	87.1
2006	3.4	8.5	23.0	26.7	10.9	12.9	12.7	4.5	4.5	-1.1	76.4
2007	2.6	8.7	24.1	26.7	8.8	22.1	22.2	6.0	6.0	-2.1	67.4
2008	1.8	6.8	25.1	25.2	8.6	14.5	14.1	-0.9	-0.9	-0.9	58.5
2009	2.5	0.9	21.2	23.4	6.3	-23.9	-23.6	-10.7	-10.7	-3.6	58.7
2010	0.3	9.2	24.4	22.2	10.5	39.9	40.2	13.9	14.3	-1.4	49.2
2011	-0.6	8.9	26.1	22.0	9.8	22.3	22.1	3.4	3.3	-3.5	44.9
2012	-0.1	1.9	23.9	21.7	10.0	-5.9	-6.2	-6.2	-6.4	-4.0	47.7
2013	-0.9	4.3	24.2	21.4	10.6	5.1	5.3	4.6	4.8	-3.5	46.9

Source: IMF World Economic Outlook Database, April 2014

As the crisis became deeper, Argentina negotiated with the IMF for a loan to allay fears of a possible debt default. By Fall 2000, Argentina effectively lost access to voluntary sources of

financing and approached the IMF for "a substantial augmentation of financial support under the Stand-by Arrangement approved in March 2000, which up to that time had been treated as precautionary" (IMF, 2004). In response, from January to September 2001, the IMF made three decisions to provide exceptional financial support to Argentina, totaling its commitments to \$22 billion. In December, however, the fifth review of the program was not completed, which marked the effective cutoff of IMF financial support. The decision to augment the existing arrangement, approved in January 2001, was based on the diagnosis that Argentina faced primarily a liquidity crisis and that any exchange rate or debt sustainability problem was manageable with strong action on the fiscal and structural fronts. After the September augmentation, economic activity and market confidence continued to collapse, making the achievement of the program's targets and the salvage of convertibility virtually impossible. While aware of this predicament, the IMF did not press the authorities for a fundamental change in the policy regime and announced in early December that the pending review under the Stand-by Arrangement could not be completed under the circumstances. Within a month of this announcement, "economic, social, and political dislocation occurred simultaneously, leading to the resignation of the President, default on Argentina's sovereign debt, and the abandonment of convertibility, soon followed by government decisions that further amplified the costs of the collapse of convertibility" (IMF, 2004). In those circumstances, the IMF was unable to provide much help and largely stood by as the crisis unraveled.

Mr. Cavallo was called by President de la Rúa in March 2001 to become the Finance Minister. Cavallo in fact initiated various heterodox initiatives - the most important of which was the voluntary mega swap of nearly US\$30 billion in Argentine government debt at the end

of May aimed at getting, "temporary breathing space by reducing some US\$12 billion in debt service obligations falling due in 2001-2005, but at a very high cost of additional payments of about US\$66 billion in later years(Saxton, 2003)."

By October, the value of Argentine sovereign bonds plummeted further, with spreads rising above 2,000 basis points. Finance Minister Cavallo announced a two-phased approach to debt restructuring.

- Phase I of the operation was directed at domestic holders of Argentine government debt, primarily banks and pension funds, who were strong-armed into accepting domestic guaranteed loans with lower interest rates and longer maturities. This involved the exchange of US\$42 billion of federal bonds, or about 65 percent of the total eligible amount.
- Phase II bonds amounted to almost US\$58 billion, but this exchange which was aimed mainly at external creditors was never completed.

On September 20, 2003, the IMF's Executive Board meeting in Dubai ahead of the joint World Bank/IMF Annual Meetings approved a 3-year, US\$12.5 billion Standby Arrangement for Argentina.

Unfortunately Argentina's prolonged current account deficit financed by private capital flows and Sovereign debt is continuing till date. However, with the exception of global financial crisis, Argentina's economy grew robustly during 2003 through 2011 with the government running a fiscal surplus during 2003 - 2008. Nevertheless, there has been a continuing erosion

of the fiscal position with the balance turning to deficit in 2009 and thereafter. Argentina continues to face difficulty in maintaining its foreign reserves position. Apart from the fact that it has not been able to borrow internationally since the 2001 default, portfolio and FDI flows have been limited in the country. Thus, Argentina is unable to withstand its borrowing constraints that require Argentina to have a current account surplus or small deficit. Interestingly, most of the doomsday predictions of the global investors have turned out to be untrue for the Argentine economy. Notwithstanding the fact that specter of Sovereign debt default is yet to leave Argentina, the country has experienced impressive growth in the recent past that has been attributed *inter alia* to high prices for Argentina's soy and other commodities, due largely to demand from China.

#### *Some Lessons*

What are the lessons from the Argentine experience for India? IMF (2004) has enumerated a number of lessons for the IMF that is discernible from the Argentine experience. Some of them are relevant for countries like India facing current account deficit.

First, the level of sustainable debt for emerging market economies may be lower than had been thought, depending on a country's economic characteristics and to that extent, "The conduct of fiscal policy should therefore be sensitive not only to year-to-year fiscal imbalances, but also to the overall stock of public debt".

Second, at times favorable macroeconomic performance could be a substitute for institutional weakness. In fact, sustained and good macroeconomic performance can "mask

underlying institutional weaknesses that may become insuperable obstacles to any quick restoration of confidence, if growth is disrupted by unfavorable external developments (IMF, 2004).

Third, the resolution of a capital account crisis works only under quite stringent conditions. When there are,"concerns over debt and exchange rate sustainability, it is unreasonable to expect a voluntary reversal of capital flows".

Fourth, at the current juncture, "Financial engineering in the form of voluntary, market-based debt restructuring is costly and unlikely to improve debt sustainability if it is undertaken under crisis conditions and without a credible, comprehensive economic strategy".

Fifth, promptness of action is the key to resolution of a crisis emanating from a sustained current account deficit. Delaying the action required to resolve a crisis can significantly raise its eventual cost.

#### **4.3 Brazil**

Brazil is a mineral resources rich economy. It has an immense reserve of iron ore; manganese and other industrial metals. The country also possesses substantial quantities of bauxite, copper, lead, zinc, nickel, tungsten, tin, uranium, quartz crystals, industrial diamonds, and gemstones (Baer, 2008). Until the 1980's Brazil was one of the fastest growing economies in the world. However, subsequently it fell into a crisis, in which a high and rising current account deficit had played a significant role. To get a sense of the perspectives, it may be noted that during the 1970s, Brazil accumulated large external liabilities, with net foreign debt

increasing from US\$6.2 billion in 1973 to US\$58.4 billion in 1980, while the current account deficit went up from US\$1.7 billion to US\$12.8 billion. There were several ramifications of the economy's vulnerabilities.<sup>7</sup>

All these developments of the 1970s, led to sharp deterioration of Brazil's external accounts in the late 1970s, when the government allowed the currency to depreciate. But the subsequent rise in inflation caused the currency to appreciate in real terms again in 1981–82, and as the current account deficit continued to increase. The Brazilian authorities took a menu approach and trade policy became subordinate to macroeconomic objectives during this period. The following deserve special mention:

- The negative import list was substantially expanded, covering 40 percent of all tradable goods in 1983.
- Firm import programs and import financing became mandatory.
- Administrative procedures (e.g., delaying the concession of import licenses) became the main instrument to control imports.
- On the export side, credit and financial subsidies compensated the exchange rate appreciation in the early eighties, and compounded the effect of a weaker currency in 1983–85.

Brazil was able to overcome the external shocks of 1979–81, turning the large current account deficits experienced in 1980–82 into a small surplus in 1984. In fact, while Brazilian

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<sup>7</sup> Subsequently, "Brazil experienced in 1981–93 a long "decade" of stagnation" (Pinheiro et al, 2001). In these 13 years, GDP grew on average 1.6 percent per annum, which given population growth, resulted in an average annual decline of 0.2 percent in per capita income.

trade balance, in contrast to a trade deficit of US\$2.8 billion in 1980 turned into a surplus of US\$13.1 billion in 1984. Adjustment was obtained through, "a substantial rise in exports, stagnant real import levels and an improvement in terms of trade, particularly after 1986, when oil prices declined considerably" (Pinheiro et al, 2001). In this period while the quantum of exports expanded there was a major compression in import quantities.

Inflation went out of control during the period 1981–93, averaging an annual increase of 768 percent, in contrast with an average annual rate of 40 percent over 1964-80 (Table 4.3).<sup>8</sup> In the early eighties, inflation was fueled by the large public deficit and sparked off by the need to achieve a substantial real devaluation. However, in an economy with an elaborate system of indexation, it became apparent that, "once triggered by a change in the exchange rate, inertia would set in and inflation rates accelerate" (Pinheiro et al, 2001).<sup>9</sup> Interestingly, as a side effect of the high rates of interest in this period, Brazil experienced a large inflow of foreign portfolio investment, with foreign reserves more than doubling from 1991 to 1992.

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<sup>8</sup>Taking the whole 1981-93 period, prices increased 7.7 billion times.

<sup>9</sup>There was an all-around attempt to rein-in inflation. Totally five heterodox stabilization plans were implemented in 1986–91, which included price freezes and changes in established contracts. A change of finance ministers in mid-1991 brought a more orthodox economic team into government, which tightened monetary policy.

**Table 4.3: Brazil: Select Macroeconomic Indicators**

	Current Account Balance	GDP Growth	Investment	Savings	Inflation	Volume of imports of goods & services	Volume of Imports of goods	Volume of exports of goods & services	Volume of exports of goods	Govt Deficit (% of GDP)	Govt gross debt
Units	(% of GDP)	(%)	(% of GDP)	(%)	(%)	(% change)	(% change)	(% change)	(% change)	(% of GDP)	(% of GDP)
1980	-8.6	9.2	21.2	18.0	90.2	16.5	-6.6	13.9	25.7	n/a	n/a
1981	-6.9	-4.4	21.0	18.6	101.7	-2.6	-13.6	13.7	21.3	n/a	n/a
1982	-8.9	0.6	19.2	15.3	100.5	-3.2	-10.0	-10.6	-7.9	n/a	n/a
1983	-4.7	-3.4	15.2	13.3	135.0	-19.2	-20.0	11.3	18.8	n/a	n/a
1984	0.0	5.3	14.3	14.1	192.1	-10.4	1.3	26.4	18.9	n/a	n/a
1985	-0.1	7.9	17.4	18.0	226.0	-1.7	-3.6	-3.2	2.2	n/a	n/a
1986	-2.1	7.5	17.4	17.0	147.1	2.5	36.7	-16.7	-18.8	n/a	n/a
1987	-0.5	3.6	20.3	21.8	228.3	-3.2	-6.3	7.2	19.4	n/a	n/a
1988	1.3	0.3	20.7	24.0	629.1	-3.3	-10.9	22.6	17.1	n/a	n/a
1989	0.2	3.2	22.5	25.0	1430.7	20.0	14.9	1.4	0.2	n/a	n/a
1990	-0.8	-4.2	18.4	19.4	2947.7	9.3	8.2	-12.3	-7.7	n/a	n/a
1991	-0.3	1.0	17.9	19.4	477.4	0.5	9.5	0.3	3.5	n/a	n/a
1992	1.6	-0.5	17.2	20.5	1022.5	-4.0	-2.2	12.0	14.3	n/a	n/a
1993	-0.1	4.7	18.9	20.7	1927.4	27.2	29.6	7.1	12.5	n/a	n/a
1994	-0.3	5.3	22.1	21.8	2075.8	23.3	29.1	10.4	7.7	n/a	n/a
1995	-2.4	4.4	18.0	15.7	66.0	30.7	30.7	-2.0	-2.0	n/a	n/a
1996	-2.8	2.2	17.0	14.2	15.8	6.2	6.2	2.6	2.6	-5.4	n/a
1997	-3.5	3.4	17.4	13.9	6.9	18.2	18.2	10.2	10.2	-5.7	n/a
1998	-4.0	0.0	17.0	13.1	3.2	1.8	1.8	3.5	3.5	-7.4	n/a
1999	-4.3	0.3	16.4	12.1	4.9	-15.0	-15.0	7.7	7.7	-5.3	n/a
2000	-3.8	4.3	18.3	14.5	7.0	13.1	13.1	11.1	11.1	-3.4	66.7
2001	-4.2	1.3	18.0	13.8	6.8	2.9	2.9	9.5	9.5	-2.6	70.8



**Table 4.3: Brazil: Select Macroeconomic Indicators**

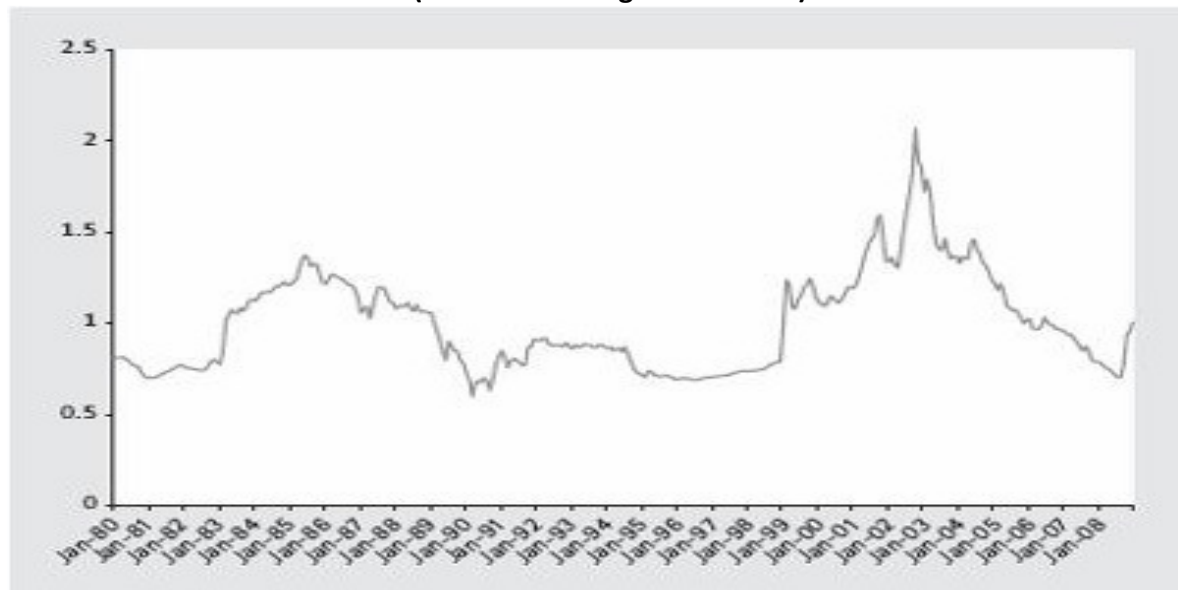
	Current Account Balance	GDP Growth	Investment	Savings	Inflation	Volume of imports of goods & services	Volume of Imports of goods	Volume of exports of goods & services	Volume of exports of goods	Govt Deficit (% of GDP)	Govt gross debt
2002	-1.5	2.7	16.2	14.7	8.5	-12.2	-12.2	8.6	8.6	-4.4	79.4
2003	0.8	1.1	15.8	16.5	14.7	-3.6	-3.6	15.7	15.7	-5.2	74.6
2004	1.8	5.7	17.1	18.9	6.6	18.3	18.3	19.0	19.0	-2.9	70.7
2005	1.6	3.2	16.2	17.8	6.9	5.4	5.4	9.4	9.4	-3.6	69.3
2006	1.3	4.0	16.8	18.0	4.2	16.1	16.1	3.3	3.3	-3.6	67.0
2007	0.1	6.1	18.3	18.4	3.6	22.0	22.0	5.5	5.5	-2.8	65.2
2008	-1.7	5.2	20.7	19.0	5.7	17.6	17.6	-2.5	-2.5	-1.6	63.5
2009	-1.5	-0.3	17.8	16.3	4.9	-17.5	-17.5	-10.8	-10.8	-3.3	66.8
2010	-2.2	7.5	20.2	18.0	5.0	38.2	38.2	9.5	9.5	-2.8	65.0
2011	-2.1	2.7	19.7	17.6	6.6	8.9	8.9	2.9	2.9	-2.6	64.7
2012	-2.4	1.0	17.5	15.1	5.4	-2.3	-2.3	-0.3	-0.3	-2.8	68.2
2013	-3.6	2.3	18.3	14.7	6.2	8.6	8.6	3.1	3.1	-3.3	66.3

Source: IMF World Economic Outlook Database, April 2014.

The Brazilian economy underwent significant structural changes during the 1990s. There was fiscal consolidation accompanied by a dramatic decline in public savings, which plummeted from a positive 4.7 percent of GDP in the 1970s to minus 5.8 percent of GDP in the 1980s. In 1994, the government reissued the *real* and instituted a crawling peg. The new currency, in combination with interest rates in excess of 30%, stabilized inflation for the first time in decades. The stabilization plan of 1994 — “Plano Real”, has turned out to be successful in stopping the inflationary bias of the Brazilian economy. High interest rates lowered inflationary

pressures and brought capital flows back into the Brazilian economy at unprecedented rates. In 1997 foreign direct investment grew by 140% over the year before.

**Chart 4.1: Brazil: Bilateral RER with the US, deflated by CPI indexes  
(Index 1 = average 1980–2008)**



Source: Frenkel, Roberto and Martín Rapetti (2011)

#### **4.4 Mexico**

Mexico's current account deficit experienced a huge expansion from \$6 billion in 1989 to \$15 billion in 1991 and to more than \$20 billion in 1992 and 1993. Some commentators viewed this as a favorable development, reflecting the capital inflow stimulated by Mexican policy reforms. However, "the large size of the deficit led some observers to worry that the peso was becoming overvalued, a circumstance that could discourage exports, stimulate imports, and lead eventually to a crisis" (Whitt, 1996). It is pertinent to note that at that time Mexico had a crawling peg exchange rate system whereby, "government intervention tended to

keep the exchange rate vis-à-vis the dollar within a narrow target band, but the upper limit of the band was raised slightly every day by a preannounced amount, allowing for a gradual nominal depreciation ... of the peso." As during the early 1990s, Mexico's inflation rate was consistently higher than the sum of U.S. inflation and peso depreciation (in real terms); consequently, the peso started appreciating and led to substantial current account deficit (Chart 4.2).



Williamson (1995) noted number of similarities between Mexican crisis in 1993 and Chilean crisis in 1981. While undergoing extensive deregulation and privatization, both the countries reduced tariffs and stabilized inflation and the exchange rate; consequently, both countries experienced substantial capital inflows and current account deficits -- 8% of GDP for Mexico in 1993 while 14% of GDP for Chile in 1981 (Table 4.4).

**Table 4.4: Mexico: Select Macroeconomic Indicators**

	Current Account Balance	GDP Growth	Investment	Savings	Inflation	Volume of imports of goods & services	Volume of Imports of goods	Volume of exports of goods & services	Volume of exports of goods	Govt Deficit (% of GDP)	Govt gross debt
Units	(% of GDP)	(%)	(% of GDP)	(%)	(%)	(% change)	(% change)	(% change)	(% change)	(% of GDP)	(% of GDP)
1980	-4.4	9.5	26.6	22.7	26.5	33.9	37.0	-5.4	-7.0	n/a	n/a
1981	-5.4	8.5	26.8	21.9	27.9	19.1	19.0	18.4	14.4	n/a	n/a
1982	-2.7	-0.5	23.6	21.0	59.2	-37.4	-39.3	10.9	14.8	n/a	n/a
1983	3.3	-3.5	21.2	24.7	101.8	-30.6	-32.0	14.0	15.4	n/a	n/a
1984	2.0	3.4	20.7	22.6	65.4	25.3	29.8	11.3	10.4	n/a	n/a
1985	0.4	2.2	21.9	22.3	57.8	12.7	15.2	-1.9	-3.0	n/a	n/a
1986	-0.9	-3.1	18.9	18.1	86.5	-6.6	-7.0	20.4	17.4	n/a	n/a
1987	2.5	1.7	20.7	23.2	132.0	6.2	8.6	10.8	12.0	n/a	n/a
1988	-1.1	1.3	19.9	18.8	113.5	35.0	41.0	16.8	16.7	n/a	n/a
1989	-2.3	4.1	20.2	17.9	19.9	19.0	18.6	6.5	5.9	n/a	n/a
1990	-2.5	5.2	20.4	17.9	26.7	19.3	17.5	7.4	8.1	-2.9	n/a
1991	-4.1	4.2	20.5	16.4	22.6	16.9	19.7	5.1	14.2	-0.8	n/a
1992	-5.9	3.6	20.4	14.5	15.5	20.5	23.2	5.0	8.2	0.1	n/a
1993	-4.6	2.6	31.3	25.1	9.8	3.1	3.8	8.1	16.4	0.1	n/a
1994	-5.6	4.7	30.6	23.6	7.0	16.3	18.4	17.8	8.7	-0.6	n/a
1995	-0.5	-5.8	26.6	25.9	35.1	-15.6	-13.2	30.2	23.7	-4.1	n/a
1996	-0.6	5.9	27.4	26.7	34.4	21.6	23.0	18.2	18.7	-5.2	46.9
1997	-1.6	7.0	28.3	27.0	20.6	21.4	22.0	10.7	16.2	-5.5	43.3
1998	-3.2	4.7	26.8	23.2	15.9	13.8	14.9	12.2	13.1	-5.6	44.1
1999	-2.4	2.7	25.7	22.4	16.6	14.1	14.2	12.3	11.8	-5.5	46.3
2000	-2.7	5.3	26.0	22.4	9.5	19.1	19.5	16.3	13.2	-3.0	41.9
2001	-2.4	-0.6	23.4	19.9	6.4	-3.8	-4.0	-3.6	-2.3	-3.1	41.1

**Table 4.4: Mexico: Select Macroeconomic Indicators**

	Current Account Balance	GDP Growth	Investment	Savings	Inflation	Volume of imports of goods & services	Volume of Imports of goods	Volume of exports of goods & services	Volume of exports of goods	Govt Deficit (% of GDP)	Govt gross debt
2002	-1.9	0.1	22.6	20.5	5.0	1.0	0.5	1.4	-0.9	-3.4	43.5
2003	-1.2	1.4	21.9	20.7	4.6	-1.1	-1.3	1.7	-2.5	-2.3	44.7
2004	-0.9	4.3	22.7	21.8	4.7	8.8	9.3	11.5	2.1	-1.2	40.9
2005	-1.0	3.0	22.3	21.3	4.0	8.5	7.3	6.8	5.3	-1.2	39.0
2006	-0.8	5.0	23.5	22.7	3.6	10.5	10.4	11.0	8.5	-1.0	37.8
2007	-1.4	3.1	23.4	22.0	4.0	5.4	4.5	5.8	3.5	-1.2	37.6
2008	-1.8	1.4	24.4	22.6	5.1	3.4	1.0	0.5	-2.4	-1.0	42.9
2009	-0.9	-4.7	22.9	22.0	5.3	-16.4	-21.1	-13.5	-7.7	-5.1	43.9
2010	-0.3	5.1	22.0	21.7	4.2	20.3	23.2	21.6	15.8	-4.3	42.2
2011	-1.1	4.0	22.3	21.2	3.4	8.1	8.5	7.5	2.2	-3.3	43.3
2012	-1.2	3.9	23.2	22.0	4.1	4.3	4.6	3.5	9.0	-3.7	43.3
2013	-1.8	1.1	22.2	20.4	3.8	1.6	3.0	2.0	2.8	-3.9	46.5

Source: IMF World Economic Outlook Database, April 2014

From a vantage point, five factors may be identified as key causes of the Peso crisis, viz., (a) large scale of the current account deficit, (b) its funding by relatively short-term capital inflows, (c) an overvalued exchange rate, (d) a high proportion of short term government debt, and (e) its ownership among non-residents (and allowing the transformation of a large part of it into dollar - denominated paper). There is significant unanimity in the literature about these causes behind the Mexican current account crisis. However, there is also an influential view

that the roots of the Mexican crisis lied in financial liberalization programme itself. This view has been captured best in the following comment:

"Two other sets of factors were also important, but have been either neglected or insufficiently emphasized in the literature. The first is that the process of liberalization in Mexico, both of the financial sector and of the capital account, was perhaps too rapid and that too many changes were made simultaneously. Secondly, the severity of the Mexican peso crisis can partly be explained by imperfections in international capital markets, which can lead to huge over-reactions to relatively small changes in countries' economic fundamentals" (Griffith-Jones, 1997).

Considerable dependence on portfolio investment and bank borrowing had made these countries all the more vulnerable (Table 4.5).

<b>Table 4.5: Composition (%) Of Mexican And Other Countries' Capital Inflows, 1990-93</b>					
	Mexico	Argentina	Chile	Thailand	Indonesia
Portfolio investment	67	37	22	6	-3
Foreign Direct Investment	21	42	31	20	28
Other (including bank lending)	12	21	47	75	75
<b>Total</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>
Source: Griffith-Jones (1997)					

To sum up the following factors seem to be responsible for the Mexican building up of CAD (Ferretti and Razin, 1999):

- a) Real exchange rate appreciation - Mexico's exchange rate, which appreciated by over 30 percent in real terms vis-a-vis the US dollar between 1977 and 1981, could have raised concerns about the sustainability of exchange rates leading to large capital flight.
- b) Large fiscal imbalances: Good macroeconomic performance between 1978 and 1981 seemed to have financed not only increased public investment but also growing public consumption causing large fiscal deficits to emerge.
- c) Misperceptions regarding oil wealth: "Policy design in Mexico was based on an overoptimistic assessment of future oil prices; when the expected price increases failed to materialize, the government did not introduce alternative measures to limit fiscal imbalances" (Ferretti and Razin, 1999).
- d) Weakness of the financial system: A highly repressed financial system was hit by the effects of the exchange rate depreciation on their dollar exposure.

### *Lessons*

What are the lessons from the Mexican experience? At the risk of broad generalization, the following broad policy lessons may be discerned. *First*, since *a priori* it is difficult to establish what is the sustainable CAD, large CAD over should be avoided over the medium term. Second, as far as exchange rate is concerned the message is more cluttered. Exchange rate flexibility could have some inflationary effect but at the same time greater exchange rate flexibility also diminishes the risk of declines in output and employment (Griffith-Jones, 1997). Third, in so far as public debt is concerned, it is advisable to avoid the "original sin", a phenomenon referring to a country's inability to borrow abroad in its own currency (Eichengreen, Hausmann and

Panizza, 2004).<sup>10</sup> Finally, importance of accumulated reserves as a self insurance mechanism can hardly be overemphasized.

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<sup>10</sup>In particular, Eichengreen & others (2004) showed that the composition of external debt and specifically the extent to which that debt is denominated in foreign currency is a key determinant of the stability of output, the volatility of capital flows, the management of exchange rates, and the level of country credit ratings.

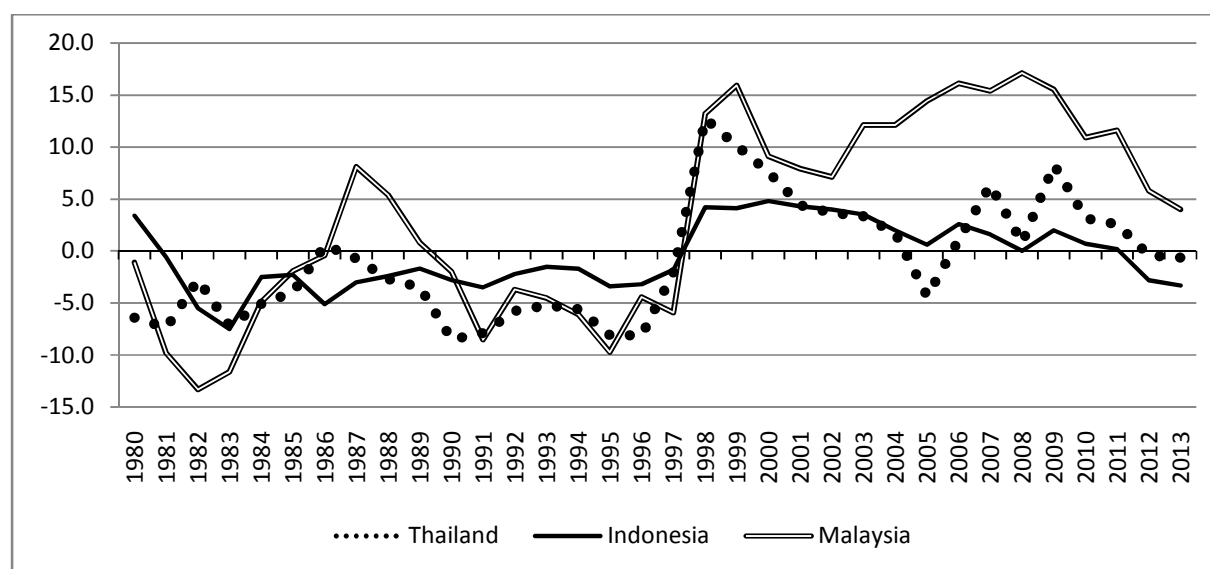


## 5. Experiences of Asian Countries

### 5.1 Some General Trends

The typical experience of Emerging Markets in Asia has been marked by the East Asian crisis period wherein, somewhat unexpectedly, major Asian economies like South Korea, Thailand, Indonesia or Malaysia witnessed attacks on their currencies leading to financial meltdown. There was also contagion in the region. A major precursor to the crisis has been substantial current account deficit in three major emerging market economies in the region, viz., Thailand, Indonesia and Malaysia. In fact, over the 1990s, till the beginning of the East Asian crisis in 1997, all these economies are characterized by substantial current account deficit (Chart 5.1).

**Chart 5.1: Current Account Balance of Select East Asian Countries (% of GDP)**



Source: World Economic Outlook Data base, April 2014.

What was the extent of current account deficit? Corsetti, Pesenti, and Roubini (1998) tried to look into the phenomenon using two measures of CAD - one derived from BoP data and the other based on National Income Accounts (Table 5.1). Though conceptually these two sources should yield unique measure of CAD for computational reasons there are discrepancies. The CAD of Malaysia, Indonesia and Thailand seemed to have increased substantially in the run-up to the East Asian crisis.

Table 5.1: Current Account and Trade Deficits in Select East Asian Economies (% of GDP): 1990-1997									
		1990	1991	1992	1993	1994	1995	1996	1997
Current Account, NIA Definition (% of GDP)	Korea	-1.24	-3.16	-1.70	-0.16	-1.45	-1.91	-4.82	-1.90
	Indonesia	-4.40	-4.40	-2.46	-0.82	-1.54	-4.27	-3.30	-3.62
	Malaysia	-2.27	-14.01	-3.39	-10.11	-6.60	-8.85	-3.73	-3.50
	Philippines	-6.30	-2.46	-3.17	-6.69	-3.74	-5.06	-4.67	-6.07
	Thailand	-8.74	-8.01	-6.23	-5.68	-6.38	-8.35	-8.51	-2.35
Current Account, BOP Definition (% of GDP)	Korea	-0.69	-2.83	-1.28	0.30	-1.02	-1.86	-4.75	-1.85
	Indonesia	-2.82	-3.65	-2.17	-1.33	-1.58	-3.18	-3.37	-2.24
	Malaysia	-2.03	-8.69	-3.74	-4.66	-6.24	-8.43	-4.89	-4.85
	Philippines	-6.08	-2.28	-1.89	-5.55	-4.60	-2.67	-4.77	-5.23
	Thailand	-8.50	-7.71	-5.66	-5.08	-5.60	-8.06	-8.10	-1.90
Trade Balance, BOP Definition (% of GDP)	Korea	-0.81	-3.04	-1.42	0.06	-1.22	-1.63	-4.36	-1.44
	Indonesia	1.68	0.91	1.81	1.48	0.72	-0.76	-1.14	0.22
	Malaysia	2.10	-3.74	1.39	-0.11	-1.59	-3.75	0.58	
	Philippines	-5.73	-3.00	-4.27	-8.53	-8.95	-8.80	-9.44	-12.30
	Thailand	-7.75	-6.88	-4.70	-4.56	-5.18	-7.09	-6.65	0.14
Source: Corsetti, Pesenti, and Roubini (1998)									

An interesting point about these countries was that saving ratios were high in these countries - e.g., in Malaysia it peaked at nearly 40 percent of GDP in 1998; Thailand experienced an average saving rate of around 35 percent of GDP in 1991–94, and Indonesia registered a maximum of 38 percent in 1997 (Chart 5.2). Moreover, fluctuations in the current account tended to reflect investment behavior rather than saving. In fact, commentators went a step further and stated, "The switch in current accounts from large deficits to large surpluses around 1998 largely reflects first surging investment and then its collapse below national saving in most countries" (Moreno, 2008). In particular, the emergence of current account surpluses in 1998 was associated with relatively stable saving ratios in Malaysia and Thailand and a fall in saving in Indonesia.<sup>11</sup> In fact, for a sample of East Asian countries it has been observed that their high savings ratio could be explained in terms of a set of fairly standard variables like dependency ratio or level of income (Das and Ray, 2012). In post-crisis years, capital flows to these countries came back. In fact, capital inflows to the five main East Asian developing economies increased from US\$ 150 billion in 1980-1989 to as much as US\$ 320 billion only in 1990-1995.

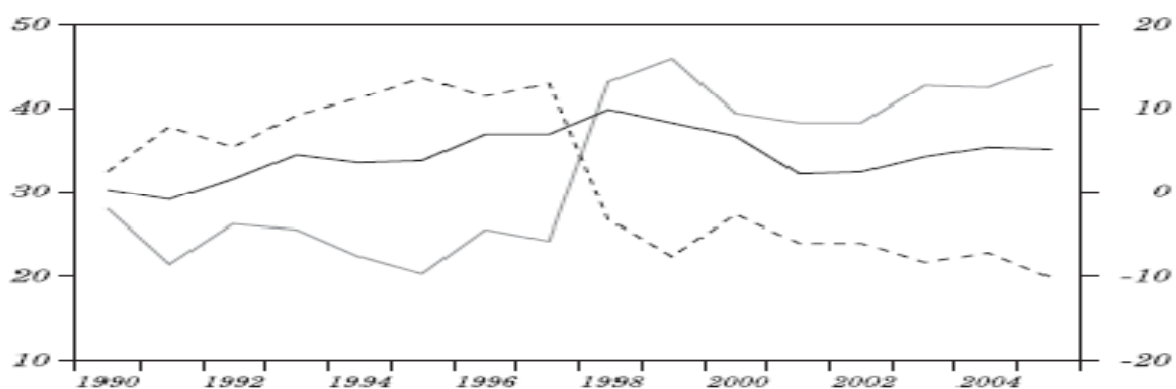
A few more features of the CAD in these countries deserve special mention. First, high export growth experienced in these countries could have been, *inter alia*, due to non-flexible nature of the exchange rate. Second, corporates of a number of countries had taken recourse to substantial of external commercial borrowing, which exposed the banking sector to huge currency risks. Third, forex reserves cover in a number of countries was insufficient.

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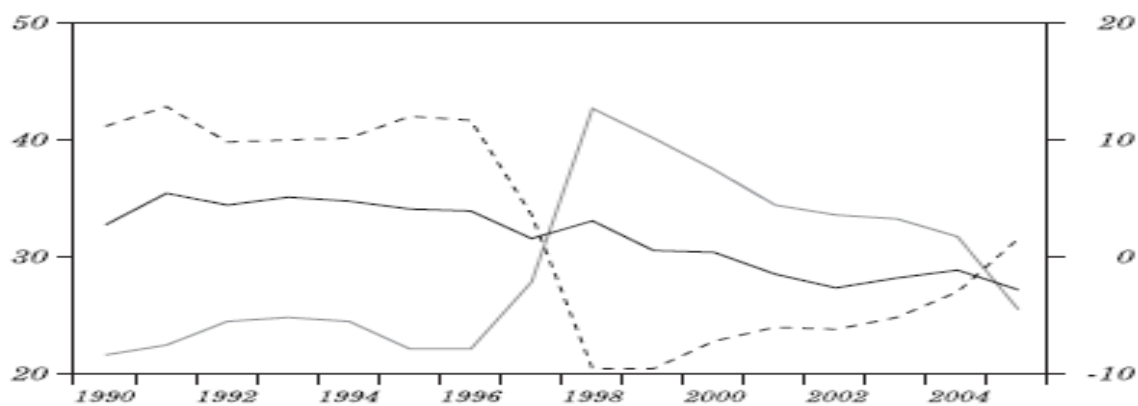
<sup>11</sup> On an annual basis, deviations in investment from trend are also more closely correlated with fluctuations in the current account than are deviations in saving

**Chart 5.2: Savings, Investment and CAD in Select Asian Countries**

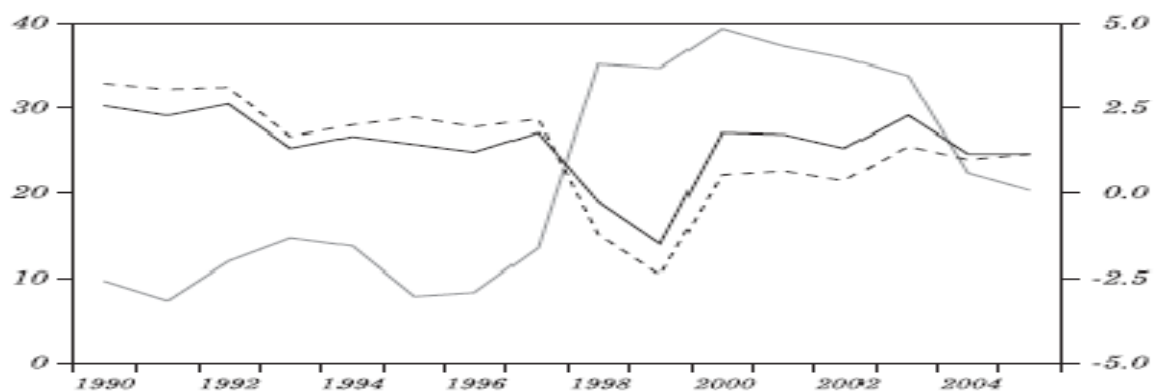
**(a) Malaysia**



**(b) Thailand**



**(c) Indonesia**



Legends: — Saving    - - - - Investment    . . . . Current account

Source: Moreno, 2008

While large and expanding CAD can be associated with crises in all these three countries in our sample, the diagnosis of the crises have many interpretations. For the sake of completeness as well as policy analysis, it may be worthwhile to take stock of them. First, financial bubbles and declining returns to investment had been identified as key cause of the crises in these countries (Krugman, 1998).<sup>12</sup> Second, Corsetti, Pesenti and Roubini (1998) pointed out that "unsound fundamentals and international capital markets" is, in some sense, at the heart of the turmoil. There are several dimensions of the imprudent macroeconomic policies: (a) a fixed exchange peg to the US dollar; (b) an investment boom, which created a savings-investment gap; (c) an excessive lending to risky and low-profitability projects, due to political pressures; (d) weak and fragile financial systems; and (e) the accumulation of short-term foreign debt in the form of foreign-currency denominated and unhedged liabilities. Third, Radelet and Sachs (1998) sought to explain the root of the crises in "self-fulfilling panics in external financial markets" as, "international loan markets are prone to self-fulfilling crisis in which individual creditors may act rationally and yet market outcomes produce sharp, costly and fundamentally unnecessary panicked reversals in capital flows" (Radelet and Sachs, 1998). Fourth, "financial under-regulation and speculative attacks" have been identified by Wade (1998) as two main factors behind explaining the crises.

Can we get some commonality between the crisis countries? In this context, Table 5.2 below enumerates some vulnerability indicators of the three crisis countries under consideration. Indicators like high Domestic Debt-to-GDP Ratios or Corporate Debt-to-Equity

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<sup>12</sup>Krugman (1997) pointed out that while "Market failures" in international capital flows contributed to large inflows in East Asia, "crony capitalism" in the region increased domestic investment in speculation-related real estate, in unsound financial activities, and in poor quality infrastructures.

Ratios turned out to be extremely important early warning indicators. As far as banking indicators are concerned, property Loans and non-Performing Loans turned out to be important. Short-Term Debt-to-Reserve Ratios in some sense measured the adequacy of reserves when faced with a crisis situation. Above all, current Account deficit turned out to be the most single important metric for measuring vulnerability of these economies.

<b>Table 5.2: Vulnerability Indicators of Crisis-Affected Countries</b>			
	Indonesia	Thailand	Malaysia
Domestic Debt-to-GDP Ratios (1992-1996)	50	87	82
Corporate Debt-to-Equity Ratios (1991-1996)	190 - 200	170 - 340	90 - 200
Family-Owned Companies (1991-1995)	67.3	51.9	42.6
State-Owned Companies (1991-1995)	15.2	24.1	34.8
Bank Credits (1992-1996)	12	37	38
Property Loans (late 1997)	25-30	30-40	30-40
Non-Performing Loans (1996)	8.8	7.7	3.9
Non-Performing Loans (1998)	40	34	19
Short-Term Debt-to-Reserve Ratios (1996-1997)	188.9	121.5	45.3
Exports (1996)	9.1	-4.5	0.9
Current Account (1991-1995)	-2.4	-7.7	-7.6
Current Account (1996)	-3.2	-8.9	-4.4
Source: Djiwandono (2007).			

With this backdrop let us try look into the experiences of three countries insofar as building up of high CAD and their resolution are concerned.

## 5.2 Thailand

In some sense, Thailand was the initial face of the crisis. In fact, by May 1997 the Thai baht came under speculative attack from foreign currency traders and consequent doubts seemed to have emerged about the competitiveness of the Thai economy. During March 1997 - March 1998, Thai Baht experienced a depreciation of more than 30 per cent (Table 5.3).

<b>Table 5.3: Exchange Rates in Select Asian Countries</b> (equivalent of \$US1)					
		30 March 1998	3 Months Ago	1 Year Ago	Gain/Loss in Value on 1 Year Ago (%)
Indonesia	rupiah	8325.00	5130.00	2419.00	-70.9
Malaysia	ringgit	3.61	3.89	2.49	-31.0
Thailand	baht	38.24	46.75	25.96	-32.1
Source: Beeson and Rosser (1998)					

Thailand had incurred consistently deficit on its current account for a fairly long period of time, viz., during 1980- 1997 (Table 5.4). During the 1990's massive capital inflows were accumulated progressively along with a high interest rate differential and under semi-fixed exchange rate regime, including capital account deregulation. The historical context of financial liberalization has been captured as:

"In Thailand, financial deregulation gained momentum after the 1991 coup, when General Suchinda Kraprayoon toppled the civilian government of then-prime minister Chatichai Choonhavan in a bloodless takeover. The new authorities were induced by foreign advisers to envision Bangkok as a new regional financial hub, as Hong Kong was

going to revert to China in 1997. The authorities were encouraged to undertake a number of new financial liberalization initiatives to facilitate this process in Bangkok. Following the restoration of parliamentary rule, the Bangkok International Financing Facility was established in 1993 and the Provincial International Banking Facility was established in 1994. Thus, people throughout Thailand could now access international finance more easily with correspondingly less central bank surveillance" (Sundaram, 2007; p. 22).

When in May 1997 Thai baht came under speculative attacks, Thailand spends billions of its foreign reserves to defend the Thai *baht*. However, such intervention yielded little results. After all, Thailand allowed too many short-term capital flows to accumulate with a high degree of currency speculation, which coupled with the weakness in the financial system led to massive amount of "capital flight". By July 1997 Thailand is forced to devalue the *baht*, which drops the value of the *baht* by as much as 20 per cent. By mid 1997, Thai insurance and finance companies begin to collapse. By August 1997, Thailand agreed to adopt tough economic measures proposed by the IMF in return for a \$17 billion loan and closed 42 ailing finance companies and imposed tax hikes as part of the IMF's insistence on austerity. Thai GDP contracted both in 1997 and 1998 by as much as 1.4 per cent and more than 10 per cent, respectively.

Was the IMF programme appropriate for Thailand? There are commentators who believe that the IMF's programme seemed to have accelerated capital flight and argued that



the IMF's inappropriate focus on "overhauling" financial institutions in the heat of the crisis worsened investor confidence by re-emphasizing domestic financial weaknesses (Radelet and Sachs, 1998). Furthermore, in dealing with the crises, the IMF was initially influenced by the first- and second-generation currency crisis theories, presuming trade/current account and fiscal deficits respectively and, thus, "instead of responding with counter-cyclical policies, the IMF pressured the affected governments to achieve fiscal surpluses (Sundaram, 2007).

**Table 5.4: Thailand: Select Macroeconomic Indicators**

	Current Account Balance	GDP Growth	Investment	Savings	Inflation	Volume of imports of goods & services	Volume of Imports of goods	Volume of exports of goods & services	Volume of exports of goods	Govt Deficit (% of GDP)	Govt gross debt
Units	(% of GDP)	(%)	(% of GDP)	(%)	(%)	(% change)	(% change)	(% change)	(% change)	(% of GDP)	(% of GDP)
1980	-6.4	4.6	26.4	18.3	19.7	2.8	0.9	13.7	8.4	n/a	n/a
1981	-7.4	5.9	26.3	18.9	12.7	5.4	6.9	4.1	6.0	n/a	n/a
1982	-2.7	5.4	23.1	20.4	5.3	-12.9	-12.6	18.8	25.0	n/a	n/a
1983	-7.2	5.6	25.9	18.8	3.7	23.6	26.4	-6.3	-8.8	n/a	n/a
1984	-5.0	5.8	24.9	19.9	0.9	1.0	1.9	12.1	14.9	n/a	n/a
1985	-4.0	4.6	28.2	24.3	2.3	-8.2	-8.2	4.2	5.2	n/a	n/a
1986	0.6	5.5	25.9	26.4	1.9	5.0	4.2	15.1	17.8	n/a	n/a
1987	-0.7	9.5	27.9	27.1	2.5	27.1	28.0	21.1	20.3	n/a	n/a
1988	-2.7	13.3	32.6	29.9	3.9	32.7	33.7	26.1	23.5	n/a	n/a
1989	-3.5	12.2	35.1	31.6	5.4	21.6	21.8	21.1	22.9	n/a	n/a
1990	-8.5	11.6	41.1	32.6	5.9	23.7	22.0	11.7	12.6	n/a	n/a
1991	-7.9	8.1	42.8	35.2	5.7	13.0	9.5	17.3	17.2	n/a	n/a
1992	-5.8	8.1	40.0	34.4	4.1	9.0	5.2	13.8	10.9	n/a	n/a
1993	-5.2	8.3	40.0	35.0	3.3	11.8	10.2	12.7	11.5	n/a	n/a

**Table 5.4:Thailand: Select Macroeconomic Indicators**

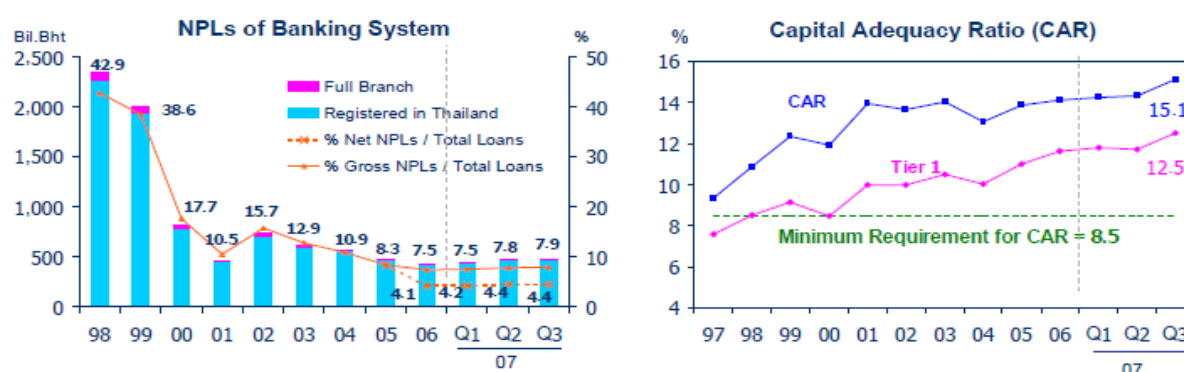
	Current Account Balance	GDP Growth	Invest- ment	Savings	Inflation	Volume of imports of goods & services	Volume of Imports of goods	Volume of exports of goods & services	Volume of exports of goods	Govt Deficit (% of GDP)	Govt gross debt
1994	-5.6	9.0	40.3	34.7	5.1	15.7	15.7	14.2	17.7	n/a	n/a
1995	-8.1	9.2	42.1	34.1	5.8	20.0	19.3	15.4	13.4	3.1	n/a
1996	-8.1	5.9	41.8	33.8	5.8	-0.6	1.1	-5.5	0.6	2.7	15.2
1997	-2.0	-1.4	33.7	32.9	5.6	-11.3	-7.8	7.2	12.2	-1.7	40.5
1998	12.7	-10.5	20.4	33.3	8.0	-21.6	-24.1	8.2	-0.8	-6.3	49.9
1999	10.1	4.4	20.5	30.7	0.3	10.5	12.5	9.0	12.1	-9.0	56.6
2000	7.6	4.8	22.8	30.4	1.6	27.1	19.9	17.5	24.2	-1.8	57.8
2001	4.4	2.2	24.1	28.5	1.6	-5.5	-3.5	-4.2	0.3	-1.8	57.5
2002	3.7	5.3	23.8	27.5	0.7	13.7	3.7	12.0	3.7	-6.7	55.1
2003	3.3	7.1	25.0	28.3	1.8	8.5	13.6	7.0	11.8	2.1	50.7
2004	1.7	6.3	26.8	28.5	2.8	13.5	20.3	9.6	14.5	1.2	49.5
2005	-4.3	4.6	31.4	27.1	4.5	12.8	6.5	12.5	7.3	1.5	47.4
2006	1.1	5.1	28.3	29.4	4.6	3.3	1.3	9.1	11.1	2.2	42.0
2007	6.3	5.0	26.4	32.8	2.2	4.4	3.5	7.8	11.9	0.2	38.3
2008	0.8	2.5	29.1	29.9	5.5	8.9	12.5	5.1	4.9	0.1	37.3
2009	8.3	-2.3	21.2	29.5	-0.9	-21.5	-23.2	-12.5	-14.2	-3.2	45.2
2010	3.1	7.8	25.9	29.1	3.3	21.5	26.7	14.7	16.4	-0.8	42.6
2011	2.6	0.1	26.6	29.2	3.8	13.7	13.4	9.5	8.3	-0.6	41.7
2012	-0.4	6.5	29.7	29.3	3.0	6.2	7.1	3.1	2.5	-1.8	45.4
2013	-0.6	2.9	29.2	28.6	2.2	2.3	1.6	4.2	0.2	-0.2	45.9

Source: IMF World Economic Outlook Database, April 2014

## Post-Crisis Turnaround

A major ingredient of the crisis management package centered around the financial sector. At the peak of the crisis, the Thai banking sector had large net losses, a declining net interest margin, low capital levels and a non-performing loan ratio that peaked at 43 per cent of total loans in 1998. Beginning in 1998, Thai authorities initiated a comprehensive restructuring of the financial sector; its major elements were: (a) intervening in weak banks and focusing on recapitalization; (b) debt restructuring; (c) reform of the regulatory and supervisory framework; (d) strengthening corporate governance of banks; and (e) introducing initiatives to deepen and broaden the capital market (Nijathaworn, 2012). Subsequently, the economy adopted Financial Sector Master Plan (2004–08) which aimed to improve the financial system's efficiency, broaden access to finance, and improve consumer protection. All these led to improvements in the health of the financial sector (Chart 5.3).

**Chart 5.2: Post Crisis Improvement in Banking Sector in Thailand**



Source: Vanikkul (2007)

### *Current Account*

After the initial depreciation of the Thai Baht in July 1997, there has been remarkable improvement in current account balance - which was turned into positive from negative (Table 5.5). The major element of the new current account management regime was a depreciated currency which generated export competitiveness and the volume of imports showed a huge decline in the first year of the depreciation. The changes in the current account were mostly caused by changes in the trade balance.

Eventually a new capital account management regime ushered in Thailand and the economy could attain a current account surplus till about 2010 (with the sole exception of 2005) and accumulated substantial amount of forex reserves. The country could also undertake significant reforms of its financial as well as corporate sector. As far as portfolio flows are concerned, while equity net flows had a consistent trend from 1998 to 2004 where the magnitude stayed at a low level, debt flows exhibited a negative net flow from 1999 to 2005 along with minor fluctuations from time to time (Sangubhan, 2007). Corporate and Government loans had been decreasing since the crisis days of 1997.

**Table 5.5: Annual capital inflows to Thailand, 1997-2006**

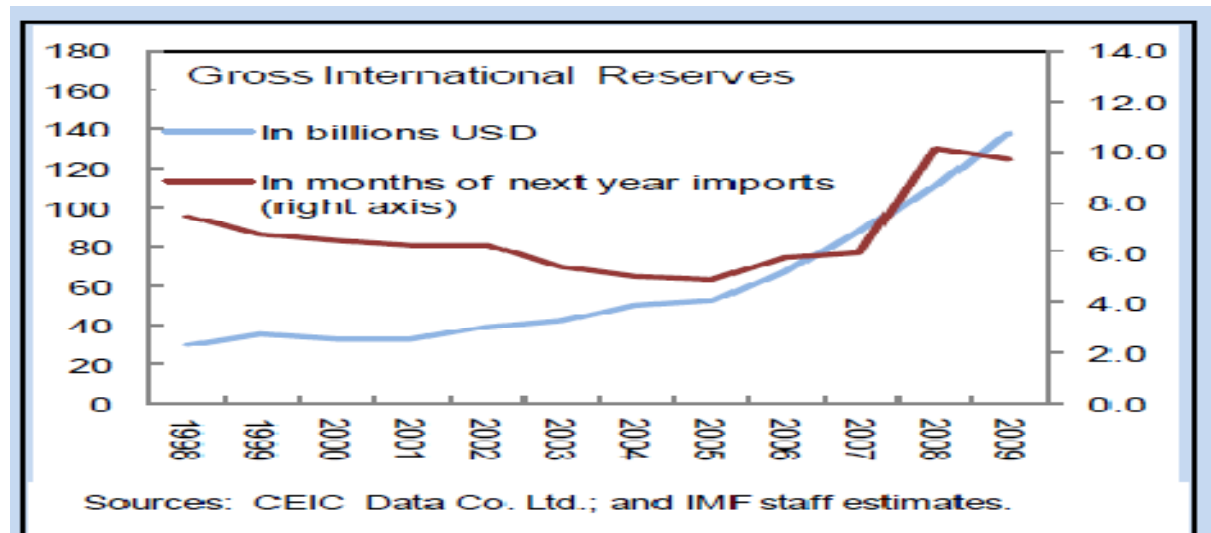
(million USD)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Current account	-3,110	14,291	12,466	9,328	5,114	5,114	4,784	2,767	-7,852	3,240
FDI	3,180	5,019	3,218	2,761	4,793	4,793	4,608	4,952	7,297	9,562
Equity	3,987	265	946	897	17	17	583	180	2,158	4,744
Debt	563	118	-555	-791	-660	-660	-827	17	487	-266
Corporates&Govt loans	-11,282	-9,211	-4,894	-7,056	-5,527	-5,527	-9,293	-7,232	3,042	3,758
Total USD Inflows	-6,662	10,482	11,181	5,139	3,737	3,737	-145	684	5,132	21,039

Source: Sangubhan (2007)

As far as the exchange rate regime is concerned, Thai baht remained mildly undervalued. Though this is not reflected in the traditional calculation of exchange rate misalignment as per the IMF, the fact that while in the on-shore market Thai baht has been consistently depreciating, in the off-shore market it has been appreciating leads one to such a conclusion. Interestingly, the Bank of Thailand intervened heavily causing a build-up of foreign exchange reserves within a short time. As the current account surplus has been accompanied by capital inflows, forex reserves touched \$138 billion as of end-2009 - this is four times higher than Greenspan-Guidotti Rule (100 percent of short term debt coverage), and cover 43 percent of broad money and 10 months of following year's imports (Chart 5.3).

**Chart 5.3: Thai Forex Reserves**



Source: Thailand: 2010 Article IV Consultation—Staff Report, IMF

### 5.3 Indonesia

In order to place the context of the Indonesian economy one may note that since 1970, restrictions on movement of foreign capital were virtually withdrawn. The subsequent situation has been succinctly captured as follows:

"During the 1970s to 1980s, official development assistance was the largest single component of foreign capital inflow. Then, throughout the 1990s up to the point of the 1997–98 crisis, it was overtaken by other types of capital, FDI, and corporate/bank lending, which were recorded as other investment items. The overall BoP was characterized by a negative current account and a positive capital account, since foreign capital inflows on the latter side created pressure for the domestic currency to appreciate, resulting in a negative current account balance" (Titiheruw and Atje, 2007).

During 1981 - 1997, Indonesia had consistently registered CAD. Triggered by the attack on Thai baht, Indonesia was among the most severely affected countries by the East Asian crisis. It was triggered by a sudden capital flight leading to significant depreciation of rupiah, against the US dollar with the rupiah-USD exchange rate moving from 2419 rupiah / USD on March 30, 1997 to 8325 rupiah / USD on March 30, 1997 (Table 5.3 above). Indonesia experienced a decline in international reserves of 22 percent from the end of the third quarter of 1997 to the end of the first quarter of 1998. The depreciation was soon followed by a national banking crisis and ended up as a national economic crisis with GDP contraction rate of over 13 per cent in 1998 (Table 5.6). The effort by the central bank to increase interest rate so as to stop capital flight did not yield much result (Tambunan, 2010). Though the current account deficit in Indonesia was less than those of countries like Thailand or Malaysia, yet at below 3 per cent of GDP, CAD was high and unsustainable (Moreno, 2008). In fact, during 1997-1998, capital flows to Indonesia swung from an \$11 billion inflow to a \$5 billion outflow. As elsewhere in Indonesia too, high CAD got reflected in a higher investment rates compared to high savings rate in the pre-crisis years. Fiscal deficit was not sizeable in Indonesia.

Interestingly, political regime interacted with the economic condition in Indonesia. Following the economic problems there was significant political turmoil all over the country and the Suharto regime came under heavy attack in terms of its capacity to deliver sustained economic reform. Subsequently it collapsed and President Suharto tendered his resignation on May 21 1998.

**Table 5.6: Indonesia: Select Macroeconomic Indicators**

	Current Account Balance	GDP Growth	Investment	Savings	Inflation	Volume of imports of goods & services	Volume of Imports of goods	Volume of exports of goods & services	Volume of exports of goods	Govt Deficit (% of GDP)	Govt gross debt
Units	(% of GDP)	(%)	(% of GDP)	(%)	(%)	(% change)	(% change)	(% change)	(% change)	(% of GDP)	(% of GDP)
1980	3.4	9.9	32.2	23.5	18.0	9.3	5.0	6.3	6.3	n/a	n/a
1981	-0.6	7.6	39.3	25.6	12.2	38.7	51.1	-24.8	-24.8	n/a	n/a
1982	-5.5	2.2	37.5	19.4	9.5	1.2	6.6	-25.0	-25.0	n/a	n/a
1983	-7.5	4.2	39.2	18.5	11.8	3.6	12.5	12.0	12.0	n/a	n/a
1984	-2.5	7.0	35.5	20.8	10.3	-10.5	-12.4	15.2	15.2	n/a	n/a
1985	-2.3	2.5	37.7	22.6	4.7	2.1	-3.7	-4.8	-3.1	n/a	n/a
1986	-5.1	5.9	38.3	20.2	5.8	-4.9	1.9	14.8	13.9	n/a	n/a
1987	-3.0	4.9	41.8	24.6	9.3	24.4	22.7	-5.9	21.9	n/a	n/a
1988	-2.4	5.8	42.3	25.4	8.0	-17.7	6.3	26.3	1.1	n/a	n/a
1989	-1.7	7.5	47.7	31.1	6.4	14.4	11.6	11.0	10.4	n/a	n/a
1990	-2.8	7.2	45.0	28.1	7.8	27.6	21.4	1.4	0.4	n/a	n/a
1991	-3.5	7.0	46.9	29.0	9.4	14.9	15.9	14.7	19.9	n/a	n/a
1992	-2.2	6.5	43.3	27.7	7.5	6.1	8.8	12.5	15.2	n/a	n/a
1993	-1.5	8.0	29.5	28.2	9.7	4.7	5.4	4.6	3.3	-0.7	n/a
1994	-1.7	7.5	31.1	29.5	8.5	15.5	20.3	11.4	13.7	0.0	n/a
1995	-3.4	8.2	31.9	28.9	9.4	20.3	17.8	8.2	7.7	0.8	n/a
1996	-3.2	7.8	30.7	27.8	8.4	9.4	10.6	0.9	5.5	1.2	n/a
1997	-1.8	4.7	31.8	30.2	6.2	0.7	0.7	13.4	23.8	-1.2	n/a
1998	4.2	-13.1	16.8	20.6	58.0	-12.5	-25.6	15.2	8.9	-2.3	n/a
1999	4.1	0.8	11.4	15.1	20.8	-24.1	-32.9	-25.7	-9.4	-1.2	n/a
2000	4.8	4.2	22.2	27.1	3.8	25.5	25.5	17.9	17.9	-2.0	95.1
2001	4.3	3.6	22.5	26.8	11.5	-9.4	-9.4	-9.9	-9.9	-2.7	80.2
2002	4.0	4.5	21.4	25.4	11.8	1.9	1.9	-0.5	-0.5	-0.9	67.8



**Table 5.6: Indonesia: Select Macroeconomic Indicators**

	Current Account Balance	GDP Growth	Investment	Savings	Inflation	Volume of imports of goods & services	Volume of Imports of goods	Volume of exports of goods & services	Volume of exports of goods	Govt Deficit (% of GDP)	Govt gross debt
2003	3.5	4.8	25.6	29.1	6.8	0.9	0.9	-2.7	-2.7	-1.4	60.5
2004	2.0	5.0	24.1	26.1	6.1	13.1	13.1	-7.0	-7.0	-0.6	55.8
2005	0.6	5.7	25.1	25.6	10.5	22.9	22.9	11.8	11.8	0.6	46.3
2006	2.6	5.5	25.4	28.0	13.1	-5.2	-5.2	3.1	3.1	0.2	39.0
2007	1.6	6.3	24.9	26.5	6.7	5.9	5.9	-3.7	-3.7	-1.0	35.1
2008	0.0	6.0	27.8	27.8	9.8	20.9	20.9	-1.5	-1.5	0.0	33.2
2009	2.0	4.6	31.0	33.0	5.0	-10.5	-10.5	7.6	7.6	-1.8	28.6
2010	0.7	6.2	32.3	33.0	5.1	25.9	25.9	8.2	8.2	-1.2	26.1
2011	0.2	6.5	32.9	33.1	5.3	13.7	13.7	6.1	6.1	-0.6	24.4
2012	-2.8	6.3	34.7	32.0	4.0	11.3	11.3	-1.0	-1.0	-1.7	24.0
2013	-3.3	5.8	33.6	30.4	6.4	-0.4	-0.4	2.2	2.2	-2.1	26.1

Source: IMF World Economic Outlook Database, April 2014

As in Thailand, Indonesia also suffered from corporate bankruptcy. Many companies started having trouble repaying their foreign loans.<sup>13</sup> This made any short-term resolution of the crisis all the more problematic. As the crisis deepened, Indonesia approached the IMF and by October 1997 the IMF offered the Indonesian government a \$23 billion support package. However, Indonesia was some sort of exception as with its exchange rate coming under pressure in early October 1997, Indonesian authorities sought a precautionary program from the IMF. With the political turmoil brewing, insofar as the IMF loan was concerned, the situation became reasonably messy as one notes:

<sup>13</sup> Perhaps the best-known example of this was the Indonesian taxi company, PT Steady Safe, whose inability to repay its debts resulted in the collapse of the Peregrine investment House in Hong Kong.

“The impetus for the program came in large part from elements of the Indonesian bureaucracy, which were identified with economic and financial reform in Indonesia. They felt their efforts had become stymied. They thought they could use an IMF program to restart the reform process if the program received a strong commitment from President Suharto. By the time the letter of intent was signed on October 31, and the IMF executive board approved the program on November 5, Indonesia was deep into crisis, and the government could not meet its policy commitments” (Truman, 2013).<sup>14</sup>

Going forward, it is pertinent to note some features of the current account balance in Indonesia. First, fluctuations in the current account tend to mirror movements in investment rather than saving (Moreno, 2008). In fact, the emergence of current account surpluses in 1998 was associated with a fall in saving in Indonesia (Chart 5.2 above). It is also noted that the high investment rates in Indonesia were largely attributable to the private sector, accounting for 76 percent of total investment. Second, post-crisis there has been a remarkable turnaround in current account balance with deficit turning into surplus. Third, despite modest outflows in capital account Indonesia (and other two countries in our sample) experienced substantial accumulation of forex reserves during 2000-2005 (Table 5.7).

Post-crisis, because of conscious policy decisions, financial and corporate sector weaknesses have lessened substantially. Two major developments deserve special mention. First, foreign borrowing (as a proportion of foreign exchange reserves and in U.S. dollar terms) has declined significantly since 1997. Second, the share of domestic lending in foreign exchange

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<sup>14</sup>For Indonesia, there were 24 letters of intent from the IMF, seven in the first year, and three in the first six months.

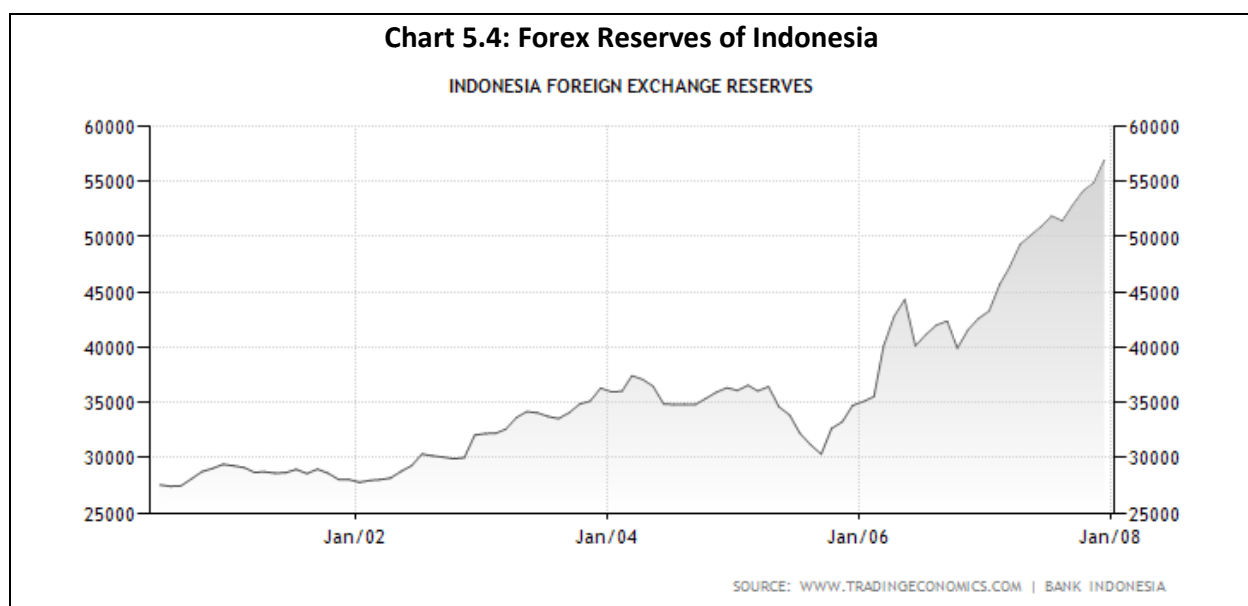
had come down significantly. The level of nonperforming loans had also declined and the banking system appeared to be well-capitalized.

<b>Table 5.7: CAD, Capital Inflows and Forex Reserves in Select South East Asian Economies</b>				
(USD billions)				
		Indonesia	Malaysia	Thailand
Current Account Balance	1990–94	–3	–3	–7
	1995–96	–7	–7	–14
	1997–98	–0	2	6
	2000–05	6	12	6
Net Capital Inflows	1990–94	5	6	11
	1995–96	11	9	21
	1997–98	–5	–0	–13
	2000–05	–3	–4	–3
Forex Reserves Accumulation	1990–94	1	4	4
	1995–96	3	0	5
	1997–98	–1	3	–4
	2000–05	2	7	3
Stock of Forex Reserves	As on September 2006	40	75	60
Source: Moreno (2008)				

In the post-crisis situation, Indonesia built up substantial forex reserves and in order to maintain exchange rate stability, Bank Indonesia has conducted several policies such as intensive monitoring of foreign exchange market transactions, moral suasion, and intervention in the domestic foreign exchange market (Bank Indonesia, 2005). In doing so, Bank Indonesia

imparted stability in the exchange rate and accumulated substantial amount of forex reserves (Chart 5.4). In fact, it has been noted,

“Foreign exchange market intervention can be used to address unwarranted exchange rate movements stemming from temporary shocks. It is not an independent policy instrument and cannot generate permanent changes in exchange rates, especially when the objectives are inconsistent with macroeconomic policies. To further reduce unwelcome fluctuations has issued several regulations such as limitations on transactions by non-residents and on net open positions, and has conducted both indirect (off-site) and direct (on-site) supervision of market participants” (Bank Indonesia, 2005).



Thus, as in Thailand, Indonesia too handled the fall out of the crisis with deep-rooted structural and financial reforms helped initially by assistance from the IMF. However, the post crisis period was marked by a turnaround in current account balance (from deficit to surplus),

reasonably stable exchange rate (with elements of mild depreciation perhaps), intervention in the forex market and substantial accumulation of forex reserves.

#### **5.4 Malaysia**

Malaysia entered the crisis with slightly better fundamentals such as short run debt, or initial reserves. However, the contagion got spread over Malaysia and on July 8, 1997 Malaysia's central bank intervenes to defend its currency, the ringgit. Subsequently, on July 24, 1997 Malaysian Prime Minister Mahathir Mohammad accused "rogue speculators" (later singled out George Soros) for Southeast Asia's crises.

As in case of other affected East Asian economies, Malaysia registered current account deficit over 1980-1997 fairly consistently with CAD-GDP peaked at around 10 percent in 1995 (Table 5.8). As the contagion spread, Malaysia GDP registered a contraction of 7.4 per cent in 1998.

After Thailand devalued in July 1997, the Malaysian ringgit came under severe pressure. There were significant portfolio outflows and foreign exchange reserves registered substantial drawdown (Chart 5.5). Till now the story is remarkably similar to other two countries studied above. However, the policy path of Malaysia differed from then on.

**Table 5.8: Malaysia: Select Macroeconomic Indicators**

	Current Account Balance	GDP Growth	Investment	Savings	Inflation	Volume of imports of goods & services	Volume of Imports of goods	Volume of exports of goods & services	Volume of exports of goods	Govt Deficit (% of GDP)	Govt gross debt
Units	(% of GDP)	(%)	(% of GDP)	(%)	(%)	(% change)	(% change)	(% change)	(% change)	(% of GDP)	(% of GDP)
1980	-1.1	7.4	32.4	32.0	6.7	15.3	10.8	5.0	1.8	n/a	n/a
1981	-9.8	6.9	37.3	31.6	9.7	-0.5	4.1	-9.6	-11.9	n/a	n/a
1982	-13.3	5.9	39.7	31.9	5.8	9.4	10.0	9.9	9.3	n/a	n/a
1983	-11.6	6.3	38.5	31.5	3.7	10.2	8.2	17.3	18.2	n/a	n/a
1984	-4.9	7.8	33.6	30.8	3.9	4.9	5.4	12.1	14.2	n/a	n/a
1985	-1.9	-0.9	27.5	25.5	2.6	-16.3	-19.2	-2.7	-3.6	n/a	n/a
1986	-0.4	1.2	25.9	25.5	0.4	-6.5	-7.0	11.8	9.8	n/a	n/a
1987	8.1	5.4	23.1	31.4	0.7	8.5	11.2	14.6	16.2	n/a	n/a
1988	5.4	9.9	25.9	31.1	0.3	24.5	26.9	11.8	13.3	n/a	n/a
1989	0.8	9.1	28.2	28.9	2.6	29.1	33.7	18.1	18.1	n/a	n/a
1990	-2.0	9.0	32.8	30.7	3.0	21.7	24.4	16.9	15.0	-2.7	80.7
1991	-8.5	9.5	37.8	29.2	4.3	22.6	24.5	14.4	16.6	-0.8	73.3
1992	-3.7	8.9	35.4	31.6	4.8	5.7	3.1	12.5	13.4	-0.7	64.4
1993	-4.5	9.9	39.2	34.6	3.5	15.2	11.0	11.8	9.9	1.5	55.7
1994	-6.1	9.2	41.2	33.6	3.7	25.4	29.1	21.5	20.7	3.9	47.6
1995	-9.7	9.8	43.6	33.9	3.5	23.9	26.7	18.6	19.0	1.7	41.6
1996	-4.4	10.0	41.5	37.1	3.5	4.1	0.4	9.0	4.8	2.0	35.7
1997	-5.9	7.3	43.0	37.0	2.7	6.3	4.3	5.3	4.5	4.0	32.3
1998	13.2	-7.4	26.7	39.9	5.3	-24.3	-23.1	-0.3	4.5	-0.7	36.6
1999	15.9	6.1	22.4	38.3	2.7	11.7	9.5	13.7	14.1	-3.3	37.4
2000	9.1	8.7	26.9	35.9	1.6	22.6	23.7	13.3	12.7	-6.6	35.3
2001	7.9	0.5	24.4	32.3	1.4	-6.8	-8.1	-2.7	-4.4	-4.8	41.4
2002	7.1	5.4	24.8	32.7	1.8	4.5	6.6	7.2	7.4	-4.3	43.1

**Table 5.8: Malaysia: Select Macroeconomic Indicators**

	Current Account Balance	GDP Growth	Investment	Savings	Inflation	Volume of imports of goods & services	Volume of Imports of goods	Volume of exports of goods & services	Volume of exports of goods	Govt Deficit (% of GDP)	Govt gross debt
2003	12.1	5.8	22.8	34.5	1.1	2.8	2.2	7.4	10.4	-5.0	45.1
2004	12.1	6.8	23.1	35.1	1.4	19.3	23.0	21.8	19.7	-3.7	45.7
2005	14.4	5.0	22.4	36.8	3.0	6.0	4.7	5.8	4.3	-3.0	42.7
2006	16.1	5.6	22.7	38.8	3.6	14.4	15.9	6.9	6.4	-2.7	41.5
2007	15.4	6.3	23.4	38.8	2.0	3.3	1.7	-3.9	-7.3	-2.7	41.2
2008	17.1	4.8	21.5	38.5	5.4	-3.9	-5.1	-7.3	-6.0	-3.6	41.2
2009	15.5	-1.5	17.8	33.4	0.6	-21.9	-23.5	-10.5	-13.0	-6.7	52.8
2010	10.9	7.4	23.3	34.2	1.7	16.5	18.1	7.7	10.1	-4.7	53.5
2011	11.6	5.2	23.2	34.8	3.2	5.9	4.6	6.2	5.3	-3.7	54.2
2012	5.8	5.6	25.9	31.7	1.7	-1.0	0.3	-6.4	-3.8	-3.9	56.2
2013	4.0	4.7	26.1	30.1	2.1	2.0	5.9	0.4	1.9	-4.4	57.7

Source: IMF World Economic Outlook Database, April 2014

Initially Malaysian authorities tried to tighten macroeconomic policies in terms of contranctionary monetary (rise in base lending rate) and fiscal policies (introduction of spending cuts). As these measures yielded little result, in early September 1998 the Malaysian authorities imposed capital controls and pegged the ringgit to the U.S. dollar.<sup>15</sup> What was the nature of these capital controls? There was a detailed administrative structure of these capital control measures, and its basic ingredients had been summarized as:

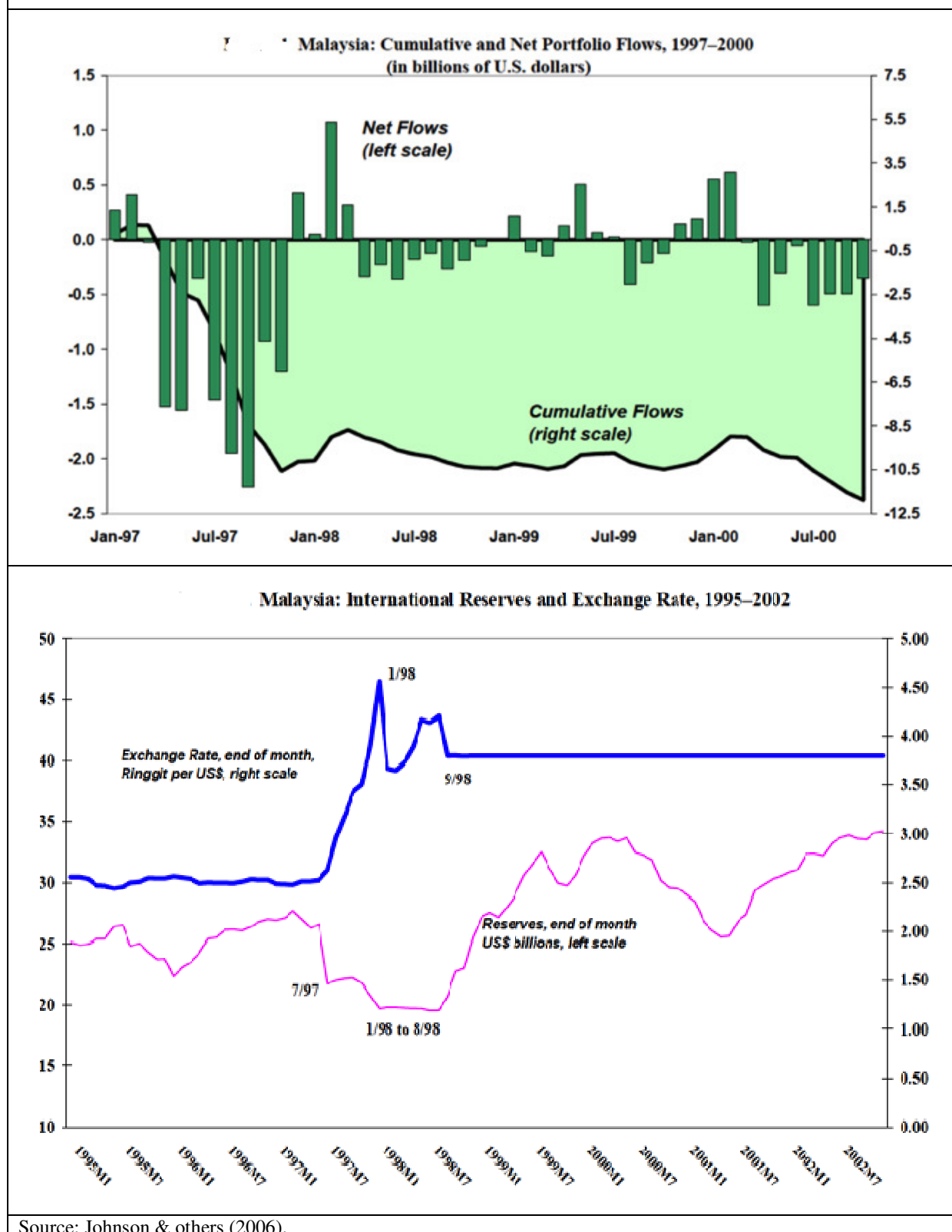
<sup>15</sup>The official press releases emphasized the following objectives: “(i) to limit the contagion effects of external developments on the Malaysian economy; (ii) to preserve the recent gains made in terms of the policy measures to stabilize the domestic economy; and (iii) to ensure stability in domestic prices and the ringgit exchange rate and create an environment that is conducive for a revival in investor and consumer confidence and facilitate economic recovery.”

“To close the offshore market in ringgit and ringgit assets, investors were required to repatriate all ringgit held offshore back to Malaysia, licensed offshore banks were prohibited from trading in ringgit assets, and residents were prohibited from granting or receiving ringgit credit vis-à-vis nonresidents. Among supporting measures, the authorities prohibited offshore trading of ringgit assets and brought to a halt long-standing trading in Malaysian shares in Singapore. In addition to controls on international transactions in the ringgit, the authorities imposed controls on portfolio outflows, particularly a one-year holding period on nonresidents’ repatriating proceeds from the sale of Malaysian securities and a prior approval requirement—above a certain limit—for residents to transfer capital abroad” (Johnson & others, 2006).

Were these measures of capital controls successful? Two views seemed to have emerged. Kaplan and Rodrik (2001) argue that the capital controls enabled a faster and less painful recovery in Malaysia compared with the experience in the Republic of Korea and Thailand. On the contrary Dornbusch (2001) argued that such a view inherently tended to neglect the sound fundamentals of the Malaysian economy as against its comparators. Illustratively, the “burden” of short-term corporate debt was more favorable in Malaysia than in other Asian crisis countries. Besides, Malaysian forex reserves as a percentage of short-term debt was favourable (Table 5.9).



**Chart 5.5: Portfolio Flows, Forex Reserves and Exchange Rate**



**Table 5.9: Foreign Exchange Reserves / Short-Term External Debt Ratio**

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Southeast Asia	1.2	0.7	1.3	2.2	2.3	2.3	2.8	3.0	2.9	2.5
Indonesia	0.5	0.4	0.9	1.3	1.3	1.6	2.3	2.6	2.1	1.9
Malaysia	2.3	1.3	2.5	3.7	3.6	3.3	3.4	4.1	3.8	3.2
Thailand	0.8	0.7	1.1	2.2	2.5	2.7	3.9	4.0	4.4	3.7

Note: Short-term external debt defined as short-term liabilities to BIS reporting banks: consolidated cross-border claims to all BIS reporting banks on countries outside the reporting area with a maturity up to and including one year plus international debt securities outstanding with a maturity up to one year; based on outstanding year-end positions.

Source: Moreno (2008)

### *Some Lessons*

What the lessons of the East Asian crisis are as captured in these country experiences?

At the risk of broad oversimplification, three broad messages may be highlighted.

First, the agility with which these countries acted on crises resolution was remarkable. In fact, all these Asian countries incurring CAD could turn themselves into current account surplus countries. It is pertinent to recall what *The Economist* in the 10th yearly Anniversary Issue of the East Asian Crises (July 4, 2007) commented:

"The situation now could not be more different. Most Asian economies now enjoy sizeable current-account surpluses and have built up extensive foreign-exchange reserves with which, in theory, they could protect their currencies from speculative attack in future. (Indeed, it is an enduring complaint of economists these days that Asian countries have gone too far in the opposite direction, having built up far greater levels

of reserves than they need.) Non-performing loans (NPLs) in the banking sector have fallen, and extensive financial reforms have taken place. As a result, not only are the region's fundamentals no longer conducive to an exact repeat of the 1997-98 crisis, but regulatory controls have also, by and large, improved substantially. Thus, even were some of the conditions that existed in 1996 and early 1997 to reappear in the region, it would no longer be so easy for companies to get themselves into as much trouble as they did then".

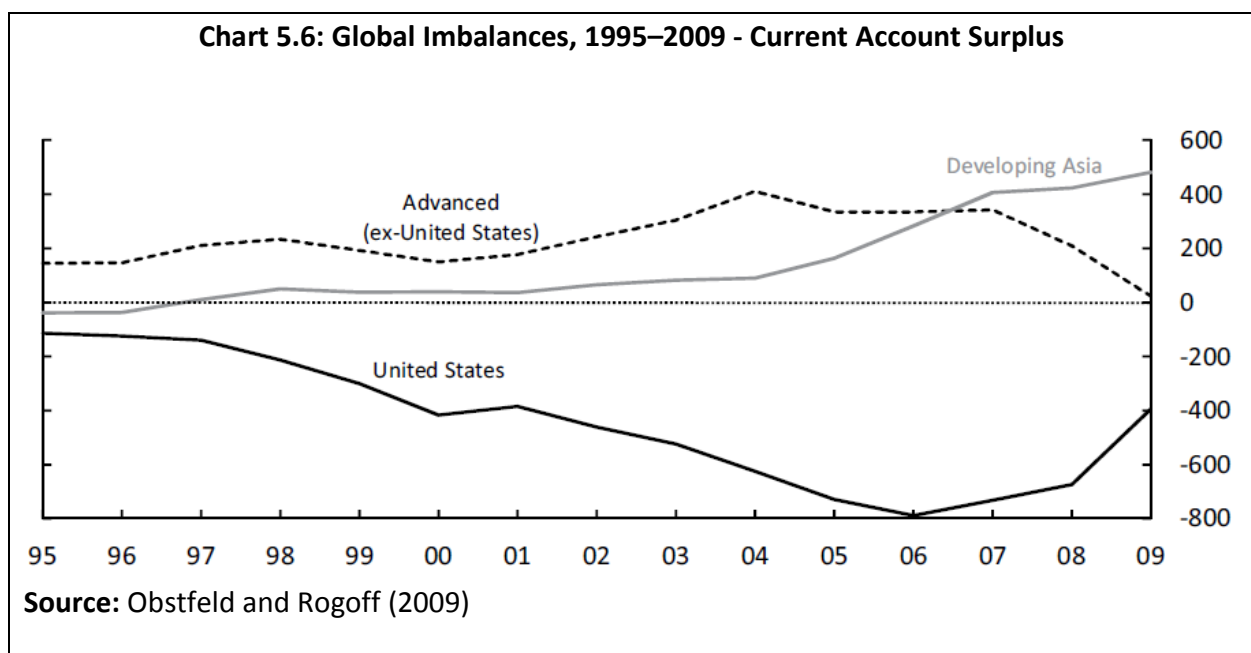
Second, the crisis prompted the global community to take a look at the facets of financial globalization. While the standard neo-classical trade theory (whether Ricardian / Heckscher-Ohlin / strategic trade variety) gives ample rationale for international trade in goods being a positive sum game and a win-win situation for both the parties, similar results for financial globalization are yet to emerge. This is the famous argument of Prof Bhagwati's seminal paper on the difference between trade in widgets and dollars (Bhagwati, 1998), which when stripped of formalism would mean - trade in goods is different from trade in finance. To quote: "This is a seductive idea: freeing up trade is good, why not also let capital move freely across borders? But the claims of enormous benefits from free capital mobility are not persuasive. Substantial gains have been asserted, not demonstrated, and most of the payoff can be obtained by direct equity investment" (Bhagwati, 1998). As far as foreign direct investment is concerned, transfer of technology (of non-shiftable nature) is admittedly a great advantage. But in case pure financial flows the gains are somewhat limited - the only thing they do is to ease the finance constraint and to allow for consumption smoothing on the part of the recipient nation. Besides, flow of finance could be: (a) fickle; and (b) subject to herd

behavior. Thus, implicitly there could be a hierarchy of financial flows - FDI is more preferable to portfolio investment or external commercial borrowing, both of which could have attendant costs.

Third, the East Asian experience also opened up the Pandora's Box of desirability and options of capital control. Malaysian experience has clearly demonstrated that measures of capital control can genuinely be a part of the country's macro-prudential tool box to combat undesirable capital flows.

Fourth, another message of the East Asian experience is the desirability of having forex reserves as a self insurance mechanism. The logical process is somewhat tenuous. After all, for a nation issuing reserve currency there may not be any necessity of reserve accumulation. For all other countries a prolonged reserves accumulation would ultimately mean insufficient movement in exchange rate. In that case, the possibility of keeping one's currency undervalued and pursuing a mercantilist trade strategy cannot be ruled out. In Asia the stature of China as an economic super-power running huge trade surpluses, maintaining a depreciated currency and accumulating huge forex reserves perhaps become economic model to imitate. Was it right for the global community? The later experience showed that the aggregate current account surplus (or, "savings glut" to use Bernanke's term) from Asia turned out to be an essential ingredient of formation of 'global imbalance' (wherein cumulative current account surplus of developing Asia and oil exporting nations ended up to the U.S via reserves accumulation in the form of investment in US Treasury bills and led to low borrowing cost in the U.S), which emerged as a major reason of the 2007 / 08 global financial crisis (Chart 5.6). Or, what is often

not explicit said - is it the way in which the unfortunate handling of the Asian crisis by the advanced powers in 1997 got a rebuff from the Asian nations in 2007? While one can only be speculative in such cases, the role of exchange rate politics cannot be ruled out in resolution of the East Asian then and in brewing up of global financial crisis now.



## **6. India's CAD: Long-term Trends and Recent Experience**

It may not be an exaggeration to say that over the post-independence period, India's experience on BoP has been marked by a number of structural breaks in terms of crisis; the following are important in particular: (i) the devaluation in 1966; (ii) first and second oil shocks of 1973 and 1980; (iii) external payments crisis of 1991; (iv) the East Asian crisis of 1997; (v) the global financial crisis of 2008; and (vi) volatility in exchange rate following hints of great tapering off.<sup>16</sup> Current account deficit has been an issue with the Indian economy perennially with external shocks like Indo-Pakistan war of 1971, oil shocks, or Iraq's invasion of Kuwait exacerbating the extent of CAD. Consequently, India had heavy restrictions on current as well as capital account till the opening of the economy in the early 1990s. Exchange rate too was heavily managed and pegged (Chart 7.1). To tide over the BoP crises, both in 1981 and 1991 India had taken IMF loan; India also adopted some measures of severe import compression as well as temporary fiscal rectitude.<sup>17</sup>

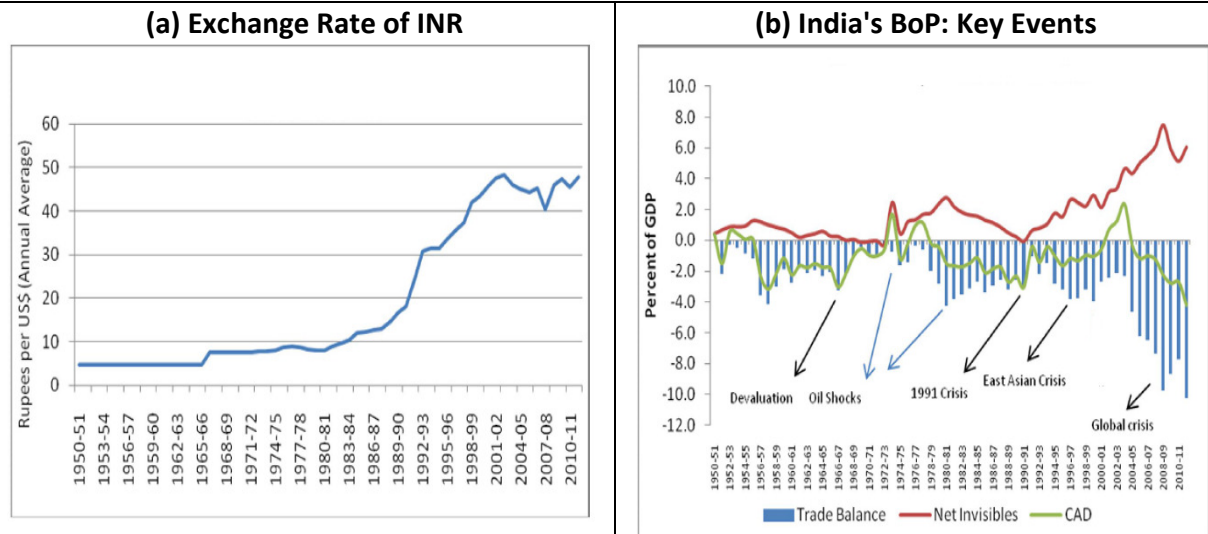
The crisis in 1991 was indeed hard hitting when India's forex reserves reached a low of US \$ 1.2 billion capable of funding essential imports of 3 weeks. Indian authorities did not allow the crisis to go waste and a host of liberalizing measures were initiated. The story of Indian liberalization is too well known to be repeated here; for the sake of completeness one can provide a skeletal view of external sector reforms and then focus on the recent experience in particular.

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<sup>16</sup> Identification of these breaks follows Joshi and Little (1994) and Mohanty (2012).

<sup>17</sup> In 1981-82, India borrowed SDR 3.9 billion under an Extended Fund Facility, the largest arrangement in IMF history at the time. During 1991-93, India borrowed a total of SDR 2.2 billion under two stand-by arrangements, and in 1991 it borrowed SDR 1.4 billion under the Compensatory Financing Facility.

**Chart 6.1: India's BoP and Exchange Rates: Long Term Trends**



Source: Mohanty (2012)

### Exchange Rates

The general philosophy of Indian external sector was laid out in the Report of the High Level Committee on Balance of Payments (Chairman: C. Rangarajan, 1993), in which trade policies, exchange rate policies and industrial policies were recognized, "as part of an integrated policy framework so as to boost the overall productivity, competitiveness and efficiency of the economy" (Mohanty, 2012). Besides, the exchange rate of rupee was adjusted downwards in two stages on July 1 and July 3, 1991 by 9 per cent and 11 per cent, respectively. A dual exchange rate system, introduced in March 1992, was turned to a unified system in March 1993. Subsequently, India moved to current account convertibility in August 1994 by liberalizing various transactions relating to merchandise trade and invisibles.

What was the exchange rate policy of India? Interestingly, in contrast to the Asian economies discussed in the earlier sector, a distinguishing feature of the INR has been that it has shown two-way movements during 2000 - 2015 (Chart 6.1a above). Despite some fluctuations, it may not be an exaggeration to say that the rupee has been able to avoid large volatility over a prolonged period of time. This is in consonance with the professed policy objective of the RBI, which can be best summarized in the words of an ex-Governor of the RBI:

“RBI does not have a fixed ‘target’ for the exchange rate which it tries to defend or pursue over time; RBI is prepared to intervene in the market to dampen excessive volatility as and when necessary; RBI’s purchases or sales of foreign currency are undertaken through a number of banks and are generally discrete and smooth; and market operations and exchange rate movement should, in principle, be transaction-oriented rather than purely speculative in nature.” (Jalan, 2003.)

The policy stance does not seem to have changed much since then. More recently, the "Expert Committee to Revise and Strengthen the Monetary Policy Framework" (Chairman: Urjit Patel, Deputy Governor, RBI) also endorsed this view when it commented that: “The RBI does not target a specific rate or level for the exchange rate ... the RBI intervenes in the market only to smooth exchange rate volatility and prevent disruptions to macroeconomic stability.” (RBI, 2014; p. 11.).



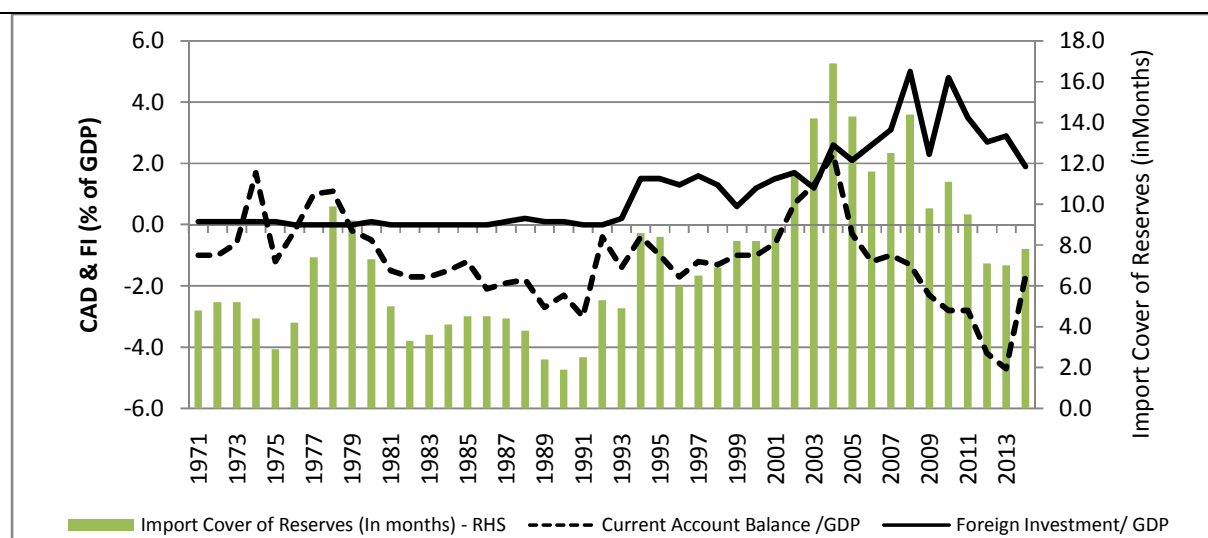
## *Current Account*

In fact, during the period 1994 - 2004 current account balance of India was turned from modest deficit to a modest surplus (Chart 6.2) with some significant reserve accumulation. The strategy was commendable as has been observed by an ex-Governor of the RBI:

"From a cross-country perspective, the Indian experience with managing the current account reveals some unique features. First, the lessons of the 1991 crisis brought forth policies which ensured a low current account deficit in the ensuing years. This approach stood us in good stead in warding off the contagion from the Asian crisis of 1997-98. Second, the sustainability of the current account was ensured by a policy choice for non-debt flows and emphasis on the consolidation and reduction of external debt. Third, the low current account deficit was underpinned by shifts in international competitiveness favouring software, IT exports and workers' remittances over traditional exports. Fourth, although the fiscal deficit remained somewhat inflexible, it was not allowed to spill over into the current account. Finally, the current account deficit being the mirror image of the absorptive capacity, it is best assessed over the business cycle rather than at discrete points" (Reddy, 2005).

The situation was different in the post-2004 period, when slowly and steadily India's CAD experienced an increase till 2013, which was financed primarily by foreign investment. Foreign investment, however, exhibited substantial volatility (Chart 6.2).

**Chart 6.2: India's CAD, Foreign Investment (FI) & Import Cover of Reserves**



Source: Compiled from RBI data

In order to focus on the current dilemmas of Indian policy making, we now concentrate on a recent episode of a sharp depreciation of the rupee during the period June–August 2013. The INR-USD exchange rate was down from a level of 56.765 in the beginning of June 2013 to 67.8787 on August 29, 2013—a depreciation of over 16 per cent.

#### *Tapering Talks and the Attack on INR: June- August 2013*

The specter of unsustainable CAD, having touched 4.7 per cent of GDP during 2012-13, seems to have made a comeback here in explaining this attack on Indian currency. Illustratively, Rangarajan and Mishra (2013) found that the estimated current account deficit for 2011–12 at 4.2 per cent of GDP was significantly above the level that could be sustained over the medium term. The RBI too in its *Annual Report* for 2012–13 had indicated the sustainable CAD for India to

be at 2.5 per cent of GDP.<sup>18</sup> The financing of this CAD was essentially done through foreign investment which was heavily tilted towards foreign portfolio investment (Table 6.1).

Table 6.1: India's BoP: 2012-2013								
(USD billion)								
	2012				2013			
	Jan– Mar	Apr– June	July– Sept	Oct– Dec	Jan– Mar	Apr– June	July– Sept	Oct– Dec
<b>1. Current Account</b>	<b>–21.8</b>	<b>–17.1</b>	<b>–21.1</b>	<b>–31.8</b>	<b>–18.2</b>	<b>–21.8</b>	<b>–5.2</b>	<b>–4.1</b>
1a) Merchandise	–51.5	–43.8	–47.8	–58.4	–45.6	–50.5	–33.3	–33.2
1b) Invisibles	29.8	26.8	26.7	26.6	27.5	28.7	28.1	29.1
<b>2. Capital Account</b>	<b>16.6</b>	<b>16.5</b>	<b>20.7</b>	<b>31.5</b>	<b>20.5</b>	<b>20.6</b>	<b>–4.8</b>	<b>23.8</b>
2a) Foreign Investment	15.3	1.9	15.9	11.9	17.0	6.3	1.5	8.5
o/w Foreign Direct Investment	1.4	3.8	8.2	2.1	5.7	6.5	8.1	6.1
o/w Foreign Portfolio Investment	13.9	–1.9	7.7	9.8	11.3	–0.2	–6.6	2.4
2b) Loans	2.7	6.0	5.2	10.8	9.2	3.6	–0.5	3.0
<b>3. Forex Reserves (Increase –; Decrease +)</b>	<b>5.7</b>	<b>–0.5</b>	<b>0.2</b>	<b>–0.8</b>	<b>–2.7</b>	<b>0.3</b>	<b>10.4</b>	<b>–19.1</b>
INR-USD Exchange Rate (Min - Max) in Rs.	49–53	51–57	53–56	52–56	53–55	54–61	59–68	61–64
Source: RBI								

One of the lessons of the East Asian crisis is that portfolio investment tends to be fickle everywhere and also suffers from herd behavior on the part of the usual suspects of investment banks, hedge funds and private equity funds. All these funds were very generous in terms of pumping money towards emerging market economies (EMEs) as long as the policy of

<sup>18</sup>At an extreme, Sen (2013) found the Indian story of nominal depreciation of the currency during this period to be entirely predictable and squarely blamed the official policy of permitting capital inflows to finance the CAD for the adverse developments on the exchange rate front.

quantitative easing (QE) was being practiced by the US Fed, whereby huge amount of liquidity was being injected. By May 2013, the then US Fed Chairman dropped his first hint that the US Fed might start tapering off the pace of QE.<sup>19</sup> Taking a cue the portfolio investors started withdrawing from those EMEs which have less strong fundamentals. India's large CAD was interpreted as an essential ingredient of its weak fundamentals and there were large-scale outflows of foreign portfolio investment during June, July and August 2013 - both on account of debt and equity (Table 6.2).<sup>20</sup>

<b>Table 6.2: FII Investment Flows during 2013</b>			
	Equity	Debt	Total Flows
	Net Investment	Net Investment	
Jan-13	4,096	614	4,710
Feb-13	4,142	755	4,898
Mar-13	1,913	924	2,836
Apr-13	1,184	1,288	2,471
May-13	3,772	520	4,292
Jun-13	-1,764	-5,366	-7,130
Jul-13	-986	-2,111	-3,097
Aug-13	-947	-1,379	-2,325
Sep-13	1,994	-1,260	734

<sup>19</sup> On May 22, 2013, US Fed Chairman Ben Bernanke made the following statement in his testimony before the US Congress: "Over the nearly four years since the recovery began, the economy has been held back by a number of headwinds. Some of these headwinds have begun to dissipate recently, in part because of the Federal Reserve's highly accommodative monetary policy. Notably, the housing market has strengthened over the past year, supported by low mortgage rates and improved sentiment on the part of potential buyers. Increased housing activity is fostering job creation in construction and related industries, such as real estate brokerage and home furnishings, while higher home prices are bolstering household finances, which helps support the growth of private consumption" (Bernanke, 2013). Financial market players took this as first cue towards tapering off.

<sup>20</sup> India was not the only country who was affected by tapering talk. Countries having large CAD like Brazil, Mexico, South Africa and Turkey were all affected.

**Table 6.2: FII Investment Flows during 2013**

(USD million)

	Equity Net Investment	Debt Net Investment	Total Flows
Oct-13	2,927	-2,095	832
Nov-13	1,130	-784	346
Dec-13	2,527	863	3,390
Source: RBI			

In order to combat this problem various measures were initiated by the RBI and the Government (RBI, Annual Report, 2013-14). While the initial measures were aimed at restricting imports, later ones were geared towards liberalizing the regime of foreign investment and external commercial borrowing. The immediate measures to combat the fall-out in the forex market were the following.

1. The RBI opened a **forex swap window** to meet the entire daily dollar requirements of three public sector oil marketing companies (viz., Indian Oil, Hindustan Petroleum, and Bharat Petroleum) with effect from August 28, 2013, under which the RBI undertook sell/buy USD-INR forex swaps for fixed tenure with the oil marketing companies through a designated bank.<sup>21</sup>

<sup>21</sup>This swap facility continued for the next three months and was withdrawn on December 2, 2013 after the rupee stabilized to a large extent.

2. The Indian and the Japanese governments have expanded their **bilateral currency swap arrangement** from USD 15 billion to USD 50 billion to impart stability to the forex situation.
3. A number of other policy measures were also initiated **to augment capital inflows**, such as, exemption of incremental FCNR(B)/NRE deposits with a maturity of three years and above from cash reserve ratio/statutory liquidity ratio (CRR/SLR) requirements; exclusion of the incremental FCNR(B)/NRE deposits from adjusted net bank credit for computation of priority sector lending targets; liberalization of FDI norms through review of limits; raising of the overseas borrowing limit of banks from 50 to 100 per cent of the unimpaired Tier I capital (with the option of swap with the RBI); and permitting of borrowers to avail themselves of external commercial borrowings (ECBs) under the approval route from their foreign equity holder company for general corporate purposes.
4. Finally, two major steps were taken to **curb gold imports**—one of the major factors responsible for increasing India's import bill. First, the RBI rationalized gold import rules whereby under the new norms, all banks and authorized agencies would have to ensure that at least 20 per cent of the imported gold was made available for exports and a similar amount retained with the customs. Second, import duty on gold was increased twice; initially, on June 5 the duty was raised to 8 percent from 6 per cent, and then to 10 per cent on August 13, 2013.

The measures aimed at ensuring some medium-term improvements in India's BoP included following ones in particular:

1. **Foreign direct investment (FDI):** The FDI regime was made more liberal through measures such as, (a) allowing nonresidents (other than portfolio investors) to acquire shares on the stock exchange under the FDI scheme in a listed Indian company; (b) allowing Unlisted companies in India to raise capital abroad without the requirement of prior or subsequent listing in India; (c) creating a new investor class, FPIs by subsuming the existing regulatory framework for FIIs and QFIIs with streamlined know your customer (KYC) procedures; (d) permitting all eligible foreign investors, including FPIs were permitted to make investments in dated G-secs having residual maturity of one year and above
2. **Swap facility to enhance banks' overseas borrowing:** overseas borrowing limits for authorized dealers (ADs) / category-I banks was raised to 100 per cent of their unimpaired Tier I capital as at the close of the previous quarter or US\$ 10 million, whichever is higher, against the prevailing limit of 50 per cent.
3. **Liberalisation in inward remittance schemes:** The scope of the Rupee drawing arrangement (RDA), one of the official channels for receiving inward remittances, has been further expanded by permitting additional activities like (a) direct payment of bills to the utility service providers and tax authorities in India and (b) equated monthly installment (EMI) payments in India to banks and non-banking financial companies (NBFCs) for repayment of loans.
4. **External commercial borrowings (ECBs):** With a view to strengthening foreign capital inflows in the infrastructure sectors: (a) the definition of the infrastructure sector was

expanded for the purpose of availing ECBs; (b) NBFCs - asset finance companies were permitted to avail of ECBs under the automatic/approval routes to finance the import of infrastructure equipment for leasing to infrastructure sectors; and (c) the ECB limit for NBFCs – infrastructure finance companies was raised from 50 per cent to 75 per cent of their owned funds, including the outstanding ECBs under the automatic route, and beyond 75 per cent of their owned funds under the approval route and their hedging requirement for currency risk was reduced from 100 per cent to 75 per cent of exposure.

Consequent to all these measures, apart from the assurance of the US Fed that the tapering will be deferred for the time being, there has been a major adjustment in India's external sector in 2013-14.<sup>22</sup> After widening to a historical annual high of 4.7 per cent of GDP during 2012-13, the CAD narrowed sharply in 2013-14 aided by a lower trade deficit.

This recent episode teaches us the possible deleterious impact of high and unsustainable CAD that is financed primarily by foreign portfolio investment and commercial borrowing. There is no way to ensure that in future such attacks will not happen. End of the day foreign portfolio investment to a country is a function of "risk-adjusted return on capital in that country" vis-a-vis risk-adjusted return on capital in its comparator / rival country". Thus, any

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<sup>22</sup>The US Fed FOMC Statement released on September 18, 2013 put an end to all speculation and stated the following categorically: "The Committee will closely monitor incoming information on economic and financial developments in coming months and will continue its purchases of Treasury and agency mortgage-backed securities, and employ its other policy tools as appropriate, until the outlook for the labor market has improved substantially in a context of price stability. ... Asset purchases are not on a preset course, and the Committee's decisions about their pace will remain contingent on the Committee's economic outlook as well as its assessment of the likely efficacy and costs of such purchases."



change in the risk-return configuration in any of the countries could lead to capital flight. It is important to remind ourselves that:

"A modest improvement in external sector indicators, however, does not warrant any policy complacency. Spillovers from renewed external pressures through the trade channel and/or financial channel may resurface and thus pose a challenge for India's external sector. The policy focus should be on improving domestic macroeconomic fundamentals so as to minimise such spillovers. In particular, policy attention is required for (i) redressal of sector-specific structural issues impeding exports, (ii) low inflation for supporting the stability of the rupee and to enhance external competitiveness, and to reduce investment demand for gold, (iii) easing of binding supply constraints in certain sectors (for example, POL, coal and fertilisers) that are critical for the domestic economy and can induce a surge in total imports, (iv) a conducive business environment to ensure a better mix of capital flows for CAD financing by attracting stable non-debt creating flows, and (v) improved governance" (RBI, Annual Report, 2013-14).

## **7. In lieu of An Epilogue: Lessons for India:**

In light of these country experiences what are lessons for India? Since issues relating to CAD are intimately interlinked to issues related to its financing, often policy prescription in this sphere becomes heavily biased towards ideology of the exponent. Illustratively, the experience of East Asian Crises could be read as failure of capital account liberalization or it can be interpreted as failure to build up appropriate institutional and regulatory structure to tackle capital flows. A priori it is difficult to decipher the correct course of action - as Blaise Pascal has said, "The heart has its reasons which reasons knows nothing of". From this standpoint, what follows below is three-fold type of lessons for India emanating from three distinct (perhaps caricatured) philosophies:

- (a) continuation of the status quo coupled with some calibrated incrementalism;
- (b) making the reform / liberalization process much faster in the external front of the Indian economy; and
- (c) overhauling the structure of the economy so that possibilities of incurring CAD are done away with.

### *The Conservative Status Quo and Calibrated Incrementalism*

In some sense this point of view was the crux of the RBI approach to external sector till recently. From this standpoint, any unbridled increase in CAD is reflection of a country's weakness as there are limits to absorption capacity of the economy. For example, in a country like India any CAD which is higher than around 2 - 3 per cent of GDP could turn out to be

unsustainable. What happens when the CAD exceeds such threshold? Given the nature of the Indian forex market, and limited ability of the RBI to intervene, exchange rate could depreciate so much that it could affect the country adversely - all the more if the country is in an inflationary situation. What should then a country do to avoid CAD to permeate to such an unviable situation? One can think of a menu of options.

First, the country should avoid "original sin" of floating Sovereign debt in a currency which cannot be printed by the country under consideration. The Latin American experience shows this. India has scrupulously avoided this sin. However, SBI-floated five-year foreign currency denominated deposit christened "India Millennium Deposit" (IMD), for mobilising funds from non-resident Indians in 2000 and SBI floated debt paper called Resurgent India Bonds (RIB) in 1998 are illustrations of quasi-Sovereign borrowing. It is good that India withstood the temptation of issuing such instruments since 2000. This policy should continue.

Second, there is hierarchy of preference among the various sources of capital inflows that can finance the CAD. FDI is preferred over portfolio investment and loans. Within portfolio flows, opening up the equity market is preferable to opening up the debt market. In this context, one is reminded of the Tarapore committee II's recommendations on three preconditions of capital account liberalization, viz., (a) low inflation; (b) low fiscal deficit; and (c) low non-performing assets of the banking sector. Going by the contemporary macroeconomic numbers of the Indian economy, the time is yet to be ripe for a drastic opening up of the external sector.

Third, the country should have a two pronged strategy of unproductive import compression along with keeping the options of capital controls open. In case of India, restricting gold imports could form part of the former; after all, a large chunk of the import bill is on account of oil and petroleum products, which may not be amenable to much compression. As far as "capital controls" are concerned, the contemporary global position is much less hostile. The IMF too has shed its earlier orthodoxy on "capital controls" and has started favouring "capital flow management" (CFM) (a euphemism for capital control) measures. It has changed its position as, "there is no presumption that full liberalization is an appropriate goal for all countries at all times; the degree of liberalization appropriate for a country at a given time depends on its specific circumstances, notably its financial and institutional development" (IMF, 2012).

Fourth, there is great value of reserve accumulation as a self insurance mechanism. From that standpoint it is foolhardy to calculate the cost of holding reserves in terms of interest foregone. Saving from crisis is huge bonus of accumulated forex reserves.

Finally, the opening up of the external sector is a process and its pace has to be calibrated (read 'slow' if you are a non-believer of this position) to suit the institutional and structural features of the economy.

#### *The Liberal and the Market Believer*

It is interesting to see that in broad terms the approach delineated above (may be in a slightly caricatured way) corresponded to the India official thinking till about 2005. Since then in

the popular perception has changed a bit - while the RBI is seen as a conservative to tackle CAD and the Government is seen liberal propagating more liberal capital inflows.

The reports of the 2007 High Powered Expert Committee on Making Mumbai an International Financial Centre (Chairman: Percy Mistry) and the 2009 Committee on Financial Sector Reforms (Chairman: RaghuramRajan) both bear testimony to this. Both these reports adopted a far more liberal approach to opening up India's external sector so that India's capital flows grow up more and is capable of supporting either a far higher CAD or reserve accumulation or both. Illustratively, Rajan Committee spoke categorically in terms of opening up investment in the rupee corporate and government bond markets to foreign investors after a clear monetary policy framework / inflation targeting is in place.

The difference of viewpoint between the RBI and the Central Government was most clearly observed in the context of the 2005 Report of the “Expert Group on Encouraging FII Flows and Checking the Vulnerability of Capital Markets to Speculative flows” (Chairman: Ashok Lahiri)<sup>23</sup> to which the RBI attached a dissent note. The difference of opinion occurred along various dimensions.

- First, “in view of macroeconomic implications, impact on financial stability, especially on exchange rate, and fiscal vulnerability, apart from monetary management”, the RBI wanted a special group to be constituted to study measures to contain large volatility in FII flows.

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<sup>23</sup>Available at <http://finmin.nic.in/theministry/deptecoaffairs/capitalmarketdiv/ReportEGFII.pdf>

- Second, the RBI differed on the threshold limits of different caps to be imposed on FDI and FII.
- Third, the RBI wanted the PNs to be wound up. Fourth, there was also difference of opinion regarding treatment of hedge funds, ceiling on holding of shares by FII and sub-accounts, operational flexibility to impart stability to the markets.

To the popular press, the stance was interpreted as, “RBI's yearning for more capital controls” (Shah, 2006).

Is there any difference of substance between the two approaches? Treating Y V Reddy, former RBI Governor, as an exponent of the calibrated conservative approach, it is interesting to refer to D N Ghosh, who commented:

“The RBI and the government were both committed to a healthy development of the financial market, but Reddy, as governor, had been stressing, and quite often at that, on the need to maintain a proper balance between the different components of what goes on in the name of liberalisation. He was of the view that unless development of the domestic bond market was put on a firm footing, it would be premature to open it up to foreign investors. ....In hindsight, it is not difficult to visualise how pitiable a condition we would have found ourselves in if Reddy had succumbed” (Ghosh, 20089)!

Thus, the 2007 financial crisis has added a new dimension to the debate. In the caricatured world of 'opening up more' versus 'opening up less', economic wisdom suddenly

seemed to have tilted towards 'opening up less'. But is that the correct reading of contemporary policy discourse? Rajan Committee has reminded us rightly:

"There are no 'correct' or 'ideal' solutions for managing the integration of a large domestic financial system into the global economy. While the gains are considerable, the penalties for mistakes can be both large and harsh. What is clear is there is a premium on consistency, clarity, credibility and continuity of policies. It is also clear that a whole range of institutional (and even political) factors go to shape each nation's response. These include the nature of the financial system, the independence of the central bank (and its relationship with the Ministry of Finance), the quality of market regulation and even the functioning of the labour market."

Thus, it seems that the difference between the two approaches is more to do with degree rather than substance and as the country becomes more and more developed (in terms of institutional framework, e.g., development of more risk mitigating products ) and strong in terms of macro-financial stability configuration, the country can withstand a far more higher CAD.

#### *Overhaul the Structure of the Economy*

CAD is indicative of a nation's indebtedness to the rest of the world. From this standpoint it hangs like Damocles' sword. However organized / productive a nation is, it is very difficult to keep its CAD under check over a long period. From an

emerging country viewpoint, is it not the best strategy then to get rid of CAD all together? After all, is it not the message from the Asian economies?

Definitionally, there are three ways to attain it. First, a country can improve its productivity and develop comparative advantage in its goods producing sector so that it starts having a trade surplus. Second, in case the country fails to develop comparative advantage in goods producing sector, it may move towards services sector so that it earns a huge surplus on account of invisibles. Third, depending upon the labour movements, the country may earn remittances. In case of India both the second and the third thing happened. But persistence of CAD in India is due to our inability to achieve a surplus in our trade account. Is there any way to achieve it?

This calls for overhauling of India's development and growth strategy. Contrary to the global trend, during the post-independence period progressing Indian growth has been tilted heavily towards the services sector - it is as if the country has moved from agriculture to services, largely bypassing manufacturing. Apart from its adverse impact on employment, such a service-oriented strategy had its toll on the trade front. In such a situation it is no wonder that Indian balance of trade has been perennially in the deficit region.

What is the way out? As essential imports of oil are quite price inelastic, exploring newer exportables is the only answer. An emphasis on manufacturing and improving "doing business indicators" for India can go a long way in this effort. The recent "Make in India" campaign with its focus on select sectors of the economy for job



creation and skill enhancement (such as, automobiles, chemicals, IT, pharmaceuticals, textiles, ports, aviation, leather, tourism & hospitality, wellness, auto components, design manufacturing, renewable energy, mining, bio-technology, and electronics) is the ideal way to ensure this. Going forward, the issue of continuance of CAD will crucially depend on the success of the "Make in India" campaign-turned-programme and India, like China, emerging as a manufacturing hub of exports.

#### *Future of Capital Account Convertibility (CAC) in India*

In light of the discussion so far, how do we see the future of capital account convertibility in India? In order to answer this question, it is pertinent to note that CAC cannot be end in itself but a means to some desirable objective of the economy. In discussing the objectives and significance of Fuller Capital Account Convertibility (FCAC) in the Indian Context, the 2006 Committee on FCAC (Chairman: S Starapore) has rightly noted:

“FCAC is not an end in itself, but should be treated only as a means to realise the potential of the economy to the maximum possible extent at the least cost. Given the huge investment needs of the country and that domestic savings alone will not be adequate to meet this aim, inflows of foreign capital become imperative. ....In India, policies for portfolio or Foreign Institutional Investor (FII) flows are much more liberal, but the same cannot be said for FDI. Attracting foreign capital inflows also depend on the transparency and freedom for exit of

non-resident inflows and easing of capital controls on outflows by residents”  
(RBI, 2006, p. 7; emphasis added).

In this context the FCAC report has enumerated the following objectives of CAC:

- a) to facilitate economic growth through higher investment by minimising the cost of both equity and debt capital;
- b) to improve the efficiency of the financial sector through greater competition, thereby minimising intermediation costs and
- c) to provide opportunities for diversification of investments by residents”

To the present author, the objectives of CAC continue to be those highlighted by the FCAC Committee of 2006. However, the recent past has been marred by the experience of the twin global crises of the global financial crisis followed by the euro area crisis. What has been their impact of the future contours of Indian CAC? Two views can be cited in this regard.

The first view has questioned the very process of financial globalization and ultimately the process of CAC. Illustratively, it has been found that there is little / no correlation between long-run economic growth and financial globalization. Rodrik and Subramanian (2009) reviewed the literature favouring financial globalization (and thereby, CAC) and found it to be unconvincing. In their view, three key assumptions drive the result of positive impact of financial globalization on economic growth, viz., (a) developing countries are savings-constrained; (b) access to foreign finance alleviates this to boost investment and long-run growth; and (c) problems with financial globalization can be remedied through deep

institutional reforms. In contrast, they argued that, “developing economies are as or more likely to be investment- than savings-constrained and that the effect of foreign finance is often to aggravate this investment constraint by appreciating the real exchange rate and reducing profitability and investment opportunities in the traded goods sector, which have adverse long-run growth consequences”. From this standpoint even the objectives of the committee of FCAC are in question and the future of CAC in India could be couched in terms of inaction – or, at least, in terms of an absence of any big bang approach in the policy regime governing CAC.

There is, however, another influential view on the whole issue. The 2009 Report of the Committee on Financial Sector Reforms (Chairman: Raghuram Rajan), on the contrary, argued that,

“Capital account liberalization is important from the viewpoint of bringing in new kinds of players and new kinds of competition. ....Capital account restrictions do not work in practice. But they do drive liquidity away from organized financial markets. By placing restrictions on investment by foreigners in domestic securities, we force them away from the market and into other channels, thereby depriving the Indian financial markets from the opportunity to benefit from the participation of foreign firms....*Indian households and Indian financial firms would be better served under convertibility, because they would have greater choice on the financial firms and financial markets that they choose to utilize.* This competitive pressure would induce significant improvements on the part of Indian market institutions and Indian financial firms. *The role of convertibility in increasing competitive pressure and fostering greater technological*

*dynamism in finance is the same as the role played by trade reforms in the case of nonfinancial firms*(Planning Commission, 2009; p.116; emphasis added).

Faced with these two contrasting views in the current context of the twin global crises, how do we see the future of CAC in India? It is useful to turn to the guiding posts of the FCAC committee in this context. The original FCAC committee recommended four signposts, viz., (a) GFD; (b) Inflation rate; (c) Gross NPA; and (d) average effective CRR for 1999-2000. We have tried to compare these signposts with the latest available data for 2014-15. While both on account of GFD and inflation rate, the actual is far worse than what was recommended for 1999-2000, the performance in the financial sector front is not too-impressive (Table 7.1). In other words, nearly after fifteen years, we are still far off from the FCAC signposts.

<b>Table 7.1: Signposts for CAC in India</b>			
Item	Recommendations of the 1997 FCAC Committee for 1999-2000	Position in 2005-06 (as reported in the 2006 FCAC Committee	Present Position (2014-15)
1. Gross Fiscal Deficit (% of GDP)	3.5	4.1	4.0
2. Inflation Rate	3.0 – 5.0 (WPI inflation – Average for 3 years)	4.6 (WPI inflation – Average for 3 years)	8.5 (CPI Inflation - Average for 3 years)
3. Financial Sector:			
(a) Gross NPA (% of Total Advances)	5.0	5.2	4.5
(b) Average Effective CRR	3.0	5.0	--
Source: RBI (2006) and author's calculation based of Annual Report, RBI, 2014-15.			

Where do all these evidence lead us to? Based on the current performance of the Indian economy and the current global economic situation, we expect no back-tracing from the professed policy of calibrated capital account convertibility. But at the

same time we expect no cold-turkey approach in this front either. Thus, the future of CAC in India is expected to be couched in terms of numerous small, marginal and gradual steps. Given the performance of the signposts, this gradualism (or slow pace of CAC reforms in India) is expected to be observed far more in context of increasing opening of debt market than that of the equity market.

To sum up, as long as CAD exists, depending upon the state of the economy and its institutional development, a nation can be conservative / liberal in terms of its financing from capital flows. But in order to get rid of CAD all together, the best route is to develop manufacturing and start having trade surplus. From this standpoint, the 'Make in Indian' Campaign is a right step towards this direction.

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