

India's Politics of Crisis and Change

By N.K. Singh

The impact of the global economic slowdown and credit crunch is hitting large swaths of the Indian economy. But the challenge to policymakers goes beyond containing the economic fallout of the crisis, writes Indian Member of Parliament N.K. Singh. The government must manage the country's complex politics of change.

EMERGING MARKETS HAVE YET to fully absorb the impact of the global financial collapse. Fortunately, economies such as India's are not unduly leveraged to troubled international financial institutions and can ride out the storm with less damage than their developed world counterparts, particularly the United States.

The origins of the financial crisis are, of course, now well known. It began primarily in the US through the explosion of the so-called sub-prime mortgage market. Housing assets were acquired at relatively low interest rates and later went through multiple stages of asset-price inflation. A web of complex financial derivatives based on these mortgages resulted in artificially high prices, compounded by a degree of opaqueness about the identity of the ultimate borrowers of the underlying assets upon which the derivatives were based.

The resulting housing price bubble in the United States also created an unserviceable debt portfolio. As a result of this situation, the US was enjoying high levels of consumption that were not matched by savings rates. America continued to import large quantities of consumer goods from Asia, particularly from China and Japan, to sustain a lifestyle that had no relationship to the savings of American consumers. Thus, while America consumed, Asia saved.

In addition, there were at least four other factors:

- **First**, banks were excessively leveraged. For instance, it was not uncommon for banks with equity of, say, \$20 billion to leverage ten times that amount in their lending activities. This was clearly unsustainable.

- **Second**, rating agencies had a conflict of interest in seeking business from the very entities that they were expected to rate. They then placed unrealistic values on assets, seriously distorting their actual worth.
- **Third**, regulatory agencies failed to detect the multiple bubbles that were being created, and didn't enforce the prudential guidelines that were in place in any of their jurisdictions. In hindsight, former US Federal Reserve Board Chairman Alan Greenspan's fabled reputation as one of the architects of an unprecedented period of economic boom in the US is now being questioned. Some of his many critics are even holding him responsible for fostering the bubbles that led to the current financial crisis.
- **Fourth**, global multilateral financial institutions like the International Monetary Fund and the World Bank utterly failed to discharge their duties. For instance, the so-called Article IV consultations of the IMF — in which the IMF is meant to engage in frank assessments of member countries' economic management — require the IMF to closely scrutinize all key segments of a country's economy, particularly the financial and banking sectors. It is, indeed, ironic that even though the IMF possesses the requisite expertise, it only subjected the economies of emerging markets to rigorous scrutiny during these consultations, while effectively ignoring financial weakness in the US and other Group of Seven (G-7) countries. In any future restructuring of the IMF and World Bank, the issue of a non-discriminatory application of revised surveillance standards to all member countries — including the US and G-7 countries — should be a principal concern.

The financial debacle that began in the US and rapidly engulfed Europe and parts of Asia is nowhere near an end. The inter-bank credit market and other aspects of the global financial system remain crippled. The \$700 billion Troubled Asset Relief Program (TARP) created by the US to buy toxic assets has failed to restore confidence or prevent a continuing downward spiral in prices.

One of the principal challenges for new policymakers under President-elect Barack Obama will be to devise a means to arrest a further fall in US housing prices. A failure here would result in fur-

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ther losses in value to assets worth trillions of dollars. This, in turn, could leave asset prices across the board volatile. Private capital simply won't return to the market as long as there is an absence of confidence in the real value of assets. Until that is restored, the overall crisis will continue.

What remains most worrisome is that what began as a deep challenge to financial and capital markets has begun to spill over to the real economy, particularly in the US, which just announced the worst job loss figures in a generation. The continuing credit squeeze, faltering growth rates, a sharp downturn in demand and perceptions of an uncertain future are beginning to affect country after country. The auto sector in the US is but one example. Other segments of the economy will soon fall in line to seek bailout packages similar to what the auto industry is pleading for. Since even the US government cannot bail out every segment of the economy, a resort to managed bankruptcy proceedings and a judicious application of Chapter 9 of the federal bankruptcy laws could well be the least destructive path. This will certainly be painful, but there aren't many options.

What does all of this mean for a large emerging market like India?

Part of the problem India faces lies in an inefficient public delivery system. This has resulted in the tardy implementation of ongoing public investments in roads, ports, power stations and local airports.

First, the Indian economy over the past few years has enjoyed relatively high growth, with gross domestic product (GDP) posting growth rates of 9 percent per year. The government's medium-term projections, set forth in its 11th 5-year plan, call for continued 9 percent growth, followed by double-digit growth toward the end of the plan in 2012.

India's economy has also become increasingly integrated into the global economy, although, luckily, Indian financial institutions such as ICICI and SBI were only modestly exposed to the global financial institutions most severely affected by the current crisis. Nonetheless, over 400 Indian multinationals have to rely increasingly on the domestic banking sector to meet their external liabilities, given the near freeze on external credit and inter-bank lending on the global market. This has generated enormous pressure on domestic banking institutions facing serious liquidity problems. While exports constitute only 16 percent of India's GDP, the slowdown in global demand, despite improved competitiveness created by the depreciation of the rupee, has hurt exports, which are a significant source of employment. A slowdown in textiles, leather, garments, carpets, handicrafts, gems and jewelry has already resulted in the layoff of over a million workers.

Other segments of the economy have also been adversely affected, particularly real estate and construction, transport (including civil aviation) and basic raw materials such as petrochemicals, steel and cement. As in other Asian countries, the near absence of inward external capital flows,

combined with the continuous flight of foreign institutional investment has exerted downward pressure on both the stock market and the currency. The continuing decline of the rupee and the inability to stabilize investor expectations is beginning to delay early inward receipt of export remittances, an important source of foreign currency. Efforts by the central bank to bolster the currency have met with limited success, even though it has thrown over \$60 billion of foreign exchange reserves at the problem both from its stabilization efforts and by adjusting the valuation of the currency basket the central bank uses.

Second, the government has taken speedy and imaginative action in easing bank liquidity pressures and ensuring solvency by significantly lowering the central bank's cash reserve ratio and statutory liquidity ratio, as well as reducing the rates on repurchase agreements and reverse interest-rate transactions. These measures have no doubt eased liquidity pressures and signaled a downward movement in interest rates. However, the enhanced risk perception among investors and a lack of confidence in the real value of assets has kept credit markets essentially paralyzed. This, in turn, has hurt both ongoing investments and new green-field projects. A further easing of liquidity and reduction in interest rates is likely, and will substantially lower the cost and increase the availability of credit.

Third, it is now generally believed that GDP growth this year may not exceed 7.5 percent — some expect it to be even lower — while 2009 and 2010 could see GDP growth as low as 6 percent. This sharp decline will have serious consequences

for poverty reduction under the UN's Millennium Development Goals, particularly in education, health, drinking water and sanitation. The big challenge for policymakers is to sustain growth by encouraging domestic consumption through a combination of monetary and fiscal policy. While interest rates are likely to decline, the government is also contemplating a large fiscal stimulus package to assist exporters and an expansion in public outlays, particularly for infrastructure and the social sector. A decline in inflation rates caused, in part, by a sharp fall in oil and metals prices has improved the fiscal space for a new stimulus package. To be sure, reducing the deficit, eliminating market-distorting subsidies and keeping current account deficits within manageable limits remain macro-economic policy challenges.

But apart from delays in the impact of fiscal stimulus on the real economy, part of the problem India faces lies in an inefficient public delivery system. This has resulted in the tardy implementation of ongoing public investments in roads, ports, power stations and local airports. Improving the efficiency of the public sector and its ability to implement policy is a major challenge. Encouraging private investment will require a significant improvement in the regulatory environment. Initiating action on stalled reforms in the financial and banking sector, outmoded labor laws, judicial reforms and the coordination between New Delhi and the state governments are all necessary to reviving faltering growth.

Finally, India is heading for a general election in early 2009. That means the current government will enter "election mode" over the next two months. For starters, it is likely to seek a vote to allow it to fund government expenditures for the first three months of the next fiscal year, which begins in April 2009. The recent terrorist attacks in Mumbai seem likely to produce a broad-based consensus on a new law to deal with terrorism and strengthen the capability of enforcement agencies. This will certainly be high on the government's immediate agenda.

The long-term Indian growth story remains robust, not least because in recent years the country has become increasingly integrated into the glo-

bal economy. It has enjoyed the extensive fruits of overall global prosperity but must now learn how to adapt to the global recession with minimal disruption to the social order.

Reliance on fiscal and monetary policy alone may not be adequate to ensure sufficient economic growth. Restarting stalled economic reforms in several key areas is needed to reverse the slowdown. Emerging markets like India are faced with unexpected challenges from an unprecedented global slowdown. The question is whether India can convert this economic crisis into an opportunity, given its relatively young population and unfulfilled desire for better infrastructure, education and health services. A great deal will depend on the extent to which its political parties can transcend the narrow concerns of partisan politics in an election year.

Managing the politics of change will be the current government's principal challenge in its remaining months in office. This will also determine the agenda of the new government that will assume office in May 2009. Broad-based, bipartisan support will ensure continuity and prevent disorderly change, as strategies are re-adapted to minimize the impact of flagging economic growth. The twin challenge of improving the internal security environment and mitigating the consequences of the worldwide economic mess will call for difficult decisions. There are no shortcuts to achieving these objectives.

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