JETIR.ORG ISSN: 2349-5162 | ESTD Year : 2014 | Monthly Issue
JOURNAL OF EMERGING TECHNOLOGIES AND INNOVATIVE RESEARCH (JETIR)
An International Scholarly Open Access, Peer-reviewed, Refereed Journal

Black Economy: Illicit Capital Flows and Impossible Trinity with Special Reference to India

Dr.NaziaJamal
Asst.Prof .IMS, University of Lucknow.

Abstract

The GFI explains illicit flows as funds which are illegally earned, transferred, and/or utilised across an international border. The main sources of illicit flows include commercial tax evasion, transnational crime and grand corruption.
India has the third-highest trade-related illicit financial flow among over 135 countries with a whopping USD 83.5 billion escaping the government's tax net owing to trade-based money laundering tactics, according to the latest GFI report.
In March 2018, it was reported that the amount of Indian black money currently present in offshore banks is estimated to be ***₹300 lakh crores or US$ 4 trillion****. An estimated* ***$770 billion*** *in black money entered India while $165 billion exited the country during 2005-2014, US-based think tank Global Financial Integrity (GFI) has said in its latest report.*

However India ranks eighth with illicit funds outflow at $1.6 billion according to a report by Global Financial Integrity in December 2012.This also says that the total outflow of black money from India since Independence until 2010 was $232 billion. In the post-reform period with the new economic reforms both capital flows and illicit flows have increased tremendously resulting in the new opportunities and threats to the Indian economy. The new liberalised era has opened the doors of the Indian economy; deregulation and liberalisation accelerated the outflow of illicit money from the Indian economy. As is well known, that macro economic objectives are contradictory in nature resulting in a dilemma to the policy makers such as Impossible trinity i.e independent monetary policy, free capital flows, and exchange rate stability gives the policy makers a tough challenge to devise an appropriate policy for a developing country like India, further with the presence and growing quantum of the illicit funds makes this task much more challenging.
Indians have deposited in foreign banks in their illegal personal accounts a sum of about $1500 billion, which have been misappropriated by them. This amount is about 13 times larger than the country's foreign debt. With this amount 45 crore poor people can get Rs 1,00,000 each. This huge amount has been appropriated from the people of India by exploiting and betraying them. Once this huge amount of black money and property comes back to India, the entire foreign debt can be repaid in 24 hours. After paying the entire foreign debt, we will have surplus amount, almost 12 times larger than the foreign debt. If this surplus amount is invested in earning interest, the amount of interest will be more than the annual budget of the Central government. So even if all the taxes are abolished, then also the Central government will be able to maintain the country very comfortably. These illegal fund flows are creating this impossible trinity far more impossible to tackle.
Thus there is a need to assess and analyse the threats and problems posed by illicit flow of capital resulting in the presence of black economy in India which in turn leads to several macro economic imbalances and policy failures. The paper is planned to be divided in six sections, while the first section traces out the quantum of illicit capital flows. The section two is devoted to a brief review of literature. How illicit capital flows in India is further increasing a challenge to the policy makers will be assessed in section three. Section four tries to

analyse the dimensions and presence of impossible trinity and its impact on dilemma faced by the policy makers in India. Section five presents the main conclusions. Finally section six is devoted to highlighting the policy approach towards these issues in India.

A vigorous debate on globalisation process highlights both its advantages and disadvantages. Supporters of globalisation suggest that opening up to global capital markets can make crucial investment funds available at a lower cost, enhance risk sharing, besides ensuring transfer of technology. Opponents suggest that global capital flows are volatile and move for reasons unrelated to fundamentals causing financial disruption and economic volatility. Decoupling from the global capital market through the use of capital controls can help protect a country from temperamental financial markets.

The optimists cite an example of the late Nineteenth century when many countries seem to have benefited from the free movement of capital. The areas of recent European settlement such as Australia, Canada, the United States, and even parts of Argentina and Brazil had high standards of living and witnessed rapid economic growth. Inward investment to these areas, coming largely from Great Britain was massive prior to 1913. But countries often squandered these inflows on frivolous military campaigns, excessive public consumption or poorly engineered projects. In addition, many countries built up large net foreign liability positions but were unprepared for the rapid cessation of capital inflows that periodically afflicted such exposed countries. Large capital inflows may pose a threat to the system by creating a negative indirect channel via financial crises. Large capital inflows may be followed by sudden reversals of a large magnitude which often result in erasing the beneficial effect of several years of growth. The set of countries that gained the least from capital flows in terms of growth outcomes were those that had currency crises, foreign currency exposure on their national balance sheets, poorly developed financial markets and presidential political systems. Countries with credible commitments and sound fiscal and financial policies avoided major financial crises and achieved higher per capita incomes. These sudden stops and reversals often culminated in financial crises particularly in financially vulnerable countries. A number of countries also faced debt crises that led to economic disturbances and affected domestic financial systems in an adverse manner.

Theory suggests that economic growth and participation of a country in the international capital market has a strong associative relationship. However the impact is experienced after a significant time lag. Various researchers have found mixed evidence of an association between economic growth and foreign capital inflows. Whatever impact occurs is transitory in nature without affecting either the steady state or the short run growth rate. This is in line with neoclassical growth models, in which long gestation lags are found to exist between large fixed investments and their resultant growth outcomes.

In the post-reform period with the new economic reforms both capital flows and illicit flow have increased tremendously resulting in the new opportunities and threats to the Indian economy. The new liberalised era has opened the doors of the Indian economy; deregulation and liberalisation accelerated the outflow of not only legal but also the illicit money from the Indian economy in huge quantum. Illicit flows differ from the broadest definition of capital flight which also includes “normal” or “legal” outflows due to investors’ portfolio choices. Specifically, illicit flows are comprised of funds that are illegally earned, transferred, or utilized—if laws were broken in the origin, movement, or use of the funds then they are illicit. The transfer of these funds is not recorded anywhere in the country of origin for they typically violate the national criminal and civil codes, tax laws, customs regulations, VAT assessments, exchange controls, or banking regulations of that country.

Apart from this difference in definition, the term illicit flow does a better job of capturing the essence of the transfer as a problem that requires the cooperation of both developing and developed countries. While developing countries need to implement appropriate economic and governance-related policy measures to curtail illicit flows, developed countries need to make the absorption of such flows in mainly Western financial institutions much more difficult. It was in recognition of the two-prong approach to curbing capital flight that the United Nations and other international organizations finally started to adopt the term *illicit financial flows* in official documents on the subject.

SECTION I:

Methods for Calculation of Illicit Capital Flow

Economists have used various models to estimate illicit financial flows, or illegal capital flight, and a review of these models was provided in the Kar and Cartwright-Smith and also in the paper *"The Drivers and Dynamics of Illicit Financial Flows from India: 1948-2008 by Dev Kar".* The conclusion of that review was that the World Bank Residual Model (based on change in external debt or CED) adjusted for trade misinvoicing, GER (based on the IMF *Direction of Trade Statistics* or DOTS database) provided the best method for estimating illicit flows. This section provides a synopsis of these methods

There are three basic methods of calculation of illicit capital flows-

1. Traditional model method

The easiest common and traditional method of calculating illicit capital flows is netting out inflows from outflows. Because of its simplicity there are several limitations of this method. Thus there are other methods also which are used for more practical calculation of such type of flows.

2. World Bank Residual CED method

The World Bank model (based on change in external debt or CED) is more practical as it is calculated as - sources of funds exceeding, recorded uses of funds reflect unrecorded outflows. Sources of funds include increases in net external indebtedness of the public sector and the net inflow of foreign direct investment. Uses of funds include financing the current account deficit and additions to reserves. In this broad macroeconomic framework, illicit outflows (inflows) exist when the source of funds exceeds (falls short of) the uses of funds.

Thus:

	← Source of Funds →	Minus	← Use of Funds →
K =	**[Δ External Debt + FDI (net)]**	**–**	**[CA Balance + Δ Reserves]**

3. Trade Mis invoicing model based on Direction of Trade Statistics GER method

GFI's estimates of trade mispricing are based on the gross excluding reversals (GER) method. In this method, only periods with export under-invoicing and import over-invoicing are considered to be illicit outflows. Finally the above two methods are more technical and practical.
The following are the main sources of illegal capital flows

Main Sources of illegal capital flows/ Main money laundering techniques		
Placement	Layering	Integration
Breaking large deposits into smaller ones • Currency smuggling • Travellers' cheques • Gambling, casinos	Correspondent banking • Bank cheques and bank drafts • Collective accounts • Payable-through accounts • Loan at low/zero interest rates • Back-to-back loans • Money exchange offices • Money transfer offices • Insurance market • False contracts and documents • Fictitious sales and purchases • Shell companies • Trust offices • Special purpose entities/vehicles • Underground banking • Foreign currency black market	• Capital market investments • Derivatives • Real estate acquisition • Catering industry • Gold market • Diamond market • Buying jewels • Purchase consumer goods for export • Acquisition of luxury goods • Cash-intensive business • Using currency to supplement apparently legitimate transaction • Export-import business • Acquisition and smuggling of arms

Source: Compiled from Unger (2007) Chapter 5

The quantum of illicit capital flows

A recent BBC report claims that India lost $ 462 bn in illegal capital flows. Indians hold about Rs 9,000 crore or 2.18 billion Swiss francs in Swiss Banks at the end of 2012 according to data released by Swiss National Bank. India saw black money outflow of $123 billion from 2001-2010. Further India ranks eighth and is among the top ten developing countries with illicit funds outflow at $1.6 billion according to a report by Global Financial Integrity in December 2012.This also says that the total outflow of black money from India since Independence until 2010 was $232 billion. According to a past study conducted by Kar and Cartwright-Smith (2008), India lost between US$23.7-$27.3 billion annually in illicit financial flows (IFFs) during 2002-2006, making it one of the top exporters of such capital. Since that report was published in December 2008, there have been significant revisions to balance of payments data reported by India to the IMF as a result of which average illicit flows are now estimated at US$16 billion per year over that same period. This data is calculated on the basis of economic and statistical models so although they are also substantial but, they are likely to be understated given the fact that economic models cannot capture all channels through which illicit capital can leave the country. It is assumed that Indians held close to US$1.4 trillion in illicit funds in foreign accounts.

While a great deal of information is available with respect to structural factors, governance indicators for the period 1948-2008 are scarce. For example, traditional governance indicators compiled by the World Bank or Transparency International (Corruption Perceptions Index) only cover a fraction of this period. A review of the literature suggests that the underground economy not only acts as a proxy for governance, it grows by absorbing illicit inflows and provides the funds for cross-border transfers of illicit capital. While the underground economy the world over often involves illegal activities, in India even legal businesses and the government contribute to it. According to the Indian Council for Research on International Economic Relations, legal businesses controlled by the government, government expenditures and taxes have also contributed to the creation of illicit funds.

The data tables given below are compiled from the Global Financial Integrity Report-The Drivers and Dynamics of Illicit Financial Flows from India: 1948-2008.The table shows the pattern of illicit financial flows from India for the period 1948 to 2008 calculated on the basis of CED &GER methods.

Tables 1 & 2 given below show the nominal and real growth rates of illicit flows from India for eight decades.

Table-1
India: Nominal And Real Growth Rates of Illicit Flows 1948 - 2008 (USD Millions)

Year	Nominal IFF (CED+ GER)	Real IFF (CED+ GER)	US PPI
1948	115	7	17.58
1949	274	16	16.70
1950	0	0	17.36
1960	836	42	20.13
1970	2721	116	23.42
1980	4822	85	57.06
1990	6624	90	73.85
2000	1384	16	84.32
2008	28262	235	120.45

Table-2
India: Nominal And Real Growth Rates of Illicit Flows, 1990 - 2008 (USD Millions)

Year	Nominal IFF (CED+ GER)	Real IFF (CED+ GER)	US PPI
1990	6624	90	73.85
1991	1185	16	74.02
1992	454	6	74.46
1993	2341	31	75.55
1994	2542	33	76.53
1995	1514	19	79.26
1996	4125	51	81.12
1997	2666	33	81.07
1998	3000	38	79.06
1999	2394	30	79.72
2000	1384	16	84.32
2001	11885	139	85.26
2002	7722	93	83.30
2003	9108	104	87.75
2004	22477	241	93.18
2005	30329	303	100.00
2006	10283	98	104.67
2007	4970	45	109.69
2008	28262	235	120.45

1. Nominal CED+GER estimates deflated by the US producer price index, line (IFS…11163...ZF…
Source: Compiled from GLOBAL FINANCIAL INTEGRITY REPORT-
The Drivers and Dynamics of Illicit Financial Flows from India: 1948-2008

Both the decadal and the year wise detailed data since 1990 of the Indian economy show that in general there has been a tremendous increase in growth rates of these illicit flows from India both in nominal and real terms through both CED & GER methods. The growth rate increases from 17% in 1948 to 120% in 2008.The main reason being the series of economic development programmes adopted by the policy makers in India resulting in increase in the size of the economy over the years, so as the GDP is increasing over the years accordingly the illicit flows are also increasing.

Table-3
India: Illicit Capital Flows
1948 - 2008 (USD Millions)/1

Year	CED	GER	(CED+GER)	Traditional total
1948	0	115	115	-1457
1949	0	274	274	-130
1950	0	0	0	-51
1960	727	109	836	753
1970	2527	194	2721	2381
1980	1472	3350	4822	3363
1990	5483	1142	6624	5668
2000	0	1384	1384	-5043
2008	7344	20917	28262	3467

Source: Compiled from GLOBAL FINANCIAL INTEGRITY REPORT-
The Drivers and Dynamics of Illicit Financial Flows from India: 1948-2008

Table 3 & 4 show decadal and year wise actual data of illicit flows from India calculated in the form of change in external debt (CED) & gross excluding reversals (GER) method and also in the form of total illicit flows as a sum total of CED + GER in US mn $.

Table-4
India: Illicit Capital Flows
1948 - 2008 (USD Millions)/1

Year	CED	GER	(CED+GER)	Traditional total
1990	5483	1142	6624	5668
1991	0	1185	1185	-3216
1992	0	454	454	-5,197
1993	0	2341	2341	-5,129
1994	0	2542	2542	-5269
1995	0	1514	1514	-8490
1996	0	4125	4125	-9005
1997	0	2666	2666	-4928
1998	0	3000	3000	-226
1999	0	2394	2394	-6101
2000	0	1384	1384	-5043
2001	0	11885	11885	5440
2002	0	7722	7722	5109
2003	0	9108	9108	7161
2004	0	22477	22477	7914
2005	0	30329	30329	7756
2006	0	10283	10283	984
2007	0	4970	4970	-35490
2008	7344	20917	28262	3467

Source: Compiled from GLOBAL FINANCIAL INTEGRITY REPORT-
The Drivers and Dynamics of Illicit Financial Flows from India: 1948-2008

It is clear from the tables that on the basis of traditional data illicit flows are negative till the year 2000, but this is perhaps the case because of the simple and faulty calculations of the traditional method. The calculations through both CED & GER are showing positive illicit outflows since 1948 onwards only and the quantum increases sharply.

Table-5
India: Nominal and Real Growth Rates of Illicit Capital Flows

Periods	Growth Rate of Nominal Illicit Flows (CED+GER)	Real Illicit Flows (CED+GER)
1948-2008	11.50%	6.38%
1948-1990	15.80%	9.08%
1991-2008	18.96%	16.04%

Growth rates calculated as slope of the logarithmic trend line ofeach series by time periods.

Source: GLOBAL FINANCIAL INTEGRITY REPORT-
The Drivers and Dynamics of Illicit Financial Flows from India: 1948-2008

This table shows the nominal and real growth rates of illicit capital flows from India as the summation of CED& GER. For 1948-2008 the nominal growth rate was 11.5% whereas for 1991 to 2008 it was 18.96% indicating the fact that during this period Indian economy has experienced a high degree of financial integration resulting in the high degree of illicit capital outflows as well. The same is the case with real illicit flows.

Drivers/ Determinants of Illicit Capital Flows

Although these flows are random, unstable and non-stationary in nature and so there are no country wise specific determinants but still there are certain drivers of these illicit flows such as i) poor governance, ii) political instability, iii) weak institutions, and iv) degree of macroeconomic reforms v) high inequalities of income and wealth v) level of financial integration etc.

Generally these drivers directly influence illicit flows as they share a direct causal relationship with the illicit flows. Such as higher the level of political instability and poor governance in the country higher would be the quantum of these types of flows, the other two drivers are indirectly related such as when economy lacks macro economic reforms and the financial institutions are weak then the capital flight is comparatively more and so does the quantum of illicit capital outflows as well. This is the case because in case of weak financial institution the investors will have less trust in the financial system of the economy and in the absence of macro economic reforms resulting in high tax rates and more capital controls, investor finds it lucrative to invest his money abroad in an illegal manner. Further both growth in GDP at constant prices as well as income distribution were found to be positively related to illicit flows, the impact of growth and distribution on illegal capital flight is positive as generally along with growth, the inequality of income and wealth also increases which results in more illicit capital outflows. In case of India also the faster pace of economic growth in the post-reform period did not lead to a more equitable distribution of income—infact income disparity increased somewhat. The increase in income disparity means there are a larger number of high net-worth individuals in the post-reform period compared to the pre-reform period. Because HNWIs are the main drivers of capital flight, this may explain why faster economic growth in the post-reform period has spurred more flight capital rather than less.

Nature and Pattern of Illicit Capital Flows

Unrecorded illicit flows from a country are driven and determined by the interaction of complex economic, structural, and governance-related factors, thus they are likely to be unstable or non stationary over time. This hypothesis is being tested by the authors in their report on ***The Drivers and Dynamics of Illicit Financial Flows from India: 1948-2008*** through the Augmented Dickey-Fuller test for stationarity .The results of the table shows that the data of illicit flows turned out to be non-stationary indicating the acceptance of the hypothesis that these kind of flows are non stationary or unstable in nature thus it is very difficult to observe any specific pattern for these kind of capital flows. In fact, till this point of time there is no valid study available, analyzing the behaviour of illicit flows in the context of a dynamic simulation model. Further as the estimates of illicit flows are found to be non-stationary, it implies that no other specific econometric testing can be applied to make long-range forecasts of illicit flows because in the long run, estimates of illicit flows

exhibit a random-walk pattern. Although the data tables shown above proves that with increasing financial integration and new economic reforms the illicit capital flows from India is following an increasing trend especially after 1990s but then in general they are non stationary by nature and nothing specific can be predicted by these type of flows as they follow a random walk pattern.

SECTION II

A Brief Review of Literature

As is already discussed that illicit flows are unrecorded from a country and are driven and determined by the interaction of complex economic, structural, and governance-related factors, thus they are likely to be unstable or non stationary over time. This hypothesis is being tested by the authors in their report on ***The Drivers and Dynamics of Illicit Financial Flows from India: 1948-2008*** through the Augmented Dickey-Fuller test for stationarity .This is the reason for which we have limited number of studies on this topic. One of the past studies by Gupta, Poonam, and Sanjeev Gupta, 1982, Estimates of the Unreported Economy in India, Economic and Political Weekly, pp. 69-75, January 16, 1982 also explains this fact that although there exist a significant portion of black economy in India but then it is unreported and unaccounted thus although through some estimations the authors have tried to estimate the data but then accuracy and further predictions again would be the issues of concern.
Some other authors have also tried to study the different dimension of this issue such as Dornbusch, Rudiger. Capital Flight: Theory, Measurement and Policy Issues, (1990). Brambila-Macias, Jose andGuido Cazzavillan. The Dynamics of Parallel Economies: Measuring the Informal Sector in Mexico, Research (2009).Cerra, Valerie, Meenakshi Rishis, and Sweta Saxena. Robbing the Riches: Capital Flight, Institutions and Instability,(2005).Chipalkatti N., Rishi. M. External Debt and Capital Flight in the Indian Economy, (2001).Collier, P.A. Hoeffler, and C. Pattillo. Flight Capital as Portfolio Choice,World Bank Economic Review. (2001).further with respect to Indian economy Arun kumar"s, illegal flows in India"s BOP accounts their composition and impact on the economy. The paper argues that macroeconomics can not be understood without understanding black economy and illegal flows associated with it. It further explains that illegal Capital flows adversely affects the current account and also results in a loss of capital to poor countries.

SECTION III

How illicit capital flows in India is further increasing a challenge to the policy makers

1. Illicit Capital flows adversely affect the current account.
2. It also results in a loss of capital to poor countries.
3. Illicit capital flows are the main driving force behind the net drain of resources.
4. While the underground economy the world over often involves illegal activities, in India even legal businesses and the government contribute to it. According to the Indian Council for Research on International Economic Relations, legal businesses controlled by the government, government expenditures and taxes have also contributed to the creation of illicit funds. Thus these funds are both the source and drivers of corruption in the country.

5. The transfer of these funds is not recorded anywhere in the country of origin as they violate the national criminal and civil codes, tax laws, customs regulations, VAT assessments, exchange controls, or banking regulations of that country.

6. This all lead to improper and inaccurate assessment of total money supply available in the country, which further results in the wrong and ineffective policy making.

SECTION IV

The dimensions and presence of impossible trinity and its impact on dilemma faced by the policy makers in India

The Impossible Trinity theory was developed by Fleming (1962) and Mundell (1963). According to the Impossible Trinity theory, it is impossible to simultaneously have a fixed exchange rate, free capital movement (absence of capital controls),and an independent monetary policy. The central mechanism of the Impossible Trinity story is that if a fixed-exchange-rate country open to foreign capital flows tries to have an independent monetary policy (e.g., sets its interest rates higher than overseas), it will receive substantial capital inflows which will persist as long as the interest differential remains. The combination of interest differentials and a fixed exchange rate set up an arbitrage opportunity which is irresistible. If the authorities try to hold down the exchange rate through intervention, this will increase base money and hence lower interest rates, frustrating the authorities' attempt to have an independent monetary policy. The corollary of this is that if they let their exchange rate float, an equilibrium is achieved in which they can maintain higher interest rates, although exactly what happens to the appreciating exchange rate is not specified.

The experience of emerging markets suggests that the Trilemma triangle, while useful, overlooks the possibility that with limited but growing financial integration, countries hoarding international reserves may loosen in the short-run some of the Trilemma constraints. This possibility may be illustrated by contrasting the Trilemma trends of Latin American and Asian emerging markets. Latin American emerging market economies liberalized their financial markets rapidly since the 1990s, after some retrenchment during the 1980s, while reducing the extent of monetary independence and maintaining a lower level of exchange rate stability in recent years. Emerging Asian economies on the other hand, stand out by achieving comparable levels of exchange rate stability and growing financial openness while consistently displaying greater monetary independence. These two groups of economies are most differentiated from each other by their high levels of international reserves holding. Without giving up its exchange rate stability and monetary independence, China has increased its international reserves holding while slowly increasing financial openness. This evidence is consistent with the view that countries' efforts to "relax the Trilemma" in the short-run can involve an increase in international reserves holding.

The Principle of the Impossible Trinity

	Free Capital Mobility	Independent Monetary Policy	Fixed Exchange Rate system	Examples
Capital controls	NO	YES	YES	China before July 2005 reform
Monetary union	YES	NO	YES	Hong Kong, EU
Floating Exchange rate	YES	YES	NO	Japan, Australia

Source: Created by Author

Problems posed by Impossible Trinity to the Policy Makers

The policy Trilemma (the ability to accomplish only two policy objectives out of financial integration, exchange rate stability and monetary autonomy) remains a valid macroeconomic framework. The financial globalization during 1990s-2000s in India reduced the weighted average of exchange rate stability and monetary autonomy.

A small open economy wishing to maintain financial integration can regain its monetary autonomy by giving up the fixed exchange rate. Under a flexible exchange rate regime, expansion of the domestic money supply reduces the interest rate, resulting in capital outflows in search of the higher foreign yield. The incipient excess demand for foreign currency depreciates the exchange rate. Hence, in a flexible exchange rate regime with financial integration, monetary policy is potent. A higher supply of money reduces the interest rate, thereby increasing domestic investment, and weakens the domestic currency, which in turn expands the economy through increased net exports. However, achieving monetary independence requires the small open economy to give up exchange rate stability,

An alternative way for the small open economy to regain its monetary independence is to give up financial integration, and opt for exchange rate stability and monetary independence. Giving up financial integration prevents arbitrage between domestic and foreign bonds, thereby delinking the domestic interest rate from the foreign interest rate. Monetary policy operates in ways similar to the closed economy, where in the short run, the central bank controls the supply of money, and monetary expansion reduces the domestic interest rate.

1. An unintended consequence of financial globalization is the growing exposure of developing countries to financial turbulences associated with sudden stops of inflows of capital, capital flights, and deleveraging crises.
2. Actual choice of the Trilemma configuration?
3. Higher monetary independence has been associated with dampened output volatility.
4. While greater exchange rate stability is associated with greater output volatility, which can be mitigated by international reserve accumulation.
5. Greater monetary autonomy is associated with higher inflation.
6. While greater exchange rate stability and greater financial openness are linked to a lower inflation.
7. Pursuit of exchange rate stability can increase output volatility when financial development is at an intermediate stage.
8. Greater financial openness, when accompanied by a high level of financial development, reduces output volatility.
9. Measuring the degree of financial integration, exchange rate flexibility and monetary independence in robust ways remain a challenge.
10. Limited capital mobility has often been difficult to operationalize and to measure in practice. Does it refer to no-legal-impediments to capital flow? Does it assume perfect asset substitutability?
11. What if the domestic financial sector is repressed? Is it possible to replace no legal- impediments to capital flows with repressing the domestic financial system by means of varying required reserves on banks' deposit liabilities (a policy used frequently by China, India, and other EMs)?
12. Finding a stable long-term equilibrium when the natural interest rates differ is made even more difficult by the probability that the emerging countries not only offer investors a higher interest rate, but an exchange rate which will appreciate over time in real terms,
13. Over-valuation and volatility not only to exchange rates, but to asset prices as well.

Illicit Capital Flows and Impossible Trinity with Special Reference to India

As is well known, that macro economic objectives are contradictory in nature resulting in a dilemma to the policy makers such as Impossible trinity i.e independent monetary policy, free capital flows, and exchange rate stability gives the policy makers a tough challenge to devise an appropriate policy for a developing country like India, further with the presence and growing quantum of the illicit funds makes this task much more challenging.

Indians have deposited in foreign banks in their illegal personal accounts a sum of about $1500 billion, which have been misappropriated by them. This amount is about 13 times larger than the country's foreign debt. With this amount 45 crore poor people can get Rs 1,00,000 each. This huge amount has been appropriated from the people of India by exploiting and betraying them. Once this huge amount of black money and property comes back to India, the entire foreign debt can be repaid in 24 hours. After paying the entire foreign debt, we will have surplus amount, almost 12 times larger than the foreign debt. If this surplus amount is invested in earning interest, the amount of interest will be more than the annual budget of the Central government. So even if all the taxes are abolished, then also the Central government will be able to maintain

the country very comfortably. These illegal fund flows are creating this impossible trinity far more impossible to tackle.

Thus there is a need to assess and analyse the threats and problems posed by illicit flow of capital with impossible trinity resulting in the presence of black economy in India which in turn leads to several macro economic imbalances and policy failures as the presence of both illicit capital flows with impossible trinity further aggravates these imbalances.

SECTION V

Conclusions

1. Because of the impossible trinity a country faces exchange rate volatility and the illicit capital flows also creates an adverse impact on current account thus making the problem much more severe for the economy and the policy makers.

2.In order to achieve higher degree of financial integration the policy makers compromises on the other two objectives of monetary independence and exchange rate stability but In order to restrict these flows capital impediments and checks are required which is against the objective of having greater degree of financial integration. Thus the task becomes very complicated.

3. Pursuit of exchange rate stability can increase output volatility when financial development is at an intermediate stage because of the presence of impossible trinity. Further Because of the illicit outflows from the economy a country loses on both exchange rate stability goal and also faces output volatility so the problem becomes much more severe.

4. In order to achieve higher monetary independence a country faces dampened output volatility and because of illicit capital outflows a country further faces lose of capital resulting in further reduction of output.

5. Finding a stable long-term equilibrium in the economy becomes very difficult as because of the existence of impossible trinity policy makers faces trillema further black economy and unreported data of macro economic indicators, makes all the policies implemented by the policy makers partially ineffective.

SECTION VI

Suggestions and Policy Implications

The subject of illicit flows (like corruption) is clouded by a lack of terminological clarity, which obstructs an effective policy debate. According to all credible evidence, illicit flows are a phenomenon on a massive scale. They have a major negative impact, particularly on developing countries, while the net effect for rich democracies may well be positive. Illicit flows are intimately linked to large-scale corruption. Acknowledgement of this is important in order to clarify the extent and ways in which corruption may be tackled via policies to stem illicit flows. Policies to tackle corruption through addressing illicit financial flows have been focused primarily on anti-money laundering (AML) policy,

Current policies to tackle, prevent, or address illicit flows – and by implication to tackle corruption by hindering such flows – should therefore be based on an evidence-based approach to policy selection, a better balance between different policy instruments (including an emphasis on good governance policies to prevent the corruption that yields illicit flows), and an equitable allocation of the costs of implementing such policies between rich and poor countries.

Other important policy initiatives to restrict the absorption of illicit financial flows by international banks, are the enhancement of transparency in the international financial system, automatic exchange of tax information and double taxation avoidance agreements; (ii) policies to curtail illicit financial outflows should also be tailored to resource-rich and resource-poor countries such as the Open Budget Initiative, tax and customs service reforms, the creation of national authorities for the regulation and management of public procurement, as well as signing on to EITI and further looking beyond this to ensure that policies are in place to facilitate greater transparency and accountability over the entire resource value chain; further effective enforcement of these measures will also be important, to boost net recorded transfers by improving the business climate so as to ensure high, inclusive and sustainable growth along with stability in the Indian economy.

REFERENCES

Acharya, Shankar, et al. Aspects of the Black Economy in India. New Dehli: Ministry of Finance, Government of India, 1978.

Aghevli, Bijan B.and Moshin S.Khan.X"Government Deficits and the Inflationary Process in Developing Countries." IMF Staff Paper 25, no. 3 1978: 383-416.

Baker, Raymond. Capitalism's Achilles Heel: Dirty Money and How to Renew the Free Market System.Hoboken, NJ: John Wiley & Sons, 2005.

Aizenman, J., M. D. Chinn, & H. Ito. 2009. Surfing the Waves of Globalization: Asia and Financial Globalization in the Context of the Trilemma. Asian Development Bank Working Papers No. 180.

Buiter, Willem H., and Ivan Szegvari. "Capital Flight and Capital outflows from Russia; Symptom, Cause andCure." European Bank for Reconstruction and Development Working Paper No. 73, June 2002.

Cavalo, M. 2006. Interest Rates, Carry Trades, and Exchange Rate Movements. FRBSF Economic Newsletter 2006/31.

Cagan, Phillip. "The Monetary Dynamics of Hyperinflation." In The Quantity Theory of Money, by Milton (ed.)Friedman, 25-117. Chicago: University of Chicago Press, 1956.

Cerra, Valerie, Meenakshi Rishis, and Sweta Saxena. "Robbing the Riches: Capital Flight, Institutions and Instability." IMF Working Paper 199, October 2005.

Chipalkatti, Niranjan, and Rishi Meenakshi. "External Debt and Capital Flight in the Indian Economy." Oxford Development Studies 29, no. 1: 31-44

Cline, W. R., and J. Williamson 2010. Estimates of Fundamental Equilibrium Exchange Rates. Peterson Institute of International Economics Policy Brief 10–15.

.Engel, C. 1996. The forward discount anomaly and the risk premium: a survey of recent evidence. Journal of Empirical Finance (32)**:** 305–319.

Edison, Hali J., and Francis E.A. Warnock. "A Simple Measure of the Intensity of Capital Controls." IMF Working Paper, no. 180 2001.

Financial Action Task Force. "India: Mutual Evaluation Report on Anti-Money Laundering and Combating the Financing of Terrorism." 2010.

Gunter, Frank R. "Capital Flight from China." China Economic Review 15 2004: 63-85.

Gupta, Poonam, and Gupta Sanjeev. "Estimates of the Unreported Economy in India." Economic and Political Weekly, January 1982: 69-75.

Global Financial Integrity Kar, Dev. Currency Invoicing and Exchange Conversion in International Trade. Washington, DC: IMF, 1986.

Kar, Dev. "Government Deficits and Inflation in Brazil: The Experience during 1948-1964." IMF Departmental Memorandum Series No. 81, October 1981.

Kar, Dev. "Long-term Trends in the Openness of National Economies: Comment." Oxford Economic Papers 35,no. 1 1983.

Kar, Dev, and Devon Cartwrigh-Smith. Illicit Financial Flows from Africa: Hidden Resource for Development.Washington DC: Global Financial Integrity, 2010.

Kar, Dev, and Devon Cartwright-Smith. Illicit Financial Flows from Developing Countries: 2002-2006.Washington DC: Global Financial Integrity, 2008.

Kar, Dev, The Drivers and Dynamics of Illicit Financial Flows from India: 1948-2008, Washington DC: Global Financial Integrity,Nov.2010.

Kar, Dev, Devon Cartwright-Smith, and Ann Hollingshead. The Absorption of Illicit Financial Flows from Developing Countries: 2002-2006. Washington, D.C.: Global Financial Integrity, 2009.

Khan, Mohsin S., and Nadeem Ul Haque. "Foreign Borrowing and Capital Flight: A Formal Analysis." IMF Staff Papers 32 December 1985.