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The Sub-prime Crisis – Likely Consequences for the Indian Economy

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In the last few weeks, the Prime Minister of India, the Finance Minister as well as the Deputy Chairman of the Planning Commission, Mr Montek Singh Ahluwalia, have been expressing anxiety over the impact of the sub-prime crisis in the United States on growth in India. In fact, Mr Ahluwalia has said that this is more worrying than the rise in energy prices. It is only the Governor of the Reserve Bank of India (RBI) who has not expressed similar views, focusing his concern more on growing capital flows and the impact on the currency.

This brief attempts to examine the likely consequences of the sub-prime crisis for India in 2008.

Two articles in the Financial Times,[2] and posts on Martin Wolf blog site[3] offer an interesting overview of the debate, the causes, effects and consequences of the United States sub-prime crisis. There is the argument that over the past several years, the United States' trade deficit has persistently drained spending from the United States' economy. As a result, much of manufacturing failed to recover after 2001 which then prompted the Federal Reserve to push interest rates to all time lows. This staved off recession but gave rise to the housing bubble – a house price inflation, a construction boom, explosive growth of non-traditional sub-prime mortgages, a debt financed consumer spending scenario and, yet, larger trade deficits.

These gave rise to trade surpluses in the rest of the world, distributing the sub-prime holdings globally. The trade surpluses persisted as the Asian countries pursued export-led growth and they blocked appreciation of their currencies against the dollar to maintain their competitiveness. A great portion of the surpluses were re-invested in dollars. Therefore, long-term interest rates did not rise even when the Federal Reserve raised short-term rates in 2004. Artificially low interest rates prompted investors to increase risky lending at diminished risk premiums. In this conceptualisation, the failure to address problems in the area of trade deficits can trigger policy responses in the area of monetary policy that can ultimately create even bigger problems. More important for India, large trade deficits cause real distortions, the consequences of which are costly, though they may be slow to emerge. Most importantly,

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[2] Thomas Palley, 'The Subprime - Trade Deficit Connection'.

[3] See posts at blogs.ft.com by Martin Wolf, Lawrence Summers, et al.

citizens have been encouraged to view their appreciated (bubble?) assets as a substitute for cash in the bank.

On the consequences for the global economy, there have been statements in the last week from responsible analysts and even the Federal Reserve that the United States' economy is likely to face a contraction in the second and third quarters of 2008, annualising about one percent. The Treasury Secretary has promised slower growth rather than a contraction through a slew of measures and it remains to be seen whether the worrying United States unemployment data of November 2007 is part of a monthly trend, or just a blip.

Against this backdrop, it is possible to look at likely consequences for the Indian economy and impact, if any, on gross domestic product (GDP) growth.

At the top are concerns of a direct impact on financial institutions in India. The RBI has clarified that the exposure of Indian banks and institutions to the crisis is 'marginal'. There is a story in Business Standard[4] that claims that State Bank of India, ICICI Bank, Bank of Baroda and Bank of India are set to book mark to market losses on their foreign offices to credit derivatives. The Business Standard has estimated the total of these losses to be around US$3 billion for the four banks put together, and has commented that the provisioning made by these banks so far has been quite small. Given the size of the banks and their balance sheets, even if these figures were accurate, there would be little impact on the overall performance of the banks. In short, the direct fall-out effect of the collapse of the sub-prime mortgages to institutions in India is likely to be quite insignificant.

Second, it is clear that there would be weak (or no) growth in the United States, and estimates by the World Bank[5] suggest that high-income countries would grow at just 2.2 percent this year, as against 7.1 percent for developing countries (estimates put China at 10.8 percent, India at 8.4 percent and South Asia at 7.9 percent). Given low inflation expectations in the United States, the World Bank suggests that emerging countries would pull high-income countries behind them. The benign part of the projection is that low growth in the developed countries would keep commodity price increases under control, lessening risks of inflation in the developing countries, and adding to stimulus for growth.

The other side of the coin is that contraction in the United States would lead to less demand for imported goods, impacting imports. There is the argument that the Indian economy is sufficiently decoupled from the rest of the world and that there is robust domestic demand and employment creation – this would cushion the economy from external shocks. But this may not be quite true. In 2002, trade was only 17 percent of GDP but it is now close to 40 percent. Thus, the trade dependency of the Indian economy has doubled in the last five years. The United States is the top trading partner for India (though China is catching up) and there would be the concern that exports to the United States may fall. The current monetary policy in India is battling with the need to control inflation, keep interest rates at level that promotes growth while simultaneously attempting to prevent undue appreciation of the rupee – a task considered to be very difficult to accomplish altogether. Already, export orders for the textile sector have fallen significantly, and large job losses are being reported. The appreciation of the rupee is largely due to accentuated capital flows, and free and flexible financial markets

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4 Subprime Crisis to hit 4 big banks' profits; Business Standard, 7 January 2008.

5 World Bank: Global Economic Prospects; 2007.

and, hence, the concern of the RBI Governor that this is likely to be exacerbated by the contraction in demand in the United States.

The policy response in India is likely to be to ensure that that the rupee does not appreciate 'too much', a task that will entail active sterilisation operations by the RBI. These sterilisation operations, through issue of market stabilisation bonds, entail an additional fiscal burden on the government for the interest costs of these bonds. Energy costs have risen but adjustment of consumer prices has not been possible due to political compulsions of the coalition. It is likely that fiscal stresses on the government may increase. It is this total picture of rupee appreciation, lower exports and fiscal stress that is causing worries in the Indian Finance Ministry and the Planning Commission.

On the positive side, data reveals that the quarter ending December 2007 has been quite good for Indian manufacturing as well as the services sector, asset prices in terms of equities and real estate remain firm, and revenue collections have been extremely buoyant. The Indian industry seems less than concerned about domestic demand growth. The measures by the RBI to curb liquidity have yielded positive results and inflation appears to be a lesser worry than in China.

The worry lies in two areas. The first is that, capital formation, in terms of investments in plant and machinery, after reaching a peak in the middle of last year, appears to be stagnant and likely to be going down. The effects of this slowdown are likely to be seen towards the end of 2008 or in 2009. This needs to be balanced by capital spending for infrastructure and it is likely that the government will come out with some initiatives, especially in the power, aviation and shipping sectors. The second is that trade deficit continues to be very high and is increasing, signaling the lack of competitiveness in the economy. The Finance Minister has already promised that he would consider sops to exporters in the forthcoming budget. He has also an election year ahead to factor in and cannot afford to see the economy slowing down. He is, therefore, wary of controls on capital flows and has been encouraging banks to reduce lending rates to spur consumption and growth. This is at variance with the task given to the RBI – that of controlling inflation and excess liquidity. Policy alternatives appear to be at cross purposes.

The growth rates of 2005 and 2006 are unlikely to be repeated, and this is due to unfinished reform agenda, as much as external factors. The United Progressive Alliance government has not been successful in bringing about reforms in the financial sector as well as in labour markets and issues related to manufacturing competitiveness such as uniform tariffs. There have been several promises at reducing processes and procedures that have not been implemented. The reforms in agriculture, much needed and much announced, remain only on paper. There is, thus, the need to find a peg to hang the lower GDP growth rate anticipated in 2008.

It is politic to blame it on global factors than on delays in infrastructure development, poor reforms in education, health and insurance, and flip flops on monetary policy. The sub-prime crisis offers such an opportunity and, in the forthcoming months, one is likely to see enhanced explanations of how the Indian economy has been affected.

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