

# Global Crisis and India

By

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## *Introduction*

President Chaini, Dr Rakesh Mohan, Dr. Ashok Ganguly, other distinguished gentlemen on the dias, distinguished ladies and gentlemen of the audience, it is a great privilege and an honour for me to be with you all here today to deliver this talk at the 101<sup>st</sup> Annual General Meeting of the Indian Merchants' Chamber. It's a special pleasure as it gives me an opportunity to speak to IMC members after more than ten years, since that was when I last had a chance to address them in this very building on India's economic reforms (at that time I was Chief Economic Adviser to the Government of India). When, a few weeks ago, Mr Chaini gave me list of possible topics, I chose this one for two reasons. The lesser reason was that my most recent book, *India and Global Crisis* (Academic Foundation, 2009), was released only last month and this gives me an excellent opportunity to bring it attention of all of you (my publisher tells me that it is available in good Mumbai bookshops like the Strand and Sterling)! The second, more important, reason is that this issue is one of the gravest confronting the global economy and India today.

How did this global crisis come about? How severe is it and how long might it last? What has been its impact on the Indian economy? What is the outlook for us and what are some the policy priorities that we must address to minimize the negative impact of the global crisis on our economic development? Finally, against the backdrop of this world crisis, what are some of the priorities for India's agricultural sector?

These are all very large and important questions. I will not be able to do justice to them in the limited time available to me. However, let me try and convey a flavour of the answers that one can try to give.

## *Causes of the Global Crisis*

There are several underlying causes of the current global crisis. Scholars will debate the importance of each of these causes for many years. Today let me give you a very summary view. Most people believe that the major causes of the crisis include the following:

- ❖ First, the United States and some other European countries enjoyed a **prolonged boom in house prices** since the early 1990s right up to end of 2006. People began to believe that house prices can only go up; they would never fall. This led to massive amounts of lending by banks for home purchases, often to borrowers who did not have jobs or steady incomes. In other words, many of these borrowers were “sub-prime” or, more simply, not credit worthy.
- ❖ This housing bubble was part of a **massive borrowing binge in the United States and some European countries** by households and financial institutions that was fuelled by the “easy money” policies of their central banks and huge inflows of funds from capital surplus countries such as China, Japan, Germany and oil exporters. These big exporting nations sold their products to American and European consumers and then parked their surpluses (over and above their imports) in American and European government securities. As an indicator of this huge borrowing binge, the ratio of gross debt to GDP of US households, businesses and government more than doubled from about 160% in 1982 to 340% in 2007. Most of this massive increase in borrowing was accounted for by households and financial firms (like banks).
- ❖ Thirdly, this huge increase in borrowing was encouraged by **rapid financial innovation** which supposedly reduced and transferred the risks (of default) by borrowers, such as sub-prime home loan borrowers. In fact, of course, these financial innovations actually spread the risks of the underlying weak credits throughout the Western financial system. Not for nothing has the billionaire Warren Buffet termed these complex “financial derivatives” as WMDs or weapons of mass destruction! The explosion of financial innovation fuelled excess growth of the finance industry and built an enormous house of financial cards on a weak base of shaky credit risks. To give you another number, the share in the total US corporate profits of

financial firms (like banks) increased from less than 10% in 1980 to 40% in 2007.

- ❖ An important reason why this massive expansion of complex financial products, built on a foundation of shaky housing loans, could go on for many years is because of a **growing culture of weak regulation** of financial institutions and markets that prevailed in the US, UK, and some other countries for the past two decades.
- ❖ Finally, the enormous increase in imprudent borrowing and excessive lending was fuelled by old fashioned **greed**, which fuelled the huge asset price bubbles in housing, stock markets and commodity prices.

### *Nature and dimensions of the crisis*

In the winter 2006/7 US housing prices started to fall for the first time in fifteen years. As a result many of the sub prime housing loans (mortgages as they are called) became bad loans. This meant that hundreds of billions of dollars of financial derivatives which were based on these underlying mortgage loans also lost most of their value. Thus, by the summer of 2007 “the house of financial cards” began to collapse and a growing number of American and European banks announced huge losses on their mortgage related securities and investments. This process of financial collapse gradually gathered steam and came to a boil in September 2008 when major American investment banks (like Lehman Brothers) collapsed and others (such as Merrill Lynch) were saved through forced mergers with healthier banks. The financial melt-down of September 2008 led to a freeze of credit markets in the US and Europe and transmitted the sudden liquidity squeeze throughout the financial world. Governments in these countries launched massive bail-outs of their banks and increased government spending to contain the impact on the rest of the economy.

Despite trillions of dollars of bail-outs and fiscal stimulus, bank credit continued to be almost frozen, leading to sharp falls in consumer spending, investment, production and foreign trade.

The sharp slowdown in economic activity in the US and Europe quickly spread across the world through the channels of a global credit squeeze and a massive drop in demand for goods and services from major exporting nations like China, Japan, Germany and several other Asian

countries, including India. In this way the financial crisis in the US and parts of Europe not only damaged production and growth in these countries but led to sharp drops in exports and production throughout all those countries which for many years had relied on the US and European markets for their export growth.

By the beginning of 2009 it had become quite clear that the current global recession is the worst since the Great Depression of 1929–32. The latest estimates and projections by the IMF and the OECD (an organization of 30 advanced economies) indicates that the global economic growth will fall from about 4% in 2007 to *minus* 2.5% in 2009; the growth of the rich advanced economies will drop from about 3% in 2007 to *minus* 4% in 2009; the growth of developing and emerging countries will slow sharply from about 8% in 2007 to less than 2% in 2009 (with some countries such as Russia, Brazil and Mexico experiencing negative growth); and world trade growth will drop from 7% in 2007 to an astounding *minus* 11% in 2009.

Nothing like this has been experienced by the global economy in the last 75 years. It really is an extraordinary economic crisis.

### ***Impact on India***

Although the global financial crisis had begun to gain force in the US and Europe by the autumn of 2007, in India it was mainly perceived to be a rich world problem right up till August 2008. It is true that there had been a steep correction in Indian stock prices in January 2008. But our main concern throughout the first 7–8 months of 2008 was with the sharp increase in inflation because of the commodity price shock that had hit us (and the rest of the world) from early 2008. I am sure you will all remember how the rate of inflation jumped from about 5% in February 2008 to over 10% by April 2008, and this despite the Government keeping the issue prices of food grains, fertilizers, petrol, diesel, kerosene, and LPG largely unchanged during that period. In fact, the steep increase in global commodity prices of oil, metals, fertilizers, food grains that had accelerated from late 2007 was much more a product of the global economic boom during 2002 to 2007 than of any recession in Western countries, which began in the spring of 2008. Indeed, right through the summer of 2008, there was a widespread view that the economic growth of Asian developing countries like China and India was “decoupled” from the slowdown in advanced countries of the West.

This view seemed to gain some support from the fact that rate of India's economic growth in the first half of 2008/9 was still close to 8%. Yes, this was a little less than the 9% growth that the country had enjoyed in the previous five years but it was still a very rapid rate of economic expansion by global standards.

This sense of complacency and illusion of decoupling from the global slowdown was shattered by the events of September 2008. With the collapse of huge Wall Street banks and the resulting freeze of bank credit flows in the West, there was an immediate worldwide liquidity crunch and a massive amplification of the recessionary forces in the US, Europe and Japan. The liquidity shock was immediately felt in India, with foreign institutional investors withdrawing their money, credit for foreign trade vanishing and loans from foreign banks drying up. Even before the end of 2008, exports and industrial output had begun to decline and overall economic growth slowed sharply to just 5.3 % in the final quarter of October-December, 2008. Growth in January-March, 2009 is unlikely to be much better, implying the full year growth of around 6-6.5% in 2008/9.

Faced by the sharp credit crunch and the sudden slowing down of the economic activity after September 2008, the Government and Reserve Bank responded quite swiftly. Over the four months of November--March the RBI quickly loosened its monetary and credit policies, reversing all the anti-inflationary tightening it had done in the previous four years. The Government, for its part, had already pumped up spending (even before September 2008) on Sixth Pay Commission pay increases, the farm loan waiver, higher spending on National Rural Employment Guarantee Programme and, of course, much higher subsidies for petroleum products, fertilizers and food grains. These large expenditure increases had been driven mainly by political or populist reasons but, fortuitously, their economic effect was the same as for "fiscal stimuli" like the ones Western countries had already launched to combat recession. The Government announced additional spending increases and tax cuts in December and January. The net result was that the combined fiscal deficit of Centre and States doubled from 5.5% of GDP in 2007/8 to about 11% of GDP in 2008/9. But for this massive increase in fiscal stimulus, undertaken for whatever reasons, India's growth slowdown in the second half 2008-09 would have been greater.

With foreign capital flowing out and export earnings dropping, the exchange rate of the rupee came under pressure. Fortunately, with over US\$ 300 billion of forex reserves in its coffers at the beginning of the year, the RBI was able to contain the slide in the value of the rupee and avoid any currency crisis. The external balance of payments situation was also helped by the sharp drop in oil and fertilizer prices from their July 2008 peaks, as global demand for all commodities suddenly deflated with the deepening of the recession in major industrial countries.

In summary, by the end of the year 2008/9, the global crisis had taken a substantial toll of India's economic performance but it was by no means catastrophic. Yes, the rate of economic growth had slowed to the 5-6% range in the second half of the year from the 9% average of the previous five years, but it was still much better than the negative growth rates in industrial countries and better than the performance of most significant developing countries with the exception of China. Furthermore, with global commodity prices falling sharply the rate of inflation was also dropping quickly in India although food prices were still uncomfortably high. However, with the sudden shrinkage in world trade after September 2008, India's exports in January-March, 2009 were about 20% lower than in the previous year. This meant that hundreds of thousands of jobs were lost in sectors like garments, textiles, footwear and leather products and gems and jewellery.

One more very important point: thanks to the RBI's conservative approach to financial liberalization, India's banking sector was not significantly exposed to the trillions of dollars of toxic assets that were swirling around global financial and credit markets. We owe a great debt of gratitude to then Governor Reddy, Deputy Governor Rakesh Mohan and their colleagues at the RBI for their wise and far-sighted policies.

### ***Outlook and Policy Priorities***

What about the future? What is the outlook for India's economic development in the next few years against the backdrop of the ongoing global economic crisis? Let us first form some views about the likely trajectory of the world economy in the year ahead. As I have already noted earlier, 2009 is likely to be a very bad year for the global economy, almost certainly the worst year since the Second World War. Output in the advanced industrial economies is expected to drop by 4% and world trade by over 10%. Views about when global recovery might start vary. Optimists

foresee the beginning of the recovery by the end of 2009 while pessimists (or perhaps realists) do not expect a recovery in the industrial countries till 2010. Both the IMF and OECD are in the latter group. Both these international organizations expect economic growth in advanced industrial economies to be zero in 2010 and, as the IMF observes, “the current outlook is exceptionally uncertain with risks still weighing on the downside”. The main reason for this cautious outlook is that the major financial institutions in the US and Europe are still weighed down by trillions of dollars of toxic securities and rising non-performing loans to businesses hit by the deepening recession. So, the capacity of the financial system to make new loans for investments and production by healthy businesses is highly constrained.

Given the huge uncertainty that prevails, it is very difficult to attempt any reasonable projections about the world economy beyond 2010. However, most analysts expect that the recovery from this deep global recession will be slow and painful. So, economic growth in industrial countries in the first couple of years beyond 2010 is more likely to be at the modest rate of 1–2% than the 3-4% that we have witnessed in the years 2002 – 2007.

Against this background of deep global recession and slow recovery what can we expect about India’s economic future? There is huge uncertainty and many different views and projections on this. For what it is worth, my own view is that Indian economy might be able to manage growth of about 5–6% in 2009/10 and this could gradually accelerate to around 7–7.5% in the following 2 or 3 years, provided that we implement suitable policies. If the Indian economy follows the trajectory that I have tentatively outlined, it will have demonstrated its resilience and capacity for strong growth in an adverse international economic environment, even if such growth falls well short of the targets laid out in the 11<sup>th</sup> Five Year Plan.

But this recovery to 7–7.5% medium term growth will not happen by itself. It will require strong policy decisions to gradually shrink the currently massive fiscal deficits; a major step-up in investment in the infrastructure sectors of power, roads, water supply and management (*bijli, sadak, pani*); reduction of rules and regulations which come in the way of greater job creation, much better policies and programmes for education and health; and, of course, sustained and broad-based development of our agricultural sector.

## ***Conclusion***

To conclude, the unprecedented global economic crisis has definitely taken a toll of India's economic performance. Most likely it has also reduced our potential for economic development in the next 3 or 4 years. However, despite the severity of the global crisis, India's economy has demonstrated considerable resilience, in part, thanks to the strength of our agricultural sector. With sound and determined economic policies we should be able to recover a growth momentum of 7 – 7.5% in a year or two. That will be a little less than our growth performance in 2003-08. But it will be far better than nearly every other significant economy in today's world. The possibility is there. The challenge for our policies and programmes is to convert this potential into performance.

Thank you.