

# Current Global Economic Crisis:

*Its Effects on the Indian Economy; and the Way Ahead*

Market capitalism, especially financial market capitalism, as practiced in the developed countries in this age of globalization is currently facing its worst crisis since the Great Depression of the 1930's.

There have been several financial crises in the world in the past originating in one country or the other and spreading to other countries or even to a region. The last regional financial crisis had occurred in Southeast Asia and East Asia during 1997-98 and was also called Asian Financial Crisis. The current financial and economic crisis has, however, become truly global in nature. It is affecting both the developed and the developing countries and is threatening to lead to a global recession of serious proportions. The United States of America, the European Union and Japan are already facing economic recession. The developing countries which are at present most seriously affected by this crisis include among others Iceland and Pakistan as they are running out of their foreign exchange reserves even to serve their external payments obligations. The fast growing emerging economies including China and India are facing slowing down of their economic growth.

The present global economic crisis has originated from the United States of America (U.S.A.). It had started a little over two years ago with the sub-prime mortgage crisis in the housing sector. With low interest rate regime and rising prices in the housing market prevailing for a relatively long time, the mortgage financing institutions in the U.S.A. started lending more to credit-unworthy (sub-prime) household borrowers for owning houses. This continuing sub-prime lending fuelled a bubble in the housing market which proved to be unsustainable. The bubble burst when the housing prices started falling and the household borrowers started defaulting in a major way for meeting their installment payment obligations. These defaults went on rising as the market value of the houses had become lower than the mortgaged values of the houses in a falling market. This led mortgage financing companies and investment banks in U.S.A. to cleverly securitize the property based assets – bundling some "good" with more "bad" assets as bundled packages. These packages were then sold using complicated hedge funds and derivatives were not properly evaluated even by credit rating agencies.

In the complete absence of regulation by any Federal Agency of the United States for such bundled "assets", the toxic assets were being greedily sold with higher profits to investment banks and commercial banks not only in U.S.A. but also to financing institutions in several other countries in the global financial market. The roots of the current crisis lie in unethical corporate governance.

Thus when this toxic asset bubble burst, financial institutions holding these toxic assets started crumbling one after the other in the United States. We saw the collapse of the two of the largest mortgage broking houses, namely, Freddie Mac and Fannie Mae. Other financial institutions also started failing and included Bears Stearns Holdings and the American International Group (AIG) - the largest insurance company in U.S.A... The ultimate and most shocking event in this sequence of stressed financial institutions was the filing of bankruptcy by the Lehman Brothers in September 2008 which was one of the oldest investments banking company operating for more than 150 years on the Wall Street. The entire community of the Wall Street Investment Banking companies nearly faced closure of their business. This led to the worst ever Stock Market crash on the Wall Street unseen in earlier years except the Great Crash of the 1930's. Washington Mutual Bank also failed in U.S.A. Many other American banks including the Citigroup with the largest worldwide presence also started facing the heat. No one knew which bank may fail soon..

The Stock Market Crash and the failure of investment banks on the Wall Street soon spread in this age of globalization to the U.K.; other European economies; and to Japan. Several financial institutions in Europe and other parts of the world had a significant exposure to the property based toxic assets bought from U.S.A. Taking cues from the Wall Street Stock Market crash, the stock markets in the European Union, Japan, China and other East Asian and South East Asian countries and India registered sharp volatility in the downward direction. This was the crisis simultaneously of liquidity, solvency and financial instability in the global economy. It soon started impacting the real sector through lack of investor confidence and lower demand for goods and services first in U.S.A and later in all major

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economies of the world. This is how U.S.A. has exported its current internal economic crisis to the rest of the world.

The United States of America has been mismanaging its economy for nearly two decades with rising fiscal deficits and current account deficits financed by external debt including holding of U.S. Treasury Bills by foreign exchange surplus countries like China, Japan, Singapore and Oil Exporting countries. Worse still, the household sector in U.S.A has near zero or negative savings as householders have been continuously overspending through their credit cards beyond their income. This cannot last forever. American Business Model especially the American investment banking model has failed due to the unregulated greed of its financial sector. We may recount here the collapse of Enron and the conflict of interest ("greed" for enlarging corporate business) reflected in the case of Arthur Anderson which raised serious question marks on the American Accounting Standards as role model for the rest of the world. Unlike the Asian financial crisis of 1997-98, this time around due to its wide spread effects on the economies of the European Union and Japan and to emerging economies, central banks around the world have coordinated their efforts to inject more liquidity into the system and to lower their benchmark interest rates as a signaling device to persuade commercial banks to cut interest rates on their lending. Similarly, fiscal authorities in most affected countries have launched (or are planning to launch) fiscal stimulus packages to promote demand and to avoid cuts in jobs.

The U.S Treasury had announced a bailout plan of \$ 700 billion in October 2008 under the so-called Troubled Assets Relief Programme (TARP). The TARP was originally designed for buying up part of troubled (toxic) assets. Soon questions arose on the final burden on the tax payers of the TARP and additional funds for

financing bailouts and on the viability of this approach to solve the basic problems of the financial institutions. The basic problems had their roots in over-leveraging (over-lending to non-creditworthy borrowers) compared to their asset/equity base. Hence the need for de-leveraging by the distressed financial institutions through sale of their assets preferably to the government for building confidence and lesser lending; and recapitalization of these institutions initially by the government to enable these institutions to perform their business functions by following prudent regulatory norms. Recognizing this need for shift in the government strategy, the U.S. Government has acquired equity in the distressed institutions and plans to recapitalize some of the troubled banks and other financial institutions. Despite international oil and commodity prices coming down sharply recently and the bailout packages announced by U.S.A. and other countries affected by the current global economic crisis, the Stock Markets have not been calmed and the fears of a deeper global recession are rising.

Most leading countries, including the G-20 countries, seem to agree on the need for global coordination and appropriate global regulation of the global financial institutions through multilateral institutions like the International Monetary Fund (I.M.F.). However, the U.S.A. appears to be reluctant to subject itself to regulation by a global supervisory agency including the I.M.F. In any case, due to holding 16 per cent of the capital of the I.M.F. U.S.A. has a veto power in decision making in the I.M.F. The World leaders will have to find ways at the next G-20 Summit in April 2009 as a follow-up of September 2008 meeting acceptable to all countries for a supra-national financial regulatory authority focusing on risk management of new complicated financial instruments based on ethical corporate governance.

Another major concern in the current scenario of global economic slowdown relates to the tendency of the national governments especially in the developed countries to take recourse to protectionism. The statement made by the President-elect Barak Obama during his campaigning for the Presidency of the U.S.A. for discouraging outsourcing of jobs (e.g. in the Information Technology sector) by American firms is illustrative of this tendency. The current slowdown in the global economy can be countered in sustained manner through further liberalization of trade and investment under the stalled Doha Development Round under the auspices of the World Trade Organization (W.T.O.). After assuming Presidency on January 20, 2009, Barak Obama should take the lead in facilitating the successful conclusion of the pro-development agenda of the Doha round at the earliest for generating more trade and investment and growth and employment in the global economy.

India is relatively better equipped than most developed countries and many developing East Asian and Southeast Asian countries to handle the effects of the current global economic meltdown

due to its lesser degree of integration with the global economy. However, compared to 1991 when India launched its economic reforms, it is much more integrated with the global economy. India will therefore not remain unaffected by the current global slowdown. India's linkages with the global economy have increased in three distinct ways. Firstly, the percentage of India's trade in goods and services as a proportion of its G.D.P. has increased from about 10.0 per cent in 1991 to around 45.0 per cent in 2007-08. Thus, the growth rate of India's exports will suffer depending on the intensity of global recession and consequently the growth rate of the economy will be lower due to this factor. Secondly, India has been attracting significantly larger inflows of both Foreign Direct Investment (FDI), and the Foreign Institutional Investment (FII) in more recent years. The growth rate of Indian economy will be adversely affected by the prospects of lower capital inflows from abroad especially in the form of FDI. The Foreign Institutional Investors have already withdrawn sizeable amounts of their investment for taking back to their home countries where they needed cash at their corporate headquarters. This has led to crash in the Indian Stock Market. The sudden demand for dollars on this account of capital outflows has in a third way impacted Indian economy. This is through faster depreciation of the exchange rate of the rupee against the dollar. It is just the converse of the sharp appreciation of the Indian rupee against the dollar when the FIIs brought in dollars for investment in the Indian Stock Market and supported the big rally of the Sensex in the Dalal Street in Mumbai last year. Last but not the least, Indian stock markets have not demonstrated any decoupling from the Wall Street Stock Market. The expectations of investors in the Indian stock markets have been linked to the expected behaviour of the Wall Street. Taking cues from the daily trading trends in the Wall Street, the movements in the Indian Sensex have been highly correlated with the movement of the Dow Jones Industrial Average and the NASDAQ in the New York Stock Exchange.

The Indian banking sector and the Indian capital market has been fairly well regulated. India has therefore not faced any threat of bankruptcy of its banks. This is notwithstanding the earlier fears of the depositors in the leading private sector bank ICICI Bank regarding its viability due to its (relatively small) exposure to the toxic assets in its international branches. The Finance Minister Mr. P. Chidambaram's assurance that no Indian bank will be allowed to fail has helped to instill further confidence in the Indian banking system. Prime Minister Dr. Manmohan Singh has also clearly stated that his government will give topmost priority to effectively deal with the adverse effects of current global meltdown on 24x7 bases. He has reiterated his commitment to ensure that the growth momentum remains on track at a fairly high level. Even in this time of expected global recession, the growth rate of the Indian economy is expected to decelerate from 9.1

per cent in the financial year 2007-08 to around 7.0 per cent by the most pessimistic projections currently available. India will still be second country in the league of high growth countries in the world in this year.

As a result of the gloomy conditions in the global economy, Indian banks have also become much more risk averse for their new lending. The Indian banks are facing liquidity shortage both in Indian rupees and in foreign exchange (especially dollars). Both the fiscal (Union Ministry of Finance) and the monetary (Reserve Bank of India) authorities are constantly incrementally evolving appropriate fiscal and monetary policies to ensure a balance between higher growth and lower inflation. The various appropriate measures already announced by the Union Ministry of Finance and for fiscal stimulus and by the Reserve Bank of India's monetary policy for injecting adequate liquidity in the financial system and attracting foreign capital (including new investment by the FIIs) and deposits from the Non Resident Indians have been widely reported in the media. These need not be recounted here. International oil prices and commodity prices have fallen sharply in the last one month. The Government of India is therefore less worried on control of inflation and can afford to pay greater attention to stimulate economic growth. This can be achieved more through active monetary policy than through fiscal policy due to the already high current fiscal deficit to GDP ratio this year. The Reserve Bank of India (RBI) has already signaled its shift to pro-growth monetary policy through cutting interest rates and injecting further doses of liquidity in the banking system. Additional measures at fiscal stimulus to the economy are being contemplated at present. The RBI is also prepared to take further appropriate measures to ensure higher growth with price stability.

What more can the Government of India quickly do to more effectively counteract the adverse effects of an expected worsening of the global recession? It is very clear that the momentum of the growth rate of the Indian economy under these circumstances can be pushed up largely by concentrating on raising domestic sources of growth. This basic shift in emphasis can be supplemented by taking further appropriate policy measures to promote India's exports and attract additional foreign investment and long term external debt for financing priority investments through public and public-private partnerships. These include financing new activities for boosting effective demand; removing supply side bottlenecks (including infrastructural support services) and increasing output and employment for putting additional purchasing power in the hands of labour for raising the rate of economic growth of the Indian economy on sustainable basis.

The following measures (in addition to the measures already being taken or contemplated by the Government) can be recommended for the serious consideration and quick adoption of a proactive role primarily by the Government of India

in line with the shift in the strategy proposed above:

The Government needs to immediately improve the efficiency of its public expenditure by fast forwarding its already planned public expenditure on infrastructure development (such as national highways) and social spending on schemes (like the National Rural Employment Guarantee Scheme) so as to put much higher level of purchasing power in the hands of both rural and urban labour.

The Government needs to launch new employment generating schemes in the productive sectors (goods and services) which are more labour intensive and less capital cum foreign exchange intensive to quickly yield output. The employability of the labour force in both urban and rural India needs to be quickly improved thorough education in vocations and bare foot management of new tiny and small scale business units in the informal sector. The following list illustrates the nature of such business units both in the manufacturing sector and services: Town and Village Enterprises manufacturing internationally competitive products; agro-processing units; repair of all types of transport vehicles; provision of maintenance services requiring electricians, masons, plumbers and the like; repairs of television sets; mobiles; computers and peripherals; and other agency services required by office going persons throughout the length and

breadth of India. Since these employment generating activities would be local in nature, these can best be organized with pro-active support of State and local Governments. The more skilled informal labour should be provided all assistance to set up their own small businesses including corner/roadside shops for trading. Appropriate credit facilities should be provided by the banks without insisting on high valued collateral assets on an experimental basis and further capital should be provided to such new mini entrepreneurs based on their profitable performance. Public-Private Partnerships especially through microfinance institutions with governments in driver's seat would be more appropriate mode for implementing this strategy. Providing adequate investment in distance education and informal education would be a prerequisite for implementing vocational employment creating activities.

Some limited pump priming can be done with prudence under current circumstances for limited pump priming the economy in quick output generating labour intensive activities which will be supported by generation of additional effective demand. A few new visibly large and focused infrastructure development projects must be launched on fast track basis. These highly selected and fully funded and properly implemented projects mainly through the public private partnership route will demonstrate the effective

political will and governance capacity for providing a "big push" to generate new growth momentum in the Indian economy.

New techniques for risk assessment of investment in modern financial instruments and schemes for incentivizing additional lending by banks in a pro-active manner need to be developed. New norms must be enforced for ethical corporate governance.

The forthcoming elections in six States of the Indian Union and the General Parliamentary Elections due in the first half of 2009 make the tasks of implementing the above recommended policy measures a difficult task. The rulers at the level of both the Central government and the State governments as well as the captains of the industry in India have a historic national responsibility to act fast at this challenging time. They must unite to rise up to the occasion and convert the present global economic crisis into an opportunity. India must now show to the world that the new Indian economic model can deliver the desired results for responding to the challenges posed by the current global economic crisis. India can become a role model for several other developing countries for evolving their own appropriate responses to the troubled time in global economy.

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