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The Costs of "Coupling": The Global Crisis and the Indian Economy

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CONTENTS

NOTE

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Chapter 1

INTRODUCTION

A NOTEWORTHY feature of the current global crisis has been the failure of most mainstream analysts (unlike heterodox economists such as Patnaik 2008 and Kregel 1998, 2008, among others) to predict its onset, estimate its duration and severity, or lay bare the mechanisms that contributed to its unfolding. This weakness of telescopic and analytical faculty has been most evident with respect to developing Asia, especially China and India. Even as the global crisis and its effects were being recognised with a lag, Asian developing countries – and these two countries in particular – were seen as the potential shock absorbers in the global system, with predictions that their persisting expansion and relatively high rates of growth would prevent the global downturn from becoming a meltdown (Bergsten 2008, Kohn 2008). Elements other than the benefits of integration were being offered as explanations. Demographic features, potentially large domestic markets and "favourable" policy environments were typically offered as alternative forces driving growth (Goldman Sachs 2007). Such arguments were reinforced by econometric studies (e.g., Kose, Otrok and Prasad 2008) that found evidence of divergence of business cycles across developed and emerging market economies in the period of globalisation. "Decoupled" giants driven by internal stimuli were seen to be obvious buffers against a global recession.

It is indeed true that despite the large gap in per capita income and level of productivity between these two countries and the developed capitalist economies (Table 1), the former's superior performance in terms of GDP and productivity *growth* over more than a decade has put them on a path towards economic convergence with the developed countries. But implicit in the perception of their role as shock absorbers is that this "trend divergence" in their growth performance also implies a substantial degree of desynchronisation of the business cycle in these two countries and in the developed industrial nations. It is the latter idea that the recent experience has challenged, revealing in the process weaknesses in the growth trajectory that could reverse the trend towards convergence with the developed countries, at least in the case of India.

The idea of decoupling was strengthened by the ability of China and India to avoid major financial crises such as have affected a number of other emerging markets. It was argued that this was the consequence of a "prudent" even if extensive programme of global economic integration and domestic deregulation, which involved substantial financial liberalisation but included some capital controls and limited convertibility of the currency for capital account transactions. Such prudence was seen to have ensured that China and India remained unaffected by the contagion unleashed by the East Asian financial crisis in 1997 and subsequently kept them protected from crises that could have cut short their high growth episodes (Cornia ed. 2006).

However, recent events have questioned the decoupling thesis. In this paper, I argue that the presumption that the Indian economy was on a robust growth trajectory decoupled in important ways from the international system is questionable. Rather, the recent boom was fundamentally dependent upon greater global integration, which also made the growth process more uneven and more vulnerable to internally and externally generated crises (Chandrasekhar and Ghosh 2004, 2006). It is commonly perceived that this reflected the impact of trade liberalisation, but in fact changes in finance were probably more significant, in ways elaborated below. Essentially, recent growth was related to financial deregulation that sparked a retail credit boom and combined with fiscal concessions to spur consumption among the richest quintile of the population. This led to rapid increases in aggregate GDP growth, even as deflationary fiscal policies, poor employment generation and persistent agrarian crisis kept mass consumption demand low (Chandrasekhar and Ghosh 2007). The substantial rise in profit shares in the economy and the proliferation of financial activities (which together with real estate accounted for nearly 15 per cent of GDP in 2007-08) combined

<table>
<tr><th colspan="7">Table 1. Selected economic and productivity indicators for the United States, China and India: 1995-2004</th></tr>
<tr><th rowspan="3">Country</th><th rowspan="3">GDP 2004 (US$) (US=100)</th><th colspan="3">Productivity growth (% average annual change)</th><th colspan="2">Productivity levels</th></tr>
<tr><th colspan="2">GDP (US$)</th></tr>
<tr><th>1995-2004</th><th>1995-2000</th><th>2000-04</th><th>Per employee 2004 (US=100)</th><th>Per capita 2004 (US=100)</th></tr>
<tr><td>United States</td><td>100</td><td>2</td><td>2.3</td><td>1.7</td><td>100</td><td>100</td></tr>
<tr><td>China</td><td>71</td><td>5.5</td><td>3.1</td><td>8.6</td><td>13</td><td>16</td></tr>
<tr><td>India</td><td>28</td><td>4.2</td><td>4</td><td>4.4</td><td>10</td><td>8</td></tr>
<tr><td colspan="7">Notes:
1. Productivity growth is measured on the basis of GDP per employee.
2. GDP is in US dollars converted at 1990 purchasing power parities.
3. China does not include Hong Kong.</td></tr>
</table>

Source: Conference Board and Groningen Growth and Development Centre, Total Economy Database (September 2006), quoted in National Science Board (2008) and available at http://www.nsf.gov/statistics/seind08/pdf/c06.pdf.

with rising asset values to enable a credit-financed consumption splurge among the rich and the middle classes especially in urban areas, which in turn generated higher rates of investment and output over the upswing. The earlier emphasis on public spending as the principal stimulus for growth was thus substituted in the 1990s with debt-financed housing investment and private consumption of the elite and burgeoning middle classes. The recent Indian growth story in its essentials was therefore not unlike the story of speculative bubble-led expansion that marked the experience of several other developed and developing countries in the same period.

By the middle of 2008, this process too was reaching its limits. The dependence of GDP growth upon largely debt-fuelled consumption of a relatively small segment of the population rather than mass demand meant a more limited and ultimately more fragile domestic market. Export growth (in software, information technology (IT)-enabled services and some manufactures) remained high but exports were not large enough to counter domestic decelerating tendencies. High rates of investment were driven by expectations of rapid growth of the domestic market as well as very substantial fiscal sops, but the latter could not increase beyond a point. As a result, Indian economic growth started decelerating early in 2008, even before the effects of the global slowdown were transmitted through sharply declining exports. Real GDP growth, which was 9 per cent in the financial year April 2007 to March 2008, decelerated to 7.6 per cent in both the subsequent quarters. Industrial production peaked in December 2007, fell by 6.5 per cent in April 2008 and remained well below the earlier peak until January 2009. So the internal bubble-generated growth process had already begun to slacken when the impact of the global crisis created further adverse pressures.

Chapter 2

THE EXPORT SLOWDOWN

WITH the onset of the crisis, growing trade integration implied that one of the routes through which the real economy was affected was a deceleration in exports of goods and services, which had contributed significantly to the earlier boom. Trade-to-GDP ratios in India increased from 11 per cent in 1995 to 21.3 per cent in 2007. However, unlike in China where much of the export expansion was on account of manufactures, export growth in India was principally due to services. In the merchandise trade area, India's export success was restricted to a few sectors such as garments, chemicals, pharmaceuticals and metals and engineering goods. While the first three categories of exports grew because of dynamism in the global market, the latter two were largely driven by increased demand from China in the period since 2002.

In services, however, India emerged as the largest exporter of computer and information services in the international economy in 2005, and its share in world exports of computer and information services was 17 per cent in 2006 (World Trade Organisation, quoted in Reserve Bank of India 2009f). Services in general had come to dominate the Indian economy, accounting for more than half its GDP, contributing an overwhelming share to its recent relatively high rate of growth and even giving rise to arguments about services emerging as the Kaldorian growth sector in India (Dasgupta and Singh 2006). Services (excluding construction) accounted for 56 per cent of the increment in GDP at factor cost over the period 1996-97 to 2006-07 (computed from National Accounts Statistics data available at Reserve Bank of India 2008).

Within services, the share of software and IT-enabled services in the incremental GDP generated from services had been rising, with a significant share coming from exports. Gross exports of software, business, financial and communication services amounted to 5.3 per cent of GDP at market prices in 2007-08, with software services exports touching 3.4 per cent of GDP, compared to 14.2 per cent for merchandise exports.[1] Services exports were therefore important sources not just of growth but also of foreign exchange earnings, supporting the balance of payments and making up for the fact that liberalisation did not really trigger a merchandise export boom from the country. However, dependence on such services export-led growth was also a source of potential vulnerability, given the high degree of concentration of exports to a few developed countries: the US accounted for 61 per cent and the UK for 18 per cent of India's IT-business process outsourcing (BPO) export revenues in 2006-07 (NASSCOM figures quoted in Reserve Bank of India 2009f).

Moreover, since the mid-1990s, a rising share of remittances, which were the other major contributor to inflows on the current account of the balance of payments, came from the US, reflecting the growing number of short-term migrants on H-1B visas offering software and IT-enabled services on location. According to World Bank estimates, remittances to India had increased by more than a third to $52 billion in 2008 from its $38.7 billion level in 2007. According to a 2006 study by the Reserve Bank of India, region-wise, North America accounted for nearly 44 per cent of the total remittances to India, followed by the Middle East (24 per cent) and Europe (13 per cent). This reflects a shift in the sources of remittances away from West Asia to the US, as a result of the impact that the software services export boom had on the nature of Indian migration to the United States and Europe. These regions have seen a significant increase in the number of short-term migrants. In the United States, for example, the flow of software

[1] Figures computed from data reported by the Reserve Bank of India at http://rbidocs.rbi.org.in/rdocs/Bulletin/PDFs/T%2042%20[Trade%20and%20Bal].pdf and the Central Statistical Organisation at http://mospi.gov.in/qr_estimate_gdp_curr_prices_12march09.pdf, accessed 17 April 2009.

and IT services workers required to provide onsite services to clients of Indian firms under the H-1B visa provision has increased substantially. Remittances from them could be seen as a form of income from trade in services, largely earned in the US and a few other developed industrial countries.

Given these forms of integration through trade, it was only to be expected that the global slowdown would directly affect exports and economic activity in India. Merchandise trade was the first to be affected. Merchandise exports from India grew by just 2.4 per cent during fiscal year 2008-09 to $166.7 billion, as compared with a rate of growth of 28.9 per cent during the previous fiscal year. The deceleration began in September 2008, after a relatively robust 33.7 per cent increase during April-August 2008. Subsequently, exports declined relative to a year ago in every month, with the highest decline in the month of March 2009 (-33.3 per cent). Import value growth too declined, influenced in part by the decline in world oil prices, but by less than the decline in export growth. As a result, the trade deficit for 2008-09 widened to $117.1 billion, 33 per cent higher than a year earlier (figures from Reserve Bank of India 2009a). Over the first four months of fiscal year 2009-10 exports had fallen by 34.1 per cent, offering little hope of recovery in the export sectors of the economy.

To some extent the implications of the widening trade deficit were mitigated by the neutralising effects of exports of services and remittance inflows, which continued to increase in this period. Therefore the current account deficit was significantly lower than the trade deficit, but even so it rose from 1.5 to 2.5 per cent of GDP during 2008-09.

A lag in the effects of the global crisis on net services exports from India was to be expected, given that contracts in software and BPO services are typically signed for long periods such as two to three years. The effect of the crisis would be on the renewal of contracts and the signing of new contracts, and the initial impact on aggregate revenues would be proportionately lower according to the weight of legacy contracts in the total. The lag was likely to be even longer in the case of remittances because workers who lose their jobs abroad and return home tend to bring their accumulated savings, and this windfall effect initially more than compensates for the fall in the value of ongoing remittances because of lower overseas employment. In addition, rupee depreciation over 2008 accompanied by growing interest rate differentials was likely to have encouraged larger remittances through rupee-denominated non-resident accounts.

However, by early 2009 it was evident that these lags had been covered, as several software and IT services firms in India predicted lower revenue growth, cut back on recruitment and even started laying off workers (*The Economic Times* 2009, Indiatimes Infotech 2009, Business Intelligence 2009, Lakshman 2009). Meanwhile, since North America accounted for nearly 44 per cent of the total remittances to India, the severity of the recession in the US and developments with regard to use of H-1B workers and issue of H-1B visas would affect remittance inflows. The World Bank (2008) estimates that remittance inflows to South Asia will be flat with zero growth in 2009, compared to the 16 per cent growth experienced in 2008. This will affect India too.

Also, by early 2009 the adverse employment effects of the merchandise export decline were evident. Quick official surveys by the Labour Bureau (Government of India 2009a, 2009b and 2009c) focussing on eight sectors (textile & textile garments, leather, metals & metal products, automobiles, gems & jewellery, transport, the IT/BPO industry and the handloom/ powerloom industry) have provided estimates of job loss as a result of the economic slowdown in the country. The surveys suggest that employment fell by 477,000 in October to December 2008 and then recovered by 277,000 workers in January to March 2009, pointing to a net job loss during this period. However, employment fell by a further 131,000 workers during April to June 2009. While employment declines were predictably higher in the export-oriented sectors, it is noteworthy that these surveys have found growing job losses in activities that cater predominantly to the domestic market as well. In addition to quantity adjustment in the labour market, workers' incomes were also hit, with reports of falling real – and sometimes even nominal – wages of workers in industry and services as well as reduced incomes of self-employed workers who constituted more than half the workforce by 2005 (NCEUS 2008). Agriculturalists, especially those producing export crops whose prices had collapsed, faced growing difficulties on top of their existing financial problems reflecting rising input costs and large burdens of debt. Small-scale producers in all sectors were squeezed by the pincer movement of falling demand and credit crunch as even informal sources of credit dried up. Since these producers account for the bulk of employment in manufacturing and services and typically hire workers on informal casual contracts, their economic difficulties translate directly into reduced employment. Surveys of home-based workers reported rapidly declining orders and falling piece rate wages even in nominal terms, for work that formed part of wider production chains for both domestic and export markets (AIDWA 2009).

Two other effects of the crisis on general living conditions deserve to be noted. First, the state governments – which in India's federal system are directly responsible for much of the public expenditure that directly affects citizens, such as on health, education, sanitation and infrastructure – have found their tax receipts falling below projections due to the downswing. Since they face hard budget constraints and many of them are subject to stringent fiscal responsibility conditions forced on them by the central government, this has constrained their expenditure and reduced essential spending on basic services, not to mention development. Second, while aggregate inflation rates have been near zero for the year April 2008-March 2009, the prices of food and essential medicines have continued to increase, even as unemployment has increased, wage incomes have stagnated or fallen and cash crop producers have faced falling prices.

Chapter 3

CAPITAL INFLOWS AND THE FINANCIAL SECTOR

EMPLOYMENT declines in the non-export sectors suggest that the route by which the effects of the international crisis are being transmitted to India goes beyond just external trade. One obvious alternative route is the effect of the crisis on cross-border capital flows, which had shown a dramatic increase in the preceding boom. Foreign investment flows rose sharply from $4.9 billion in 1995-96 to $29.8 billion in 2006-07 and then more than doubled to $61.8 billion in 2007-08 (source: Reserve Bank of India). In 2007-08, capital inflows into India amounted to over 9 per cent of GDP even though the current account deficit in the balance of payments stood at just 1.5 per cent of GDP (Subbarao 2009). Thus, the accumulation of large foreign exchange reserves was the result of capital inflows that were far in excess of India's current account financing needs. The greater part of the capital inflow was in the form of portfolio investment, which was stimulated by a continual process of liberalisation of the rules governing such investment: its sources, its ambit, the caps it was subject to and the tax laws pertaining to it (Chandrasekhar 2008). The process of liberalisation also kept alive expectations that the caps on foreign direct investment in different sectors would be relaxed over time, thereby providing the basis for eventual foreign control. Those who acquired shares could hope to sell them later at a profit to firms interested in acquisitions. One consequence was the rapid expansion of private equity in India and a private placement boom, which was not restrained by the extent of free-floating shares available for trading in stock markets.

While financial liberalisation began early in the 1990s, the surge in foreign investment flows occurred much later. So liberalisation was a necessary condition for such inflows, but not a sufficient one. Until 2003, net inflows were relatively low, reaching a maximum of $8.2 billion in 2001-02 even though rules regarding foreign portfolio investment in the Indian stock market and external commercial borrowing by Indian firms were liberalised in 1993. Net capital inflows rose to $15.7 billion in 2003-04, partly encouraged by tax concessions offered to foreign investors in that year. Thereafter, for a variety of reasons, India was "discovered" by foreign investors and effectively became the target of a capital investment surge. Net foreign investment flows to India more than doubled from $29.8 billion in 2006-07 to $61.8 billion in 2007-08, before declining to $21.1 billion in 2008-09. And more recently there is evidence of a revival of foreign investment flows. This suggests that India was and is serving as a hedge for financial investors when uncertainties engulf emerging markets elsewhere in Asia and the world.

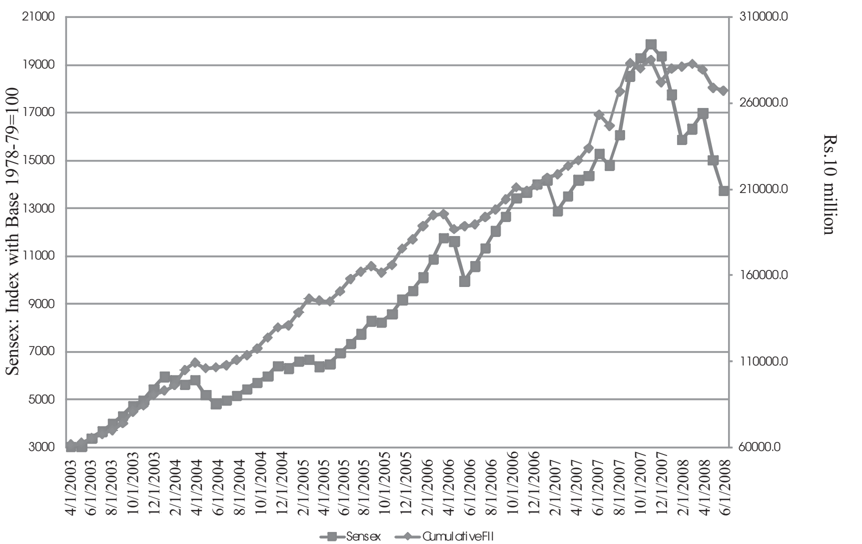
Capital inflows rose also due to large increases in commercial borrowing by private sector firms. As constraints on external commercial borrowing by domestic companies were relaxed and because interest rates ruled higher in the domestic market, large Indian firms at the margin took the syndicated loan route to borrow money abroad at relatively lower interest rates. They engaged in a version of the carry trade, borrowing money in foreign exchange from the international markets where interest rates were lower and making investments in India (in addition to leveraging investments and acquisitions abroad). Net external borrowing by India rose from $24.3 billion in 2006-07 to $51.5 billion in 2007-08, with the bulk of the increase in the form of short-term borrowing. The stock of India's liabilities in the form of debt securities, trade credits and loans rose from $105.1 billion at the end of June 2006 to $175.6 billion at the end of September 2008 (Reserve Bank of India 2009d).

A surge of external equity and debt inflows of this kind, combined with a much smaller increase in the current account deficit and a liberalised exchange rate regime, is likely to exert upward pressure on the domestic currency. This would adversely affect the country's export competitiveness and encourage further speculative inflows of capital. To forestall such effects, the central bank typically seeks to manage the exchange rate by buying up foreign currency and building its reserves, and this was in fact the policy of the Reserve Bank of India. As a result, India's foreign exchange reserves increased from just $76.1 billion at the end of March 2003 to $309.7 billion at the end of March 2008, essentially due to increased inflows of short-term foreign capital (Reserve Bank of India 2009c). At more than 15 months' worth of imports, these reserves were clearly excessive and became a symptom of India's coupling with the world system through the capital inflow route.

Dependence on portfolio equity and debt inflows of this magnitude meant that if any internal or external development was seen to warrant pulling out of India, the exit could be as strong as the earlier inflow of foreign capital. The outbreak of the global crisis therefore resulted in a sharp outflow of capital, especially portfolio capital brought into the stock market by foreign institutional investors (FIIs). Needing cash to meet commitments and cover losses at home, these FIIs sold out in Indian markets and repatriated capital abroad – as much as $15 billion net outflow in the fiscal year April 2008-March 2009, as compared with a net inflow of $20.3 billion during 2007-08 (Reserve Bank of India 2009g).

One consequence of the capital outflow was a collapse of India's stock markets, just as the earlier capital inflows had triggered a speculative bubble in both stock and real estate markets. They had caused an unprecedented rate of asset price inflation in India's stock markets and substantially increased volatility. FII investments were an important force, even if not always the only one, driving markets to unprecedented highs, with a high degree of correlation between cumulative FII investments and the level of the Bombay Stock Exchange (BSE)'s Sensitive Index (Sensex), as evident from the accompanying chart.

Chart: Net FII Stock of Equity Investment and Bombay Stock Exchange Sensitive Index



Source: Reserve Bank of India (2008, 8 October), *Handbook of Statistics on Indian Economy*, retrieved 21 March 2009 from Reserve Bank of India: http://www.rbi.org.in/scripts/AnnualPublications.aspx?head=Handbook%20of%20Statistics%20on%20Indian%20Economy.

Stock markets in developing countries like India are thin or shallow in at least three senses. First, stocks of only a few companies are actively traded in the market. Second, of these stocks there is only a small proportion that is routinely available for trading, with the rest being held by promoters, the financial institutions and others interested in corporate control or influence. Third, the number of players trading these stocks is also small. The net impact is that speculation and volatility are essential features of such markets, for several reasons. Because an increase in investment by FIIs triggers a sharp price increase, it provides additional incentives for FII investment and in the first instance encourages further purchases, so that there is a tendency for any correction of price increases to be delayed. When the correction does begin, it typically would have to be led by an FII pullout and could then take the form of an extremely sharp decline in prices. In addition, the inflow of foreign capital can result in an appreciation of the rupee, which increases the return earned in foreign exchange. As a result, the investments turn even more attractive, triggering an investment spiral that implies an even sharper fall when any correction occurs. Finally, the growing realisation by the FIIs of the power they wield in such shallow markets encourages speculative investment aimed at pushing the market up and choosing an appropriate moment to exit. This implicit manipulation of the market, if resorted to often enough, obviously generates a substantial increase in volatility. And in such volatile markets, domestic speculators also attempt to manipulate markets in periods of unusually high prices. All this said, the four years ending in early 2008 were remarkable because of the prolonged bull run in the Indian stock market.

After such a speculation-induced bubble, the reverse tendency of collapse in stock markets was triggered by the exit of foreign investors, who then responded to the stock market decline in a cumulative process. This affected not just stock market valuations but also the external reserve position and the exchange rate. By October-December 2008 the entire capital account turned negative, with a deficit amounting to an estimated 1.3 per cent of GDP. While this was mainly due to net outflows under portfolio investment, banking capital and short-term trade credit, there were also falls in foreign direct investment and external commercial borrowings inflows. Even inflows under short-term trade credit declined. This led to an overall balance-of-payments deficit for that three-month period of as much as 6.2 per cent of GDP. In the circumstances it was not surprising that India's foreign exchange reserves, which stood at $316 billion in June 2008, fell to $248.6 billion at the end of January 2009. This was a significant fall, but the volume of reserves still remained high, amounting to around 9 months' worth of imports (Reserve Bank of India 2009c). Another consequence of the outflow of capital was a sharp depreciation of the rupee, by more than 30 per cent vis-à-vis the US dollar in the year to March 2009, taking the currency's value to more than Rs.51 per dollar. Although this decline has since been partly corrected, the currency does remain vulnerable.

One indicator of that vulnerability is the movement of foreign exchange out of the country in the form of outward remittances under the liberalised remittance scheme for resident individuals. These remittances totalled $9.6 million, $25 million and $72.8 million in the three years ending 2006-07. But they shot up to $440.5 million in 2007-08 (Reserve Bank of India 2009e). This is possibly indicative of speculative trends that could push down the value of the rupee. In the face of determined speculation, even reserves in excess of $200 billion are no insurance against a large depreciation.

Chapter 4

THE CRISIS AND CREDIT-FINANCED DEMAND

A THIRD channel through which integration has influenced the way in which the global crisis has affected India is its impact on the role played by credit in financing private consumption and investment. Internal financial liberalisation in India had resulted in a process of institutional change in which the role played by state-owned financial institutions and banks was substantially altered. As regulatory structures for private banks were dismantled over the 1990s, and private banks cornered the most lucrative clients, even public sector banks had to alter their strategies to seek new sources of finance, new activities and new avenues for investments, so that they could shore up their interest incomes as well as revenues from various fee-based activities. So banks linked up with insurance companies and entered other "sensitive" markets like the stock and real estate markets. This led to a relatively rapid transformation of banking in India, with growing exposure of commercial banks to the retail credit market with no or poor collateral, the associated accumulation of loans of doubtful quality in their portfolios, and a growing tendency to securitise personal loans.

Total bank credit grew at a scorching pace from 2005 onwards, at more than double the rate of increase of nominal GDP. As a result, the ratio of outstanding bank credit to GDP (which had declined in the initial post-liberalisation years from 30.2 per cent at the end of March 1991 to 27.3 per cent at the end of March 1997) doubled over the next decade to reach about 60 per cent by the end of March 2008. Thus, one consequence of financial liberalisation was an increase in credit dependence in the Indian economy, a characteristic imported from developed countries such as the US. This increase in credit could appear to be positive inasmuch as it reflected a greater willingness on the part of banks to lend: the growth in credit outperformed the growth in deposits, resulting in an increase in the overall credit-deposit ratio from 55.9 per cent at end March 2004 to 72.5 per cent at end March 2008. This increase was accompanied by a corresponding drop in the investment-deposit ratio, from 51.7 per cent to 36.2 per cent, which indicates that banks were shifting away from their earlier conservative preference to invest in safe government securities in excess of what was required under the statutory liquidity ratio (SLR) norm. (Data in this and the subsequent four paragraphs are from CFSA 2009.)

However, rapid credit growth meant that banks were relying on short-term funds to lend long. From 2001 there was a steady rise in the proportion of short-term deposits with the banks, with the ratio of short-term deposits (maturing up to one year) increasing from 33.2 per cent in March 2001 to 43.6 per cent in March 2008. On the other hand, the proportion of term loans maturing after five years increased from 9.3 per cent to 16.5 per cent. While this delivered increased profits, the rising asset-liability mismatch increased the liquidity risk faced by banks.

These changes do not appear to have been driven by the commercial banking sector's desire to provide more credit to the productive sectors of the economy. Instead, retail loans became the prime drivers of credit growth. The result was a sharp increase in the retail exposure of the banking system, with overall personal loans increasing from slightly more than 8 per cent of total non-food credit in 2004 to close to 25 per cent by 2008. Of the components of retail credit, the growth in housing loans was the highest in most years. As Table 2 indicates, the (new) private banks were the most enthusiastic adopters of such a strategy, followed by foreign banks.

This rapid increase in credit and retail exposure, with inadequate or poor collateral, would have brought more tenuous borrowers into the bank credit universe. A significant (but as yet unknown) proportion of this could be "sub-prime" lending. According to one estimate, by November 2007 there was a little more than Rs.400 billion of credit that was of sub-prime quality, defaults on which could erode the capital base of the banks.[2] To attract such borrowers, the banks offered attractive interest rates below the benchmark prime lending rate (BPLR). The share of such loans in the total rose from 27.7 per cent in March 2002 to 76.0 per cent at the end of March 2008. This increase was especially marked for consumer credit and reflected a mispricing of risk that could affect banks adversely in the event of an economic downturn.

Table 2. Personal loans as a percentage of total outstanding credit of commercial banks

	1996	2000	2007
State Bank of India and associates	9.5	10.7	22.0
Other nationalised banks	9.1	10.9	15.8
Foreign banks	8.8	17.1	24.8
Regional rural banks	10.5	18.8	20.5
Private sector banks	9.7	7.9	37.3
All scheduled commercial banks	9.3	11.2	22.3

Source: Reserve Bank of India (1997-2008).

Additional evidence of mispricing of risk in the Indian financial system came from the exposure of the banking system to the so-called “sensitive” sectors, like the capital, real estate and commodity markets. This increased to 20.4 per cent of aggregate bank loans and advances in March 2007, with real estate contributing 18.7 of that figure, the capital market 1.5 per cent and commodities 0.1 per cent. Further, the off-balance-sheet exposure of banks increased significantly from 57 per cent of total bank assets at the end of March 2002 to 363 per cent at the end of March 2008.

This increase was mainly on account of derivatives, whose share averaged around 80 per cent, and once again was led by private and foreign banks. Public sector banks followed, with their exposure rising subsequent

[2] Estimate by M.G. Bhide and cited by S.S. Tarapore, former Deputy Governor of the Reserve Bank of India, in a speech in Mumbai reported in Business Line Bureau (2007).

to the amendment of regulations to permit over-the-counter (OTC) transactions in interest rate derivatives. Since the current accounting standards in India do not clearly specify how to account for and disclose losses and profits arising out of derivatives transactions, the propensity of some players to use derivatives to assume excessive leverage made it difficult to gauge the actual market and credit risk exposure of commercial banks.

These changes in the financial sector point to two further ways in which the current global crisis can affect India. First, the credit stringency generated by the exodus of capital from the country and the uncertainties generated by the threat of default of retail loans that now constitute a high proportion of total advances could freeze up retail credit and curtail demand, as is happening in the developed industrial countries. Second, individuals and households burdened with past debt and/or uncertain about their employment would prefer to postpone purchases and not to take on additional interest and amortisation payment commitments. Thus, the off-take of credit can shrink even if credit is available, resulting in a fall in credit-financed consumption and investment demand. Since growth in a number of areas such as the housing sector, automobiles and consumer durables had been driven by credit-financed purchases encouraged by easy liquidity and low interest rates, this would immediately affect the demand for housing, automobiles and durables. This in turn would have second-order effects in terms of contracting demand for other sectors and economic activities. As a result, a wide range of industries, services and segments of the labour market are likely to be indirectly affected by the crisis.

If the growth slowdown persists or recurs with greater intensity with more severely adverse employment effects, defaults on the accumulated legacy of retail credit are likely. Combined with losses on investments triggered by the growing appetite for risky assets among scheduled commercial banks after liberalisation, this poses a real danger of insolvencies because of an increase in the proportion of non-performing assets in the Indian banking sector.

Chapter 5

THE INDIAN GOVERNMENT'S RESPONSE

WHEN the crisis first broke internationally, within official circles in India there was a perception that the Indian economy would be less affected and the Indian financial sector would be relatively immune to the winds from the international financial implosion. The presence of a large nationalised banking sector and a somewhat more stringent regulatory regime for real estate lending by banks were seen to protect the Indian financial system from harmful contagion from abroad. However, as shown in previous chapters, these expectations have been partially belied, with adverse movements not only in real economic indicators, particularly export production and employment, but also in financial variables such as stock market indices and currency values.

The initial responses of the government focussed on the financial side of the current crisis, with three major components to the first stimulus package adopted in late 2008. These included measures by both the Reserve Bank of India and the government aimed at reducing interest rates and increasing the access to credit of large and small firms, state governments and individuals. At the same time, access to credit from foreign sources was sought to be enhanced through measures that further liberalised the remaining constraints on external commercial borrowing. The ceiling on FII investment in rupee-denominated corporate bonds was more than doubled. The slogan appeared to be, "if domestic credit is unavailable or expensive, borrow from abroad." There were also measures aimed at getting state governments and an infrastructure investment fund set up by the central government, the India Infrastructure Finance Company Limited (IIFCL), to borrow more to finance capital, especially infrastructure, expenditure. Finally, there were attempts to spur the demand for automobiles and housing through various incentives to buyers and to banks to provide credit for such purchases. So banks and financial institutions were encouraged to lend and different economic actors were invited to borrow and spend. This includes borrowing in foreign exchange to finance expenditures in areas like real estate which are unlikely to yield foreign currency revenues that can be used to meet future repayment commitments.

Even if they had worked, such policies would only have strengthened the very same economic tendencies that generated the crisis in the developed countries in the first place. In any case, and perhaps unsurprisingly, by April 2009 it was already evident that these monetary measures all proved to be lacking and did not ease credit conditions in any meaningful way. This was partly because of the liquidity-trap characteristics of the situation as the most creditworthy potential borrowers were unwilling to borrow because of the prevailing uncertainties and expectations of slowdown, and partly because banks also suddenly became more risk-averse. This meant that all other enterprises, even those which desperately required working capital just to stay afloat, found it increasingly difficult to access bank credit even as they faced more stringent demand conditions.

In such a situation, reducing interest rates does not solve the basic problem of tightened credit provision, even though it may marginally reduce costs for those who are able to access bank credit. The real economy is unlikely to be revived through such measures in the absence of a strong fiscal stimulus. It is now increasingly accepted that there is no alternative to the standard Keynesian device of using an expansionary fiscal stance to create more economic activity and demand, and thereby lift the economy from slump. Even so, the government of India took an inordinately long time to announce what turned out to be a relatively small fiscal package, involving less than 0.5 per cent of GDP of additional direct public spending. This was combined with various tax cut measures, with estimated revenue losses still less than 1 per cent of GDP.

Part of the reason why the fiscal stimulus in India was stronger than provided for was the presence of pre-committed expenditures in the form of implementation of the Sixth Pay Commission's recommendations that involved payment of huge arrears to central government servants. As a result, the overall fiscal deficit (of central and state governments together) in fiscal year 2009-10 is likely to increase significantly, though a large part of it would be the result of tax cuts and subsidies rather than direct spending. There are several problems with relying upon price-based fiscal measures. To begin with, tax cuts stimulate economic activity only if producers respond by cutting their own output prices and such price cuts in turn generate demand responses, or if they enable firms that would otherwise have closed down to survive. But neither is inevitable, nor even very likely given prevailing market structures in India. Across the world, governments are finding that in times of economic uncertainty, tax cuts are much less effective in stimulating activity than direct government expenditure. Similarly, measures that try to provide additional export incentives (such as interest reductions for export credit) to exporting sectors such as textiles, garments and leather do not counteract the effect of big losses of export orders as the major markets start shrinking.

Therefore direct public spending would be a far more effective way of dealing with the current slowdown even in India. However, the fiscal stimulus provided thus far has been both small and also not directed towards forms of expenditure that are likely to have high multiplier effects. Some of the most critical areas of potential spending have been ignored or neglected, such as increased resource allocation to state governments, direct investment to ensure mass and middle-class housing, interventions to improve the livelihood conditions of farmers, expansion of the public food distribution system, enlargement of employment schemes and provision of social security. It is in this context that the talk of the need for "exit" from the spending thrust needs to be assessed. Combined with the loss of the once-for-all stimulus delivered by Pay Commission-related arrears, this could dampen or subvert the recovery, especially in a year when the monsoon has been less munificent.

This inadequacy of fiscal and monetary policies to address the current economic problems in India is combined with the near-absence of measures to regulate finance, especially to prevent excessive risk-taking that destabilises the real economy. The Indian government appears to be moving towards more financial deregulation and privatisation of existing public financial institutions. In particular, its strategy seems to be to further inflate the embryonic credit bubble to prevent growth from slipping sharply, in other words generating another speculative bubble to drive the real economy recovery, regardless of the possibility that this could pave the way for a financial meltdown that would subvert such a recovery. But such a possibility must be acknowledged. Even if it is not as yet in a debt-driven crisis, the Indian economy is substantially dependent on rapid expansion of private credit to sustain growth.

In addition, the strategy pushes infrastructural investment financed not only with domestic debt, but also with external commercial borrowing. This not merely adds to the debt spiral, but involves a currency mismatch inasmuch as infrastructural projects are unlikely even in the medium term to yield foreign exchange revenues that can be used to meet interest and amortisation commitments payable in foreign exchange. On the other hand, with global interest rates being much lower than domestic rates, firms may not adequately take account of exchange rate risks and opt for foreign borrowing whenever available. This could lead to solvency problems if the rupee depreciates sharply, and strain India's foreign reserve position if the exodus of foreign capital continues. The reliance of the Indian state on encouraging more private debt-financed spending to trigger a recovery is indeed fraught with problems.

It also does not work. As of July 2009 the evidence suggests that the recovery in industrial growth is only marginal despite the government's efforts. Industrial growth during the first four months (April-July) of fiscal 2009-10 (relative to the corresponding period of the previous year) was, at 4.6 per cent, lower than the 5.6 per cent recorded during April-July 2008.

While the export decline noted above could partly explain this adverse turn, the substantial dependence of Indian manufacturing on the domestic as opposed to the export market implies that the fundamental problem facing the economy is a slackening of domestic demand. This domestic demand recession is surprising for a number of reasons. First, even though the government's crisis-induced effort at providing a fiscal and overall demand stimulus to the economy remained half-hearted, that effort came on top of the fortuitous stimulus provided by the implementation of the Sixth Pay Commission's recommendations, which included the payment of arrears that offered windfall gains to domestic consumers. Since the beneficiaries of the Pay Commission's recommendations fall in the middle- and upper-middle-class categories, it is to be expected that their windfall gains and higher salaries would be directed towards demand for manufactures, besides luxury services. If, despite that, industrial growth has been indifferent or poor, other factors must have neutralised the effects of this fortuitous stimulus.

Second, the effects of the crisis have been transmitted to India precisely at the time when the political business cycle would have worked to drive up economic growth. With India having gone in for a general election during April and May 2009, spending in various forms would have substantially increased. Not only would government expenditures have been higher on average as incumbent governments sought to push ahead with programmes and concessions to win over the electorate, but the recorded and unrecorded expenditures undertaken by the Election Commission on the one hand and the political parties and candidates contesting the elections on the other would have injected additional demand into the system. This too seems to have been inadequate to stall a recession.

While it is undoubtedly true that if these fortuitous stimuli had not played a role the manufacturing recession would have been even deeper than revealed by the extant numbers, the element of surprise is that those stimuli have not been able to prevent the downturn. The effects of the global recession have been significant. This in turn implies that all earlier talk of India being decoupled from the international system was exaggerated.

This experience has a larger lesson about the effects of liberalisation on manufacturing growth in India. While liberalisation did change the sources and pattern of growth in India, this was not because of a shift in favour of an export-based stimulus, but because of the expansion of new sources of credit-financed consumption that widened the demand and market for manufactured goods. What the current crisis has done is to challenge the sustainability of that form of growth.

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THE COSTS OF "COUPLING": THE GLOBAL CRISIS AND THE INDIAN ECONOMY

In the early stages of the current global economic crisis, it was suggested that the Indian economy (along with China), with a robust growth pattern which diverged from that of the developed countries, would be spared the raging market turmoil. Subsequent developments, however, have cast serious doubt on this "decoupling" thesis.

This paper contends that the pre-crisis boom in India was in fact fundamentally dependent on greater integration into the world economy – an integration which also rendered the growth process uneven and vulnerable to crisis. The paper examines three channels through which this integration has come to influence the impact of the present crisis on India:

- a slowdown in exports of goods and services
- outflows of foreign capital
- a contraction in credit-financed domestic demand.

Assessing the Indian government's response to these adverse effects of the crisis, the paper finds it to be inadequate on both the fiscal and monetary policy fronts. On top of this, the government appears intent on continuing further down the very path of financial integration and deregulation which could lead to increased economic instability.

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