Chindia to the rescue

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India and China are being increasingly seen as the two emerging economy growth engines that may stave off a global recession, and perhaps help drag the advanced countries out of their recession. Sudipto Mundle examines...

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Nothing like the present financial turmoil has been seen since the stock market crash of 1929, which led to the Great Depression. Finance capitalism is remarkably fragile at its core, driven by unpredictable market sentiments. When things start to go wrong, 'bearish' sentiments prevail. Panic feeds on panic and dark expectations become self-fulfilling. Depositors rush to withdraw money from banks, and investors withdraw from stock markets, causing the collapse of both. Asset prices fall and capital erodes. Credit dries up and chokes off production. Unemployment soars. This is what happened in the crash of 1929. Is this happening again now, in the crash of 2008? Are we on the brink of a similar great depression?

As the US sub-prime loan defaults soared to an estimated $1.4 trillion, it triggered a chain reaction throughout the financial world. Around $10 trillion of capital will be wiped out for financial institutions globally, and global credit flows may shrink by up to $30 trillion. Virtually all the advanced countries are now in recession, and their authorities have responded with remarkable speed. In less than two months since the collapse of Lehman Brothers, the advanced countries have introduced a comprehensive package of financial measures to deal with the crisis, and fiscal

stimulus packages are under preparation. But it’s still too early to tell whether these measures are enough to restore market confidence and pull them out of recession. Where does that leave India? Fortunately, direct Indian exposure to the US crisis has been limited. Indirectly, Indian stock prices have been severely affected by foreign institutional investors’ (FIIs’) withdrawals. FIIs invested well over Rs 10,00,000 crore between January 2006 and January 2008, driving the Sensex first past the 10,000 milestone, and then 20,000 over the period. But from January to mid-October this year, FIIs pulled out over Rs 50,000 crore, partly as a flight to safety and partly to meet their redemption obligations at home. These withdrawals drove the Sensex down from over 20,000 to less than 10,000 in only nine months. Dollar purchases by FIIs and Indian corporations, to meet their obligations abroad, have also driven the rupee down to its lowest value in many years. Within the country also there has been a flight to safety. Investors have shifted from stocks and mutual funds to bank deposits, and from private to public sector banks. Highly leveraged mutual funds and non-banking finance companies (NBFCs) have been the worst affected. Rumours that some banks had also lost heavily froze inter-bank money market transactions, with overnight call money rates crossing 15 per cent in mid-September. Coming together with the second-quarter income tax deadline, this severely squeezed liquidity, further compounding the problem for mutual funds and NBFCs.The Reserve Bank of India (RBI) reacted swiftly to
restore liquidity and calm the markets. It reduced the cash reserve ratio (CRR) by 2.5 percentage points in two steps, created a special Rs 20,000 crore window for bank lending to mutual funds, and provided another Rs 25,000 crore as part reimbursement for farm loan waivers. These measures generated extra liquidity of Rs 1,45,000 crore. It also reduced the re-purchase (repo) rate, and relaxed norms for both external commercial borrowing and FII investments to encourage dollar inflows. Despite these prompt measures, stock prices remain depressed, and liquidity remains constricted, with the RBI’s dollar sales sucking up a part of the liquidity it generated. On October 31 the call money rate spiked to 20 per cent. The RBI responded immediately with a slew of weekend measures. The repo rate has been further reduced to 7.5 per cent, the CRR to 5.5 per cent and the statutory liquidity ratio to 24 per cent. The special window for lending to mutual funds and NBFCs has been enhanced from Rs 20,000 crore to Rs 60,000 crore, adding another Rs 1,20,000 crore of liquidity.
Prompt, determined RBI action has helped to arrest the stock market fall. Bank lending is also starting to revive. Additional RBI steps could further strengthen credit flows and bolster market sentiment. Most experts now recommend counter-cyclical reforms like tightening controls during periods of buoyancy and allowing some slack during periods of stress. However, monetary policy reforms alone cannot tackle this crisis. It is time to direct attention to a fiscal stimulus, focusing on infrastructure and social spending to minimise the adverse effect on growth. The sharp decline in oil and other commodity prices, together with an excellent harvest, will yield a significantly

lower inflation rate by January next year, giving the government more room to manoeuvre.
Growth will certainly be affected, and could fall from 7 per cent or more this year to 6 per cent next year, reflecting the full-year impact of the crisis. Such growth rates of 6-7 per cent are high by developing county standards, and beyond the reach of advanced countries even at the best of times. India is only facing a growth deceleration and not a recession, let alone a great depression. On the contrary, India and China are being increasingly seen as the two emerging economy growth engines that may stave off a global recession, and perhaps help drag the advanced countries out of their recession.

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