American Economic Crisis and Its Impact on Key Economic Sectors of India

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Abstract:

Globalization, no doubt, came as a boon for developing nations and brings myriads of new opportunities for the developed nations also. Various activities of a nation became no longer centric to their geographical boundaries, they, rather, transcended them. Globalisation guarantees profits to the participants, but also does not spare a participant-nation from being adversely affected in 'Hard Times'. By 'Hard Times' I meant 'global recession' and that too in a limited sense being related to the America & India only. This paper examines the causes of great recession in the context of America and its effect on Indian economic structure. Attempt has also been made to suggest some steps to be taken to engulf the American crisis. This paper also details some of the domestic endeavours being undertaken by various Indian agencies viz. RBI to curb the effect of American crisis on Indian economy, structural soundness of Indian Economy which resulted in safeguarding, to a larger extent, Indian economy from the repercussions of this American crisis or the Global Recession.

I. BACKGROUND

It is not immemorial when members of a particular society used to prosper in isolation. Some societies were there which were self-contained, self-sufficient and prosperous as well at the same time. But this cannot be conceived of in today's scenario. No society, group of individuals and even a nation can sustain for long in desolation. New technological inventions, changing societal perspectives towards one another, and many other factors including economic bound the mankind to interact with one another more than ever.

Each day, in every area of human activity, one is enjoying / participating in the combined efforts resulting from above-said interactions. No economy in the world is self-sufficient in itself, compelling/encouraging, then, to participate in the global exercise to fulfill its needs or to achieve aims. This interaction of human groups or nations with other groups or nations results into the globalization of activities, thus making them inter-dependent, if not wholly, at least partially, and in some cases even substantially.

Where on the one hand, this 'interdependence' or 'globalization' created opportunities for better prospects for every person, made the nations a developed ones, and espoused many others benefits, also made the world society more susceptible to the collateral damage caused out of any one nation or society. For every nation or society is in one way or the other dependant, in varying degrees, upon the other, even a slight downfall in economic activity of a nation bound to affect the other also. One such economy is of United Sates of America which is conceived of as a highly developed economy in the world. United States is involved in economic activities with almost every nation of the world, and conversely each and every nation is having some sort of economics activity with the US, be it manufacturing sector, services, IT Sector, etc. US has been a biggest victim of the recession due to several factors, resultantly, economies tied with it also suffers great loss in their respective economies. The devastation of Lehmen Brother Bank results into the major economic crisis in the US and other nations as well.

This new situation reveals the true nature of the globalisation process. The enthusiasm for globalisation grew at a time when some of the northern economies were booming. Then, it was the norm to single out crises elsewhere as the consequence of an individual country's mistakes alone, or – at best – of an incomplete exposure to the beneficial effects of globalisation. But with the world economy now slowing down, globalisation may have adverse consequences.

It is, however, possible to regard this global impasse as a unique opportunity. Coordinated expansionary policies might be advocated and even implemented. This is not a popular idea. Fiscal policy has long been stigmatized as the cause of policy failure and economic downturn

II. AMERICAN ECONOMY – AN OVERVIEW

The expansion of the 1990s occurred alongside the most restrictive fiscal stance in at least four decades. During the same period, monetary policy intervention was minimal. Thus, whereas economic growth and productivity during 1992–2000 were not unprecedented, the particular configuration of expectations, market forces and policy (in-action) were indeed novel. Most importantly, the composition of demand was unique. The main accounting relationships are revealed by disaggregating the economy into its main sectors (private, public and external). The resultant accounting identity reveals both the financial balances of the main sectors and the contributions of net spending to aggregate demand.

The private-sector *as a whole* cannot liquidate financial assets and, simultaneously, sustain an economic expansion. Concurrent sales of financial assets would result in a stock market collapse with consequent capital losses. At some point an economy driven by private spending in excess of current income must slow down. The above analysis of the boom is now the basis of the explanation of the recession.

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The recession that began at the end of 2000 was the result of a fall of (aggregate) private expenditure relative to income. This was caused by the slowdown of the net-flow of credit.

A blind belief in the 'resilience of corporate America' has overlooked these basic facts, instead focusing on productivity increases to promote a rapid restoration of economic growth to full potential and, perhaps, beyond. However, a combination of excess capacity, sluggish demand arising from almost all other sectors and high unemployment followed by faster productivity-potential will cause more lay-offs, a lower state of confidence and, eventually, a persistent recession.

To sum up, private-sector spending beyond income was the *sole* cause of the US expansion during the 1990s. The boom was entirely due to the ever-growing debt of the private-sector. The scale and duration of the expansion were not extraordinary, but since it was driven by a single sector, the pace of spending needed to be so much in excess of income that it required an unsustainable accumulation of debt. The private-sector imbalance must eventually be resolved. This has begun to happen.

III. FROM SLOWDOWN TO RECESSION: IMPACT OF 11 SEPTEMBER

The terrorist attacks that were carried out on USA on 11th September are having significant and far-reaching effects on the global economy. While the immediate and direct effect was a loss and destruction of physical and human capital in USA, economic activities were also affected in a variety of ways. The shock was a bit too hard for an already weak economy to absorb. As a result, the US economy now faces the real danger of a recession - as the country's GDP has contracted in the third quarter of 2001, and is almost certain to continue the same trend in the subsequent quarter. And given the high degree of integration of today's global economy, and more particularly, the dependence on America's economy, the adverse effects quickly spread to other countries - thus threatening to produce a global recession. The decline in consumer confidence in USA not only affected business sentiment (and economic activities) within the country; through a reduction in the demand for imports, it immediately affected countries with a high degree of dependence on USA market for their exports.

IV. IMPACT ON INDIAN ECONOMY

Vulnerability of poor developing economies to external shocks can spring from many sources. The most common are terms of trade shocks due to volatility in primary commodity prices, commodity booms resulting in the Dutch disease, external aid reduction and natural disasters (floods, droughts and tsunami). India, like most other emerging market economies, has so far, not been seriously affected by the recent financial turmoil in developed economies.

V. INDIA & FINANCIAL GLOBALISATION:

The Indian economy is now a relatively open economy, despite the capital account not being fully open. And as such, developments in international markets are bound to affect the Indian economy and policy makers have to be vigilant in order to minimize the impact of adverse international developments on the domestic economy.

The relatively limited impact of the ongoing turmoil in financial markets of the advanced economies in the Indian financial markets, and more generally the Indian economy, needs to be assessed in this context. Whereas the Indian current account has been opened fully, though gradually, over the 1990s, a more calibrated approach has been followed to the opening of the capital account and to opening up of the financial sector. This approach is consistent with the weight of the available empirical evidence with regard to the benefits that may be gained from capital account liberalisation for acceleration of economic growth, particularly in emerging market economies.

Accordingly, in India, while encouraging foreign investment flows, especially direct investment inflows, a more cautious, nuanced approach has been adopted in regard to debt flows. Similarly, portfolio investment in government securities and corporate bonds are also subject to macro ceilings, which are also modulated from time to time.. In regard to capital outflows, the policy framework has been progressively liberalised to enable the non-financial corporate sector to invest abroad and to acquire companies in the overseas market. Resident individuals are also permitted outflows subject to reasonable limits.

In order to further strengthen capital requirements, the credit conversion factors, risk weights and provisioning requirements for specific off-balance sheet items including derivatives have been reviewed. Furthermore, in India, complex structures like synthetic securitization have not been permitted so far. Introduction of such products, when found appropriate, would be guided by the risk management capabilities of the system.

In addition to the exercise of normal prudential requirements on banks, the Reserve Bank has also successively imposed additional prudential measures in respect of exposures to particular sectors, akin to a policy of dynamic provisioning. In brief, the Indian approach has focused on gradual, phased and calibrated opening of the domestic financial and external sectors, taking into cognizance reforms in the other sectors of the economyThese characteristics of India's external and financial sector management coupled with ample forex reserves coverage and the growing underlying strength of the Indian economy reduce the susceptibility of the Indian economy to global turbulence.

VI. IMPACT OF THE CRISIS ON INDIA

While the overall policy approach has been able to mitigate the potential impact of the turmoil on domestic financial markets and the economy, with the increasing integration of the Indian economy and its financial markets with rest of the world, there is recognition that the country does face some downside risks from these international developments. The financial crisis in the advanced economies and the likely slowdown in these economies could have some impact on the IT sector. In summary, the combined impact of the reversal of portfolio equity flows, the reduced availability of international capital both debt and equity, the perceived increase in the price of equity with lower equity valuations, and pressure on the exchange rate, growth in the Indian corporate sector is likely to feel some impact of the global financial turmoil.

VI. IMPACT ON EMPLOYMENT AND POVERTY

The economic slowdown that the global economy is currently going through demonstrates that market economies continue to remain subject to periodic cycles of booms and busts. With recession come the associated adverse social effects in terms of rising unemployment, underemployment and poverty. Experience of economic crises in various parts of the world in recent years shows that unless timely action is taken, sharp economic downturns can cause a lot of suffering to the poor working population. As far as economic revival and job creation are concerned, a combination of monetary and fiscal policies appears to be a step in the right direction. The relative merit of fiscal instruments, and within them of measures capable of inducing increased consumption and investment expenditures, has already been mentioned earlier. Increases in public spending in a well-targeted manner (so as to create necessary multiplier effects) deserve special attention in that respect. Alongside increased public spending, it is necessary to adopt measures to support micro and small enterprises.

VII. IMPACT ON THE INDIAN IT/ITES INDUSTRY

If we look at the top 5 IT services companies in India, all of them generate more than 50 % of their revenue from US. So it is clearly evident that most of the Indian IT companies are dependant upon the US. So if any thing happens to one of these large US companies all those sit idle. Some of the key third party service providers for mortgage included Equinox, WNS, EXL, Wipro BPO and Infosys BPO. Many of them have had to revisit their strategies to tide over the problem. Indian IT market will always have to feel the pinch if they are more US centric and fail to come out of this cocoon. The India IT management will need to focus and spend some time to develop markets in Middle-East-Asia and Europe or even local market.

VIII. BANKING AND FINANCIAL SERVICES

The real losses incurred by most financial institutions from the exposure to mortgage business are yet to be confirmed. Such uncertainties on overall projected earnings will call for stricter budgetary controls and the overall demand for IT services will go through a slump in the first two quarters of 2008. However, most financial institutions will introduce new controls to their credit risk management processes. These initiatives will not only be voluntary in nature but also be made mandatory as the regulators will demand more transparency. Regulatory and process improvement initiatives would become the primary sponsors of new IT initiatives within these organizations.

IX. IMPACT ON THE INDIAN BANKING SYSTEM

One of the key features of the current financial turmoil has been the lack of perceived contagion being felt by banking systems in EMEs, particularly in Asia. The Indian banking system also has not experienced any contagion, similar to its peers in the rest of Asia.

A detailed study undertaken by the RBI in September 2007 on the impact of the sub-prime episode on the Indian banks had revealed that none of the Indian banks or the foreign banks, with whom the discussions had been held, had any direct exposure to the sub-prime markets in the USA or other markets. However, a few Indian banks had invested in the collateralised debt obligations (CDOs) / bonds which had a few underlying entities with sub-prime exposures. Thus, no direct impact on account of *direct exposure* to the sub-prime market was in evidence. However, a few of these banks did suffer some losses on account of the mark-to-market losses caused by the widening of the credit spreads arising from the sub-prime episode on term liquidity in the market, even though the overnight markets remained stable.

X. RBI RESPONSE TO THE CRISIS

The Reserve Bank has been effectively able to manage domestic liquidity and monetary conditions consistent with its monetary policy stance. This has been enabled by the appropriate use of a range of instruments available for liquidity management with the Reserve Bank such as the Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) stipulations and open market operations (OMO) including the Market Stabilisation Scheme (MSS) and the Liquidity Adjustment Facility (LAF).

XI. CONCLUSION

While each financial crisis no doubt is distinct, they also share striking similarities, in the run-up of asset prices, in debt accumulation, in growth patterns, and in current account deficits. New unregulated, or lightly regulated, financial entities have come to play a much larger role in the financial system, undoubtedly enhancing stability against some kinds of shocks, but possibly increasing vulnerabilities against others. Technological progress has plowed ahead, shaving the cost of transacting in financial markets and broadening the menu of instruments. The air of pessimism of a possible slowdown of the US economy has been a cause of concern for the Indian IT industry at large. Nevertheless there are several perceptible risks going forward. The first is the extent of slowdown that may manifest in the economies of the developed world. There could however be continued inflationary pressure.

However, there is a possibility that the slowdown may turn into recessionary conditions in the US, especially if there are adverse geo-political developments, which, at times, act as triggers. In such an event, a decline in business confidence at the general level can combine with a prospective compression of export demand, to cause a significant slowing of the domestic economy.

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