OPINION

How India Can Cope With Plenty

By Eswar Prasad

News that India's current account deficit widened to a record $15.8 billion for the July-September quarter has sparked debate. The capital investment that finances this deficit helps the country to grow. But India is certainly awash in foreign capital inflows, the trouble being that these foreign investors can be fickle. Previous emerging-market crises have made it clear that dependence on foreign finance can be dangerous. So what should India do?

Trying to cut the current account deficit itself is the wrong way to go. Talk of boosting exports is all well and good, and may eventually happen. But for now the operative fact is that Indians' demand for goods exceeds their ability to produce them. Reducing the deficit beyond a certain point would require forcing Indians to forego some of the tangible benefits of development.

Instead, policy makers must focus on how that deficit is financed. The key is to create more ways to channel capital inflows into productive investments, which would help the country attain many of the potential benefits of foreign capital with less exposure to the risks of volatile short-term flows.

This involves a variety of policy measures to shift the composition of inflows toward longer-term uses. Inflows currently are heavily tilted toward equity markets, which are well-developed and well-regulated and offer foreign investors easy access. While this is not inherently bad—equity markets are an important way for companies to raise capital for growth-boosting investment—it does carry risks. Experience shows equity inflows tend to be flighty and can turn on a dime.

Create new, longer-term investment opportunities to absorb large capital inflows.

So now, policy makers should focus on opening new pathways, especially for foreign direct investment—capital to build factories or stores, for instance, or longer-term joint ventures with local firms. FDI is one of the more stable forms of inflows into emerging markets. FDI investors are almost by definition interested in staying for the long term.

Unfortunately, India has traditionally not been friendly to FDI. This kind of investment tends to involve a different kind of foreign investor—one who wants to bring technological and managerial expertise in addition to capital. Populist politicians in India have thus feared that entry by perhaps-superior foreign competitors could hurt domestic firms. That's certainly one argument used against opening up the retail sector, for instance: A 2009 parliamentary committee thought that the presence of Wal-marts and Carrefours in India would drive mon-and-pop stores out of business. But it's precisely these areas of investment that can not only keep capital in India longer, but help its market economy: Without more efficient supply chain managers, India's retail markets help create food shortages.

As for portfolio inflows, India must do a better job welcoming foreign investors who see India as a country with long-term growth potential rather than just as an opportunity to make a quick buck. This requires the development of corporate bond markets, which would help absorb foreign capital inflows more effectively and channel them toward longer-term investments that the country badly needs, especially infrastructure projects.

Such reforms will require more than merely liberalization of those particular investment types. India must tackle other barriers that discourage all long-term investors, such as corruption and bureaucratic red tape. Research shows that countries with higher corruption and lower public transparency scores tend to get a greater proportion of their inflows in more volatile forms.

Meanwhile, policy makers must strongly resist any urge to impose capital controls to discourage short-term capital flows. As India continues to integrate into the global economy, the notion of trying to manage inflows through capital controls is likely to prove futile and perhaps even counterproductive. This approach would solve none of the long-term issues related to persistent capital inflows. Instead, it simply perpetuates opportunities for corruption and affords protection to politically well-connected firms. Worse, a track record of imposing capital controls scares off long-term investors who could contribute to India's enormous needs for corporate finance.

Instead, policy makers should focus on those parts of the current-account deficit that do need to be cut. While the deficit is partly a result of high investment that boosts long-term growth, part of it also represents the fact that profligate government is dragging down the national savings rate, negating some of the thriftiness of households.

For the country's domestic and external stability, it is vitally important to rein in the government budget deficit and put the public debt on a sharp downward trajectory. Switching from inefficient subsidies to direct cash transfers to households would help rein in government expenditures and make the social safety net more efficient. This is especially important as the benefits from foreign capital are inevitably going to be spread unevenly and there will be many losers in this process, particularly in sectors where many domestic firms are unable to cope with foreign competition. The lack of an efficient safety net could drain away public support for capital-account opening, despite its broader benefits.

Clearly, the challenge of managing capital flows and absorbing them effectively touches on a broad range of policies. Fortunately, all these reforms should be a lot easier now that the economy is growing strongly. A period of high growth and large inflows offers policy makers as good an opportunity as they may ever get to implement these important measures. India can't afford for them not to do so.

Mr. Prasad, a professor of economics at Cornell University and a senior fellow at the Brookings Institution, is the co-author of "Emerging Markets: Resilience and Growth Amid Global Turmoil" (Brookings Institution Press, 2010). A related editorial appears today.

Realism on China Is More Realistic

By Michael Auslin

U.S. Secretary of Defense Robert Gates will visit China next week, seeking to improve strained relations between Washington and Beijing. He faces an uphill task, as a new realism about China has descended on the U.S. capital.

Years of waiting for China to play a more constructive global role have given way to the realization that American and Chinese national interests may simply be too divergent for the two to create a meaningful partnership. Though few will admit it, the new China realism is a good thing. It will allow Washington and its allies to better respond to the array of challenges China poses and will help define norms of acceptable behavior in the vast Indo-Pacific region. Paradoxically, it may also allow for greater cooperation between Washington and Beijing, though only if China's leaders recognize the chance they have to end the distrust they themselves have engendered.

China's growing assertiveness in security issues has been a source of concern to many for years, yet only recently has it caught the attention of some observers. This new realism was brought about by China's own actions, including its continued resistance to condemning North Korea's attacks on South Korea and its warnings against U.S. naval exercises in East Asian waters.

Yet perhaps the tipping point was Beijing's refusal to let jailed Nobel Prize Laureate Liu Xiaobo or any members of his family attend the Nobel ceremonies in Oslo last month. There could be no clearer evidence of the fundamental differences between China's political system and America's than the empty chair that represented Liu on the Nobel stage.

Washington's new realism is finally catching up with much of the rest of the Indo-Pacific region. Both openly and in private, officials in countries from Japan to India have been warning U.S. bureaucrats of their concerns about China's growing power and influence. China's maritime assertiveness against Japan, Vietnam and Indonesia has raised tensions over the past year.

This has led Japan to revise its decades-old defense policy to focus on threats to its southern territories, near China, and to commit to increasing its submarine and air capabilities. India is in the midst of a major naval buildup. Southeast Asian nations look to the United States as a counterweight to China's increased presence in shared waters.

America's concerns are growing, too. Last week, the commander of U.S. Pacific Command, Admiral Robert F. Willard, revealed that China's new anti-ship ballistic missile, the DF-21D, has reached initial operating capability, thus raising the possibility that U.S. aircraft carriers and other large ships could be vulnerable in the future to land-based attacks.

A more hard-nosed view of regional affairs paves the way for greater stability.

China's new fifth-generation stealth fighter, revealed this week, is more advanced in production than many had believed. It may contest air supremacy with the F-22, whose production was stopped last year by the Obama administration. State and Defense Department spokesmen are using harsher language in demanding that China start reining in North Korea.

So how is the new realism a good thing? For one thing, Washington can now develop a clearer understanding of Beijing's perceived interests. China's massive military buildup has been watched by the U.S. armed forces, but often ignored in the capital.

With no obvious threat to China, why has the country modernized its military forces, building dozens of submarines, hundreds of short-, medium- and intermediate-range missiles, and advanced fighter aircraft? What national goals are these offensive weapons systems designed to achieve? Having a clear-eyed understanding of China's capabilities and goals will allow the United States and its allies to defend their interests.

Secondly, understanding that Beijing does not share many of the same interests as the United States and its allies should help revitalize alliances and partnerships in the Indo-Pacific region. Nations that share certain goals on human rights, the rule of law, civil society and the like should consider banding together more regularly to discuss issues of common concern. Continuously extending a hand to China when the hand is often rebuffed simply misses opportunities to promote liberal norms and enhance democratic systems around the region. Moreover, bickering between Washington and Tokyo over U.S. troops should diminish as the concern over China rises.

Third, as nations of the region start to band together to protect their interests and to assert a standard of common behavior, Beijing may begin to alter its behavior, as well. For too long, China has taken advantage of the perception that it was the next great power to act in ways that degraded regional stability. That should come to an end as a new realism takes hold in capitals from Delhi to Tokyo.

By making clear to China's leadership that it needs to work with the regional order now in place, and not seek to substitute another one, the liberal nations of the Indo-Pacific will increase stability and the chance that China will recalculate its national goals. Beijing should recognize that its future interests lie not in its oft-claimed "peaceful rise," but in a new "cooperative rise."

Such realism will restore a sense of balance to the region. It will assure nations large and small that freedom of the seas and skies will be maintained. It will reduce the expectations all have on China to play a leading role in coming years. It will make political cooperation among liberal nations more robust and influential.

What is needed is a continued realistic view and the courage not to accommodate Chinese demands counter to the maintenance of order. his new approach may lead to a China we can live with.

Mr. Auslin is director of Japan studies at the American Enterprise Institute and a columnist for WSJ.com.

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"Those are just to hide the cracks in the wall."