THE IMPACT OF WESTERN DEBT CRISES ON INDIA

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Abstract

In recent years the global economy has been experiencing a critical phase in terms of decline in gross national products, rise in unemployment levels, and slump in investment activities. Such global scenario has thus affected the global growth and welfare. The epicenter of these problems is the economic and financial crises of west. The crises originated from deceptively small sources of west - sub-prime lending in the US in 2008 and government debt in Greece in 2011. These crises have wobbled the backbone of the world economy. India being relatively integrated with and open to the global economy has been affected. Currently, the national economy is passing through a phase of high inflation, exchange rate crisis, volatile capital market, discouraging investment scenario and increase in fiscal deficits. Thus, the present study is an attempt to make a post-mortem of the debt crises of west and impacts on Indian economy. The study suggests that there should be effective supervision of all financial activities, both private and public, if the country is to be crisis resilient. Besides a robust regulatory framework that integrates a system-wide approach and has built-in buffers to smooth cyclical volatility should be instilled. Since the depositors are the most sensitive groups during crises and deposit insurance systems have the ability to safeguard the depositors interests, such systems should be encouraged.

Key Words: Debt Crises, US, Euro-Zone, India

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I. Introduction

The beginning of 21st century witnessed the first crisis with the burst of Dot.Com Bubble followed by US Subprime Crises and recently the European Debt Crises. The crisis was preceded by long period of rapid credit growth, low risk premiums, abundant availability of liquidity, strong leveraging, soaring asset prices and the development of bubbles in the real estate sector. Over-stretched leveraging positions rendered financial institutions extremely vulnerable to corrections in asset markets. As a result a turn-around in a relatively small corner of the financial system (the US subprime market) was sufficient to topple the whole structure. The prediction went right and the USA faced 21st century's worst crisis in 2008. The crisis manifested itself as an acute liquidity shortage among financial institutions as they experienced even stiffer market conditions for rolling over their (short-term) debt. The concerns over the solvency of financial institutions were looming large, but a systemic collapse was deemed unlikely. This perception dramatically changed when a major US investment bank (Lehman Brothers) defaulted in September 2008.

The default by investment bank Lehman Brothers collapsed the confidence of investors. The loss in confidence leads to massive liquidation in their positions and stock markets went into a tailspin. From then onward the EU economy which is related with the US economy also entered the steepest downturn on record since the 1930s. The transmission of financial distress to the real economy evolved at record speed, with credit restraint and sagging confidence hitting business investment and household demand, notably for consumer durables and housing. The cross-border transmission was also extremely rapid, due to the tight connections within the financial system itself and also the strongly integrated supply chains in global product markets. This has resulted into shrink in the real GDP of the EU.

In order to overcome from the financial crisis of 2008 and bring quick recovery in the economy, governments of many countries had initiated several stimulus dosages in form of cash subsidy, cash infusion, equity bail out, reducing borrowing rates, lowering tax rates etc. The idea was to boost confidence and drive consumption. This was mainly funded by printing money or/and public borrowing programme. Already some of these countries were high on Debt to GDP ratio and the stimulus packages made it still higher. The assumption was – as the economies starts recovering consumption would drive production and thereby increasing the GDP of their nation. GDP would be then sufficient enough to service the increased debt. But the assumption went wrong and the plan misfired for few countries. As some European countries never recovered & their GDP failed to rise, they started filling short of funds to service their debt obligation. To service their earlier debt they raised new debt and then some more. Thus the debt balloon expanded out of proportion w.r.to GDP, pushing them into debt trap and resulted in default on payment of external debt obligations.

The outright default on payment of debt obligations incurred under foreign legal jurisdiction, including nonpayment, repudiation, or the restructuring of debt into terms less favorable to the lender than in the original contract is characterized as External debt crises. These events have received considerable attention in the academic literature from leading modern-day economic historians, such as Bordo, Eichengreen, Marc Flandreau, Lindert and Morton, and Taylor. The recent global financial meltdown can be attributable to the following two most important causes.

II. Private Debt Crisis in USA (2008)

The biggest and strongest economy in the world which is in the verge of economic crisis is because of the massive underlying weaknesses in the financial sector. These weaknesses set the stage for trouble in the housing sector that set off financial market declines and spread to the decline in real economy. Declines in the real economy exacerbated the problems of financial institutions. The economic problems were first evident in the financial sector as investors began to doubt the true value of structured securities such as CDOs and CDSs that were built off real estate collateral. Many of these financial assets are traded and once their prices started to fall, this meant investment funds had to mark them to market and some were pushed into bankruptcy as early as the spring of 2007. During August of 2007 when a liquidity crisis hit, as financial institutions that had been relying on very short term borrowing were no longer able to roll over their liabilities at reasonable costs. Northern Rock in the UK and Bear Stearns in the US went under as a result. Banks started to doubt each other's stability and LIBOR, the main index of the rates charged by banks for lending to each other, soared. Central banks, including the Federal Reserve had been very active in responding to the crisis, and Lehman Brothers declared as bankrupt leading to full scale crisis in the financial sector.

III. Public Debt Crisis in Euro zone (2011)

The Euro-zone crises are attributed to government budget deficits in excess of the values stated in the Stability and Growth Pact (SGP), as part of the Maastricht treaty. The governments of several countries in the Euro-zone have accumulated what many consider to be unsustainable levels of government debt, and three—Greece, Ireland, and Portugal—have turned to other European countries and the International Monetary Fund (IMF) for loans in order to avoid defaulting on their debt. The crisis now threatens to spread to Italy and Spain, respectively the third and fourth largest economies in the Euro-zone. Greece has been at the center of the Euro-zone debt crisis. It has the highest levels of public debt in the Euro-zone, and one of the biggest budget deficits. Greece was the first Euro-zone member to come under intense market pressures and the first to turn to other Euro-zone member states and the IMF for financial assistance. Over the past year, the IMF, European officials, the European Central Bank (ECB), and the Greek government have undertaken substantial crisis response measures. At the behest of European leaders in July 2011, holders of Greek bonds have also indicated that they will accept losses on their investments to alleviate Greece's debt payments in the short-run. If these plans are carried out, Greece will be the first advanced economy to default in almost half a century.

IV. Impact on India

The Indian economy looked to be relatively insulated from the global financial crisis that started in August 2007 when the 'sub-prime mortgage' crisis first surfaced in the US and the recent Euro-Zone Crises. But if we look from the macroeconomic point growth rate in Indian economy will be slow down, since Indian market is closely related with the western market.

The impact and transmission of the global crises to the Indian economy can be expected through the following channels- the financial contagion, Europe's fiscal consolidation effects, foreign trade and exchange rates.

The Financial contagion to developing countries may occur in the form of spillovers through financial intermediaries and stock markets, as well as shifts in investor market sentiment and changes in investor perception of risks. European banks hold a big share of Greek sovereign debt, with Germany, France and the UK holding \$22.6 billion, \$15 billion and \$3.4 billion respectively. If Greece defaults, European banks may experience significant losses and, as a result, they may need to cut their credit lines in developing countries to restore their capital adequacy ratios. Growing uncertainty on the full extent of European default may further limit bank liquidity, thereby increasing difficulties for developing countries in securing lines of credit on international markets.

The Euro-Zone crisis has caused some turmoil in the Indian bourses but the impact was not severe as it was exhibited in 2008-09 because of US Crises. The equity markets have seen a near 60 percent decline in the index and a wiping of about USD1.3 trillion in market capitalization since January 2008 when the Sensex had peaked at about 21,000. This is primarily due to the withdrawal of about USD12 billion from the market by foreign portfolio investors between September and December 2008 bringing the Sensex and Nifty a historic low (Fig.1& 2).

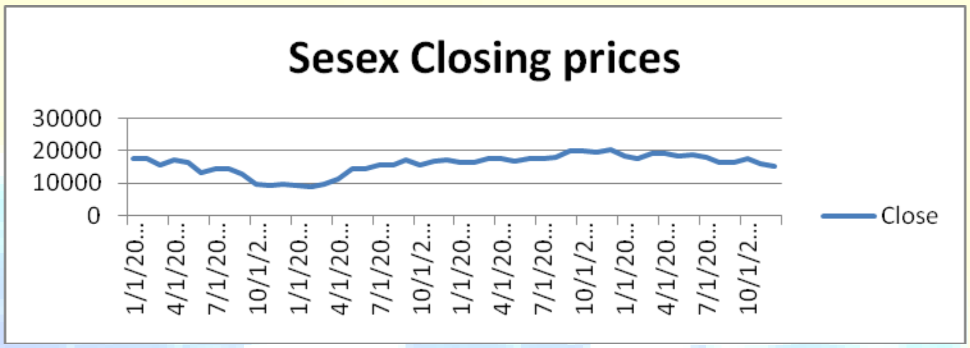

Fig.1- Monthly Average of BSE30 Index

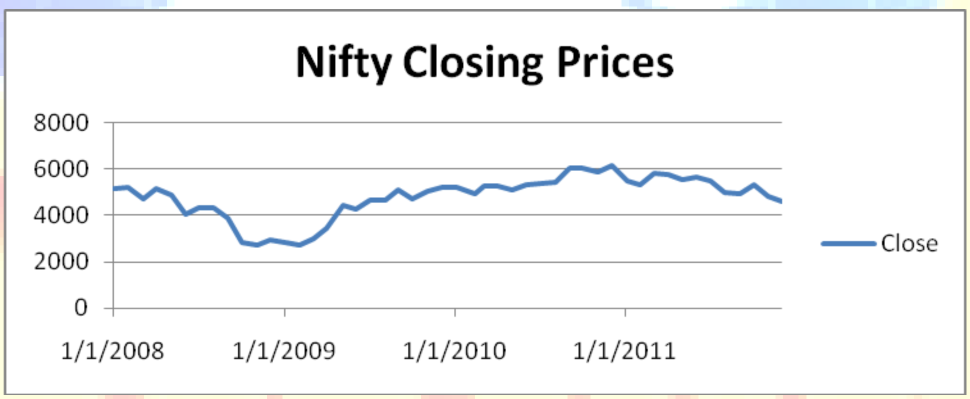

Fig.2- Monthly Average of NSE50 Share Index

The banking sector remained unharmed though fortunately, the Indian banking sector was not overly exposed to the sub-prime crisis. Only one of the larger banks, ICICI, was partly affected but managed to thwart a crisis because of its strong balance sheet and timely action by the government, which virtually guaranteed its deposits.

The austerity packages in several European economies have led to a considerable rise in unemployment and weakened growth. This may impact developing countries in several ways. Fiscal consolidation plans may force European governments to slash spending. These cuts might lead to declines in aid to developing countries, adding to concerns in a context where several European countries are struggling to meet aid targets after the global financial crisis. Slower European growth may also have a severe impact on developing countries by reducing EU demand for commodities, manufactured goods and services. The euro area unemployment rate has also increased and the US is also suffering, with a rise in unemployment rate. This will certainly translate into fewer remittances to the developing world as immigrants struggle to maintain or find new jobs.

The exchange rate movements may also pose new challenges for the developing world. The consequences of US Crisis made the outflow of portfolio investments, higher foreign exchange demand by Indian entrepreneurs seeking to replace external commercial borrowing by domestic financing, and the consequent decline in foreign exchange reserves weakened Rupee. The weaker Rupee should encourage our exporters and it is possible that with imports declining as sharply as exports, the country's trade deficit may actually improve in the short-run and the external sector balance may remain stable and not pose any major policy issue. The euro-zone crises have resulted into weaker euro visa-vise USD. Euro depreciation against the dollar (Figure 3) may affect trade flows in developing economies in two opposing directions.

Fig.3- USD to 1 Euro as on May to October 2011

[Source: www.x-rates.com (accessed 19 October 2011)]

On the one hand, the countries with currencies pegged to the euro may actually benefit from a weaker euro that makes their exports more competitive in world markets. On the other hand, countries with dollar-based exports will suffer from an appreciation of the dollar against the euro. A weaker euro is also likely to reduce the value of remittances originating in Europe and flowing to developing countries.

The US crisis has resulted into steep decline in demand for India's exports in its major markets. The first sector to be hit was the gems and Jewellery which felt the impact in November itself and where more than 300,000 workers have lost their jobs. The negative impact has since covered other export-oriented sectors garments and textiles, leather, handicrafts, and auto components. While exports of both goods and services, still account for only about 22 percent of the Indian GDP, their multiplier effect for economic activity is quite large as the import content is not as high as for example in the case of Chinese exports. Therefore, an export slump will bring down GDP growth rate in the year 2008-09 (Fig.-4).

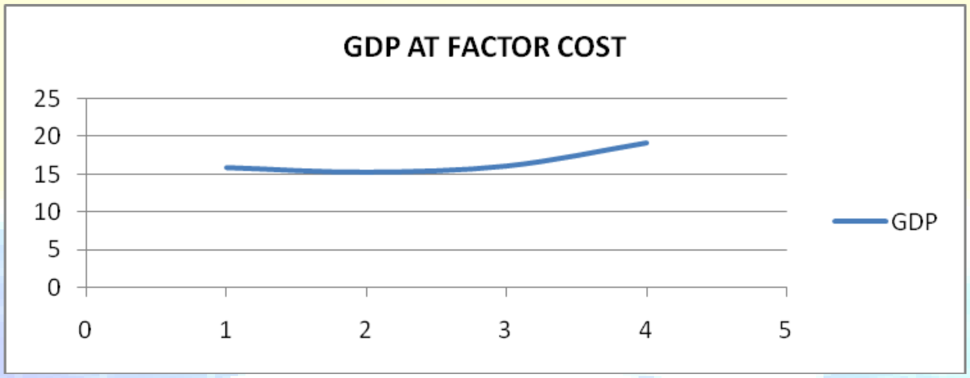

Fig.4- Growth rate of GDP at factor cost

The impact of crises on the Fiscal deficit can have an adverse impact. The fiscal deficit is already in the rising trend and any further increase in fiscal deficit could downgrade India's credit rating and business confidence (Fig.-5).

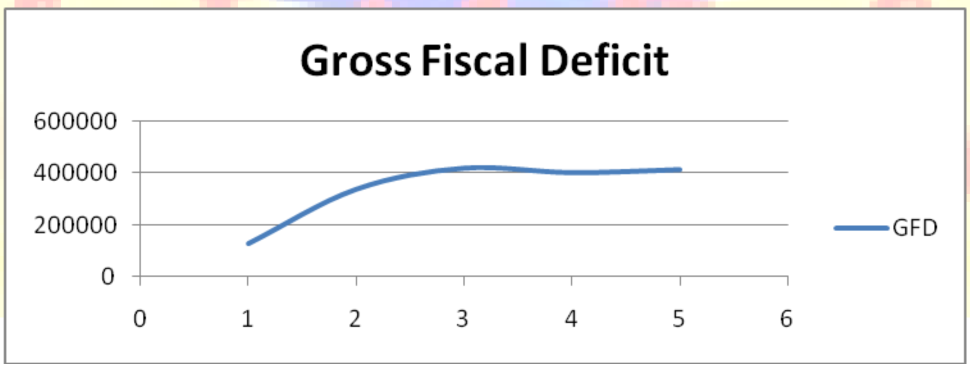

Fig.5- Gross Fiscal Deficit

The increase in fiscal deficit can be financed by the government through external commercial borrowings, foreign aids and grants etc. Primarily government deficit is being financed through the financial aids from developing world but due to financial crises the EU nations are unable to contribute their share to the fund used for financing the development works in developing nations. Thus in order to finance the deficit government may either go for ECB or may reduce the deficit by controlling the capital expenditure. External Commercial Borrowing will lead to higher interest expenses and in future a large chunk of budgeted revenue will be used for repayment of loan. This might cause in sluggish growth rate.

V. Conclusion

The slowdown in the global economy has impacted the Indian economy though not as badly as those in countries which are more globally integrated. The relative integration of Indian economy with the western economy has marginally impact few sectors. The impact of the crises has been observed in capital market with the fall of Sensex and Nifty to a historic low because of the loss of confidence on share markets by the investors. Although Euro-zone crises have no immediate effect on our bourses yet we cannot undermine the impact on other macroeconomic variables. A strong USD with respect to Euro has resulted into depreciation of INR with making import more expensive. If EU countries will take austerity measures towards cost cutting then it may result into decline in exports from developing world like India. Any decision from the EU towards stabilizing the economy of worst hit countries may increase the unemployment situation in India. Thus the Indian planners and the policy makers must be well equipped in advance to withstand the aftermath of the European crises. Besides a robust regulatory framework that integrates a system-wide approach and has built-in buffers to smooth cyclical volatility should be instilled. Since the depositors are the most sensitive groups during crises and deposit insurance systems have the ability to safeguard the depositors interests, such systems should be encouraged.

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