Financial Globalization and Trade Openness in China and India: Impacts and Policies of Mitigating Adverse Effects

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ABSTRACT

One of the most intensely debated topics in recent day world economic scenario is benefits and costs financial integration and globalization across the globe. Some economists argue that increased openness to capital flows has, by and large, proven essential for countries aiming to upgrade from lower to middle income status, while significantly enhancing stability among industrialized countries. While the counter opinion suggests that it has been widely disastrous as increasing capital account liberalization and unfettered capital flows is a serious impediment to global financial stability. Legal restrictions on cross-border capital flows (capital controls) are the most commonly used measures of the degree of financial openness, as revealed from the earlier empirical studies. The objective of the present study is to examine the nature and extent of financial globalization in context of the global crisis in case of two Asian giants India and China. The basic objective is to establish both short and long run relationship between growth in GDP and five macroeconomic variables- trade (as percentage of GDP), real effective exchange rate, FDI net inflows (as percentage of GDP), external debt (as percentage of GNI) and net financial flows (as a ratio to GDP) in selected Asian countries (China and India). It focuses on related policy measures adopted to curb the possible adverse effects of financial and trade liberalization. It is supported by secondary time series data analysis for the period 1990 to 2014.

KEYWORDS


INTRODUCTION

One of the most intensely debated topics in recent day world economic scenario is benefits and costs financial integration and globalization across the globe. Some economists (e.g., Fischer, 1998; Summers, 2000) argue that increased openness to capital flows has, by and large, proven essential for countries aiming to upgrade from lower to middle income status, while significantly enhancing stability among industrialized countries. While the counter opinion suggests that it has been widely disastrous as increasing capital account liberalization and unfettered capital flows is a serious impediment to global financial stability (e.g., Bhagwati, 1998; Rodrik, 1998; Stiglitz, 2002), leading to calls for capital controls and the imposition of frictions such as “Tobin taxes” on international asset trade.

Legal restrictions on cross-border capital flows (capital controls) are the most commonly used measures of the degree of financial openness, as revealed from the earlier empirical studies. Such capital controls may take varieties of forms—controls on inflows versus those on outflows, quantity versus price controls, restrictions on foreign equity holdings, etc. Although there has been substantial

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progress in developing finer and more sophisticated measures of capital controls, all of these measures suffer from a variety of similar shortcomings. The surge in financial flows to developing countries, as well as the shifts in the composition of these flows, can be broken down into “pull” and “push” factors (Calvo, Leiderman & Reinhart, 1994). These are related to, respectively (i) policies and other developments in developing countries and (ii) changes in global financial markets. The first category includes factors such as policies with respect to capital and trade accounts, institutional quality, and governance practices and policies toward privatization of state-owned companies. For example, there has been a substantial increase in the fraction of countries with liberalized capital and trade accounts since the mid-1980s. Moreover, more financially integrated economies are those that have registered the largest increase in the degree of trade openness over the same period. The second category includes the growing importance of depositary receipts and cross-listings, and the emergence of institutional investors as key players driving international capital flows to emerging markets (Prasad, Rogoff, Wei, & Kose, 2003).

Financial crises and accompanying economic recessions have occurred throughout history and it is a form of the normal business cycle. Financial globalization contributed to the unprecedented growth and prosperity on the one hand but has also resulted in greater instability through excessive use of credit, lowering of credit standards, and heavy reliance on leverage due to poor governance. Contrary to the presumed benefits of financial liberalization due to risk sharing and consumption smoothing, it is significant that the recent global crisis provides almost experimental evidence on how aspects of such globalization can adversely affect economic welfare. There is a general consensus amongst scholars that the trigger for the global economic crisis of 2008-2010 (the great recession) was provided by the difficulties of the US housing sector – the so-called subprime mortgages market. So, the recent economic crisis is widely viewed as a glaring example of limitless pursuit of deregulation of financial markets and failure of global corporate governance at the expense of caution, prudence, due diligence and regulation. The global economic slowdown and its impact on the developed and developing economies adversely impacted the growth in GDP and employment opportunities throughout the world.

Robert Solow (2009) noted that the combined result of the housing and the stock market shocks was a fall in US household wealth from US$ 64.4 trillion in mid-2007 (before the crisis) to US$ 51.5 trillion at the end of 2008. Thus 13 trillion dollars of household wealth disappeared in the space of about one year. The spread of the decline in stock market prices from the US to the rest of the world, it is suggested, was entirely due to “financial globalization” in the previous two decades when the world’s financial markets began a process of integration as a result of extensive de-regulation of the financial institutions.

Liberalization of foreign trade is a watershed in development policy of both India and China. To start with, both the countries adopted inward-looking import substitution policies with an emphasis on self-sufficiency. Later in 1978, China adopted the policy of ‘opening up to the outside world’ and in 1991, India initiated an import liberalization policy. Comparative advantage replaced self-sufficiency as the basic tenant of trade policy and both the countries are now pursuing market-oriented and outward-looking policies. India has been a member of the WTO since its inception and China joined the WTO in the year 2001. Both the countries are adhering to the WTO rules in conducting their international trade. Over the last twenty years many developing countries, including India and China have abruptly and substantially lowered tariffs and scaled back other trade barriers.

China was able to preserve positive trade balance for a long period with the exception of early 1950s and in mid-1980s. Remittances from overseas Chinese have made an important contribution to the balance of payments. Besides, they also brought skill, and knowledge of foreign markets to enhance production and exports. Investments from Hong Kong and Taiwan made a major contribution to China’s rapid growth of foreign trade after the open-door policy. However, this was not the case with India, the NRI contribution is insignificant and FDI was not export-oriented. More importantly, the volume of FDI was also small as compared to China. In recent years, bilateral trade and investment between India and China are growing, indicating the existence of a vast potential for economic cooperation.
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