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India and the Economic Meltdown: Challenges and Possible Responses

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Policy recommendations to arrest the downturn and spur the Indian economy:

- Give highest priority to public investment in infrastructure and social sector.
- Ensure credit for private sector to enable participation in infrastructure and manufacturing sectors. This would generate employment and spur GDP growth.
- Encourage public and private investments through tax and other incentives in Rural Development and Agriculture sectors. Make supply chain infrastructure a national mission.
- Develop alternate business models to 'SEZs'. Policy must encourage 'rural business hubs' along with development of rural markets.
- Develop domestic BPOs and IT services markets. Special emphasis on development of IT infrastructure in rural and peri-urban areas.
- India must seek out a new geo-economic space for itself through regional and international trade arrangements.

The financial crisis across the globe and the ensuing responses by nations and non-state actors has dominated both public consciousness and political debate in the recent past. The discussion on suitable stimulus packages, the causes for the financial disorder and future restructuring of the financial systems has often been dominated by the rhetoric of specific constituencies serving individual interests even as

it loses sight of the substantive argument. In India too, the eagerness to commend our regulatory practices has tended to brush the larger debate on the actual economic impact of the crisis under the carpet. As the world economy lurches ahead, the fallout on the country and the innovative measures necessary to guide the Indian economy through this downturn need to take centre stage. The recently concluded G-20 summit at London

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too did not result in any concrete measures and the outcome was a litany of intentions rather than actions.

This paper examines the “conservative and prudent practices” within the Indian financial sector that cushioned the direct impact of the institutional meltdown witnessed in the West and discusses the measures that the country must pursue to regain the growth momentum and help restructure the global financial order. It seeks to highlight some of the priorities that must guide India's responses on the path to economic recovery.

Recapitulating the Crisis

By 2007-2008, Globalization was at its peak, as geographies and boundaries became irrelevant and services, unrestricted flow of goods and capital increasingly defined the world. Four new and interrelated challenges were perceived to threaten the emerging global order the dangers posed by climate change, food availability, energy security and the global spectre of terrorism until they were capped by the financial crisis. In hindsight social scientists may debate whether the coalescing of these concerns was a mere coincidence or, as some would suggest, the outcome of pursuing a one-size-fits-all model of globalization, a liberal market economy with scant regard for diversity, demography and individual development trajectories.

In a world that has become increasingly integrated, the spread of the financial contagion across the globe came as no surprise. With its origins in the US, the crisis has struck both developed and developing nations and it could get far worse for all before it gets any better. The problem initially manifested itself as the sub-prime crisis in the US largely exacerbated by Housing assets, acquired on low interest rates and re-processed several times over in the debt

markets leading ultimately to a housing bubble created by the artificial purchasing capacity generated among consumers, as well as a debt bubble created by unreal levels of leveraging. While the sub-prime crisis may bear global ire as the immediate cause of the current crisis, it is just a manifestation of the larger systemic problem that has ailed liberal capital markets in the US and much of the developed world.

The three words that best describe this problem are Arbitrage, Leverage and Derivatives. IMF Data¹ shows that in 2007 with a global GDP of about \$55 Tn (EU 15.7, N.America- 15.2, Asia 11.8), global financial Assets (bank assets, bonds and stock market value) stood at \$230 Tn, amounting to a staggering 400% of the global GDP. Regionally, it was Europe, and not America, which was the most leveraged with its financial assets amounting to over 500% of the GDP. For the sake of comparison, as per a McKinsey report; in 1980 this ratio of GDP to financial Assets was roughly 1. In the three decades since, financial re-engineering was perhaps the single most influential factor that led to these unreal levels of distortion. Worse still, this high level of leveraging did not factor global financial derivatives of \$ 596 Tn that included Interest rate derivatives, CDS markets and exchange trades. If these are added to the kitty financial assets are found to be leveraged by over 14 times the global GDP. Larry Summers's description of the present day developments was on the mark when he commented that “all financial crises have a common element: money borrowed in excess and used badly”.²

The other structural imbalance that aggravated the crisis was the savings to consumption imbalance. While America consumed, Asia saved. Due to the lack of sufficiently developed capital markets at home, much of these Asian savings came to be parked in the OECD countries, lending another dimension to the current

problem. Commenting on the causation of the current developments, Ben Bernanke³ placed the blame squarely on the saving glut in East Asia, ignoring the inept management of the funds available with the banks.

Besides exposing the inequity and fragility of the global financial architecture, the crisis is testing the very idea of globalization. The asymmetry in how the crisis would affect the Developed World on the one hand and the Least Developed Countries (LDCs) and Emerging Market Economies (EMEs) on the other is stark. The limited means available with the latter in responding to the crisis through fiscal stimulus would place them at a disadvantage that would demand effective responses from the polity of these countries. These nations would have to walk the proverbial tightrope as they balance growth objectives and social imperatives with limited financial means and with diminished support from developed nations, preoccupied with rescuing their own economies.

The meltdown has also revealed the inability of the legal and regulatory frameworks of today to respond to a global financial contagion. This warrants an honest discussion of the role and scope of the IMF and whether it could be converted into a more democratic and participative 'Supra-Regulator' that oversees the global financial systems. The fear is that, in the absence of such a regulator, emerging economies would be loathe to further liberalize and integrate their financial systems with the world and would therefore be deprived of access to low cost capital that their development agendas so urgently demand. Promises at the recent G-20 summit notwithstanding, substantial progress is still needed for a securer and more regulated financial order.

Finally, this crisis has tested the tenets of globalization; countries are responding unilaterally to suit their own best interests.

Individual nation states have shaped their responses to the crisis under immediate domestic or regional pressures. These actions have the potential to precipitate adverse developments in other parts of the globe. The protectionist tendencies exhibited by the West recently from the reversal of capital flows to vanishing employment opportunities for expatriates are an outcome of the response of the US and others to the crisis. Some of these measures may in fact impact the LDCs and EMEs even more than the crisis itself.

Unilateralism in terms of national stimulus package(s) and government bailout(s), some argue, is perpetuating the liberal market economy that in the first place caused the crisis and is obviating the urgent need for a debate on restructuring of the financial processes that led to the crisis. Positioning itself as a major stakeholder in the outcome would pose as significant a challenge to India, as the domestic worries on ensuring capital flows for the growth of its diverse large medium and small enterprises, providing stimulus for growth in infrastructure, consolidation and strengthening of the rural economy and working towards the development of new domestic and regional markets.

The Indian Story: Saved by Regulation?

Irrespective of the causes, India can neither wish this crisis away nor pretend it is far removed from Indian shores. Even though not fully integrated with global systems with capital account convertibility, India is now a relatively open economy. Its current account (sum of current receipts and payments) had risen to 53 per cent of GDP in 2007-08 from 19 per cent in 1991 while the Capital account (sum of gross capital inflows and outflows) increased from 12 per cent in 1990-91 to around 64 per cent in 2007-08.⁴ With this degree of coupling, international markets are bound to increasingly influence the Indian

economy.

A common refrain of the Indian government against accelerating the pace of banking and financial sector liberalization had been the need for cautious and calibrated policy measures to minimize the impact of adverse international developments on the Indian economy. This was in spite of the fact that there were indicators on the benefits of capital account liberalization for emerging market economies. Even according to the Indian Central Bank,⁵ greatest gains are obtained from opening the economy to foreign direct investment, followed by portfolio equity investment. The benefits of external debt flows are never compelling enough for financial markets in developing economies. Be that as it may, while the Indian current account was opened fully since the 1990s, the opening of the capital account and the financial sector was indeed slow.

The Central Bank in India never permitted complex structures like synthetic securitization. The Indian policy on capital flows thus focused on encouraging FDI, regulating debt flows with end-use restrictions and ceilings on external commercial borrowings and limiting portfolio investment in government securities and corporate bonds. All of these, as per the Central Bank, were policies to prevent excessive recourse to foreign borrowings and 'dollarization of the economy'.⁶ With respect to capital outflows, policy measures were taken to enable non-financial companies to invest and acquire companies overseas. Resident individuals were also permitted outflows within limits that increased with time. Andrew Sheng, who recently spoke at New Delhi, stated that 'Complexity' is the hall mark of the current crisis.⁷ The victims of this complexity were indeed transparency and accountability. Robust banking regulations did make sure Indian banks were not exposed to toxic loans to any significant level and have thus not needed bailouts or recapitalization till now.

On the liquidity risks, while the Central Bank has over the past weeks undertaken steps, it is still to be seen if it will be able to balance the excess liquidity injected into the Indian economy in the face of a dramatic fall in the inflation rate and a depreciating rupee versus the dollar. Some of previous steps initiated by the Bank⁸ included restricting the overnight unsecured market for funds to banks and primary dealers (PD), limits on borrowing and lending operations of these entities in the overnight inter-bank call money market, limits on borrowed funds for banks, Asset liability management guidelines and guidelines on securitization of assets and on provision of liquidity support to Special Purpose Vehicles (SPVs).

In hindsight, while these regulations may have saved India from some of the direct economic effects of the crisis, they will not cushion the economy against the secondary, though equally potent after effects. Predictably enough, today, Indian policy makers are quick to take credit for the limited impact of the credit turmoil on India and would have us believe that it is business as usual. In fact, due to the preoccupation with the upcoming general elections, one may actually be led to believe that while there is an unmistakable slowdown, the economic crisis has given India the slip.

After Shocks of the Crisis: Managing and Developing an Indian Response

If the Government is to be believed, the Indian economy is expected to grow at under 7 percent this year. However, analysts have predicted far lower growth for the current year as well as the year ahead. Even a 7 percent growth amounts to a sharp 2 percent decrease from the five-year average 9 percent growth, which in itself is an important after effect of the crisis facing India and other EMEs. The World Bank estimates that every 1 percent decline in developing country

growth rates traps an additional 20 million people in poverty.⁹ This happens because, while the West discusses job losses, India and other EMEs are actually grappling with the problems of job creation for an ever expanding youthful population many of whom are trapped at the margins of growth.

While domestic consumption and domestic investment continue to drive India's economic growth, its integration into the world has been on the increase. The Trade to GDP ratio has gone up from 13 percent in 1991-92 to 21 percent in 2000-01 and further to 35 percent in 2007-08. If we consider the trade in services it will be even higher; at about 46 percent of GDP. India is now confronted with a growing de-globalization of the world. This implies slowdown or withdrawal of investments by US and Western firms from overseas along with a sharp decline in US and Western demand for foreign goods and assets. With reversal of trade flows, protectionism will also gain momentum. If popular pronouncements on bail-out packages in the US are any indication, we are already witnessing de-globalization of jobs.

The most worrying trend has been the reversal of capital as it heads home towards the West. This reversal can be dramatic. In January 2008,¹⁰ at their peak, global portfolio flows in India stood at about USD 300 billion. Today they stand at USD 50 billion. So far, on a year on year (for the first half of 08-09) comparison, Foreign Direct Investment has nearly doubled and the repatriation of funds (which is twice the size of the former) by the Diaspora has remained steady. However, as the Indian community abroad deals with job losses and salary cuts, remittances would come under pressure and could collectively diminish the capital flow into India.

Infrastructure is still India's Achilles Heel. The impact of the reversal of portfolio equity flows,

reduced availability of capital and pressure on the exchange rate are likely to impact the Indian corporate sector and it will be a challenge to fund the massive infrastructure development that is required. From a macro perspective and with a sense of optimism, low external savings utilization and high domestic savings rate can help to minimize the impact.

However, government funding of infrastructure would need to be balanced with its commitments to social programmes. Further, government borrowings could squeeze the credit availability to the private sector. With 74 % of India's GDP being generated in the private sector, access to capital for this segment would probably better revive faltering GDP growth and aid in employment generation. Today, despite injection of liquidity, banks are unwilling to extend credit. Rising costs of capital are leading to slowdown and closure in the manufacturing and trading sectors. A concomitant problem of government driven infrastructure development is in managing the huge fiscal deficit at a time when the government is already expected to spend on the social sector.

Enhanced public outlays for infrastructure projects in India have not served their purpose. This developmental model was predicated on the belief that when private investment remains subdued, public investment leads to demand escalation and income generation besides creating employment. Effective and speedy utilization of funds for public projects remains a serious handicap in the Indian context. Most public sector projects face endemic time and cost overruns. Disbursement procedures remain complex. Unless systematic measures are taken to improve the speed and quality of public expenditure, assigning additional outlays has limited benefit. As a matter of fact, of the 909 infrastructure projects worth Rs. 4,18,567 crore (approx. \$80 billion), 346 projects are running

behind schedule.¹¹ Creative public-private partnerships would be the order of the day provided credit can flow smoothly to investors for capital creation.

Generating adequate employment and preventing job losses will remain a major challenge before the government. In the present financial crisis, over 10 million jobs may be lost. How does India create jobs in urban and rural areas? In this context the country needs to look at the overall domestic investment climate and use the crisis as an opportunity to stimulate investments and growth rather than choke future potential through over-zealous and restrictive regulation. Some of the lesser developed regions within the country offer vast investment opportunities across sectors and are the potential markets that could stimulate demand and fuel economic growth. Targeted investments in social sectors and in rural schemes could cover sections of the country that had been left behind in the last economic cycle. A case in point is the IT sector. Can the country devise schemes that promote new business models that can spur a new wave of domestic consumption in the IT sector? Are rural 'SEZs' or 'Rural Business Hubs' serving domestic markets in order? If implemented, such schemes can be an effective bridge over the rural urban divide. Regional BPOs and intra-nation outsourcing offer an alternate to export oriented business models. This would also help in reducing the overheads of corporations and businesses located at large urban centers and help in meaningfully lowering urban migration.

Legacy issues have till recently prevented investment in rural and agriculture projects that could develop an efficient supply chain infrastructure. India feeds 20% of the world population with 2% of the global land mass. Waste, decay and pilferage account for over 30% of agriculture produce lost. The secondary consequence is that agriculture subsidies (which

also include massive fertilizer subsidies) on this huge chunk are actually wasted with no benefit being derived by the producers or the economy. This may be the time to kick-start investments in supply chain and distribution networks that can benefit agricultural producers. These must be identified as projects of national importance and pursued through public and private investments. 'Infrastructure Status' incentives for investments across the supply chain must be considered at these times specially.

Some opportunities would also arise as a consequence of this crisis. The foremost would be the greater strategic space that would be available to India in terms of pursuing and engaging with nations and communities which up to now were engrossed in engaging with the West. India would need to deftly navigate the geopolitical arena and scout for partnerships and investments which were hitherto unavailable. These could be in terms of commodity investments, trade arrangements as well as in the areas of infrastructure development. Depressed commodity prices, also a result of the global downturn, help India in more ways than one. They not only reduce the import bill of the country but also present the most opportune time for India to take advantage of depressed commodity prices to acquire productive assets abroad for the strategic objective of securing long to medium term energy and food security. The Chinese have already embarked on an ambitious strategy to convert their holdings to investments in strategic geographical locations. India must actively consider the same.

India should utilize this moment to consolidate its economic interaction with its neighbours and enter into regional and economic groupings. Some have also suggested creation of Sovereign Funds, Monetary Funds and Regional Infrastructure Development Banks; an option that must be explored aggressively. More

importantly India needs to engage with the new emerging world order and its transforming architecture.

The End of Bretton Woods?

In the face of the financial meltdown, a measured global response, rather than a multiplicity of unilateral responses, is what the world community needs. However, this cannot be effective without reconfiguring the existing International Financial Architecture. There is a genuine fear that many of the stimulus packages will only serve to help the recession linger and prolong the life of moribund institutional systems in urgent need of overhaul. The EU and USA are themselves caught in a fierce debate on greater regulation versus greater uninhibited spending through stimulus packages. The US understandably would like to see a global architecture with the US remaining at the centre through an increased role for the IMF and the World Bank even as it suggests that nations such as China and India bear part of the cost of stimulating the global economy. The Bretton Woods Institutions themselves would resist any fundamental change that threatens their present status.

The IMF, on its part, has stressed the need for wider international consultations and consensus to address the current turmoil. Under the Charter of the IMF, particularly Article IV consultations, the Fund is expected not only to review government policies but also the regulatory environment in so far as it affects overall stability and growth and suggest appropriate diagnostic measures. Clearly this crisis was in the making for sometime and the Fund's surveillance mechanism failed to detect this.¹² The key reform issues would include making surveillance and regulation more effective, particularly over the US and the developed world. The IMF's attitude towards the LDCs and EMEs during their sporadic financial troubles over the past 20 years hasn't gone down

well with the developing countries. The IMF has given too little attention to improving financial structures in developing countries and too much to expensive rescue operations, be it in South East Asia or more recently in Russia and Brazil. Its systems of short-term crises management have turned out to have imponderable human costs, its responses deemed to be too slow, its advice is seen as often incorrect and its efforts to influence policy and practice too blatantly intrusive. Quotas, and hence voting powers, no longer reflect the reality of altered global economic rankings. The recent G-20 summit fell short of addressing these aspects. The commitment on 'higher surveillance' too would be ineffective without introducing fundamental changes to its constitution and operations.

The rich G-7 countries continue to dominate decision making. The U.S. continues to have more than 17 per cent of the voting power, enough to block any special business (that requires 85 per cent approval).¹³ On the other hand the major EMEs (BRICSA), which account for half of the global population, together account for a meager 10.47 percent of voting rights {Brazil (1.38) China (3.66) India (1.89) Russia (2.69) and South Africa (0.85)}. The continuance of the existing calculus will only see the disparity between those who govern the fund and those who avail themselves of its loans grow bigger. This structural deficiency and imbalance would need to be addressed so that the EMEs and LDCs have greater voice and vote in global governance.

As a final point, many of the challenges for India and other EMEs do not arise from the crisis directly but are a result of the unilateral, nationalist and protectionist responses of nations first affected by the crisis. These responses are likely to harm the Indian economy and its growth more than the actual event itself. This in effect will make the political content of this crisis as large, if not larger, as the economic content. India and

EMEs will need to engage politically with the world to safeguard their economic interests. This need for engagement also dilutes the “decoupling” hypothesis, which has dominated Indian economic discourses and which assumes

independence of the India's growth from that of the United States in particular and the West generally. Indeed, the conventional that nations must prosper or perish together would return with a vengeance.

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