External Account and Sovereignty

At one place, in his *Capital in the Twenty-First Century*, Thomas Piketty asks "*To what extent will some countries find themselves owned by other countries over the course of the twenty-first century? Are the substantial net foreign asset positions observed in the colonial era likely to return or even to be surpassed?"* The implication is that when the net external liabilities become unserviceably high, a country can become a financial colony of its creditors, with its macroeconomic and "structural adjustment" polices being dictated by them. The latest example of this is of course Greece, whose fiscal policies; tax rates and administration; old-age pensions and social welfare policies; privatisation program; etc. are being dictated by the "troika": the European Central Bank, the European Union and the International Monetary Fund. Even when this approach works, the country bears a huge cost: lower living standards, with the largest burden falling on the poorest.

To be sure, Greece is not like most other countries in the world which have their own currencies: in a way, it had already surrendered a part of its "sovereignty" by participating in the common currency. But the point made by Piketty has broder application, including to our country whose International Investment Position (IIP) is negative to the extent of $ 350 bn. During the recent controversy about the Monetary Policy Committee and its powers, Governor Raghuram Rajan has been lionised by media for his achievements since taking charge: for example, the Financial Times editorially praised him for giving "*the rupee a slug of credibility when other developing countries were under attack*" (July 25). T C A Srinivasa-Raghavan (Business Standard, August 1)) praised him as one man who can save the Indian economy from being "*a hapless leaf on the turbulent and merciless seas of global finance*", dominated by "*the enormous international financial powers that are at work*". He also emphasised Dr Rajan's "*ability and the power to keep an eye on global speculators, who can wreak complete havoc*". In the context of TCA's comments on global finance, it is interesting to see what Dr. Rajan has argued on the point, in *Saving Capitalism from the Capitalists* (2003), a book co-authored by him, criticising the crony capitalism prevalent in too many countries:

"Capital controls were meant primarily to prevent a twenty-year-old investment banker from moving money across the world to the country providing the highest returns – what government bureaucrats derisively term speculative capital.

"In the absence of the competitive discipline provided by cross-border capital flows, domestic financial institutions obtained monopoly over finance. Productive firms that were not in political favour could not get finance. Capital controls also took away a significant source of budgetary discipline on governments, thus giving them leeway for constant intervention in the economy."

Now, I am not a bureaucrat, but I still believe that much of portfolio capital flows are speculative, aiming at profiting from price changes, not long term returns from the investment: and so does TCA as his comments suggest. But, Dr Rajan seems to look at the "*the turbulent and merciless seas of global finance*" differently, as a "*source of budgetary discipline on governments".* I, for one, shudder at the idea of a bonus-driven "*twenty-year-old investment banker*", disciplining a government elected by *"we the people of India"* -- presuming of course that the poor fellow finds time and energy to do this after LIBOR-rigging, forex rate manipulation, and many other more creative activities. Interestingly, Dr. Rajan's co-author, Luigi Zingales, seems to have changed his views. In his recent presidential address to the American Finance Association, he acknowledged that "*there is no theoretical reason or empirical evidence to support the notion that all the growth of the financial sector in the last forty years has been beneficial to society. In fact, we have both theoretical reasons and empirical evidence to claim that a component has been pure rent seeking."*

This loss of sovereignty to "a 20 year old" occurs when a country becomes a large net debtor to the rest of the world. At one time, Keynes believed that "*Owe your banker £1,000 and you are at his mercy; owe him £1 million and the position is reversed."* One wonders whether this is equally true in the era of liberal capital flows, where the decision makers are bringing in somebody else's money which they are merely managing; a century back, much of the money bankers lent was their own. The money managers often display the so-called herd instinct, particularly in relation to short term credit or investments in the debt or equity markets. What is perhaps truer is that debtor countries can get locked in "a debtors' prison", where they are required to work hard to pay their creditors rather than consuming the output of their labour. (By one estimate, Greece will have to transfer 4% of GDP every year for three decades to come to a sustainable debt level).

But to come back to budgetary discipline, one pillar of the current economic ideology is that it focuses far more on the domestic liabilities of a government rather than a country's net external liabilities: this is strange when there have been few crises over the last 100 years originating in the former; many more from the latter. Again, conventional fiscal accounting ignores a government's assets – ports, roads, railways, public sector shareholdings, etc., etc. Is this the right way to look at a balance sheet?

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