

Recession, Recovery and Resurgence in the Indian Economy: Myth and Reality

Dr. N. S.Shetty*

The genesis of global financial crisis, dimensions of its impact and policy responses in terms of bail-out packages and fiscal stimuli are now well known and do not require repetition. Hence, from the Indian economic point of view, it is important to reflect on the following set of questions: How and why the global crisis affected Indian economy and how did India respond? Whether the policy responses adopted are realistic? Whether recovery from recession has really started? How credible the perception of recovery leading to resurgence in the Indian economy is and whether it is sustainable? The general impression created by the policy makers is that India witnessed downward trend in the economy of crisis proportion due to global recession and hence, India badly needed massive monetary and fiscal stimulant measures to combat its impact and initiate process of recovery. As a result of these stimulus measures, India weathered worst of its crisis and experiencing recovery and prospect of robust resurgence. Let us look into the myth and reality of these impressions.

Global Crisis and Impact on Indian Economy

The financial crisis, which first surfaced in the subprime mortgag sector in the US in August 2007, become global in nature in September 2008 following the collapse of Lehman Brothers. With collapsing financial asset bubbles, inter-bank markets in advanced countries were affected by severe liquidity crisis. With the monetary markets witnessing a squeeze, the liquidity problems transformed into a solvency problem leading to bank failures in advanced countries, which ultimately accentuated to the real sector crisis. In the context of rapid global integration and close interconnections between financial institutions, the crisis quickly moved

across markets and economies. The impact of the global melt-down can be gauged from the magnitude of write-downs by banks and other financial institutions to the extent of US\$3.5 trillion and contract of world GDP by 0.8 percent and world trade volume by 12 percent. Thus the global economy was in its worst crisis in 60 years since depression.

When the financial crisis erupted in developed countries in 2007, the policy makers in India were confident that India would be immune to the global financial melt-down because of high growth, strong economic fundamentals and well regulated financial system. As the direct exposure of Indian banks to subprime assets was negligible, a decoupling theory was also propagated to justify this optimism. However, the myth of decoupling hypothesis was exploded, when the recession in developed countries hit the economic activities in emerging market economies including India. In an integrated and interdependent globalized world, it is impossible to insulate any economy from the spillover and contagion effects completely, particularly when it is happening in the developed world. The issue is how India was impacted and what was its magnitude?

The main channels of spillover effects were trade channel-merchandise exports and invisible and foreign capital inflows. The impact on the Indian financial markets was rather muted as direct exposure of banks to contamination of financial assets was negligible. The impact of global recession was first felt through reversal of capital flows and fall in equity prices in the domestic stock markets due to large scale sell-off by the foreign institutional investors (FIIs). The capital outflow during April – December 2008 was \$20.4

billion, which resulted in crash in stock market and lowering of domestic liquidity. Simultaneously, the access to external commercial borrowings dried up due to squeeze in international credit markets. India's foreign exchange reserve declined from \$300 billion to \$250 billion. The shortage of foreign exchange inflow put significant pressures on Indian rupee along with its increased volatility.

The transmission of the external demand shocks was severe on India's export growth. As demand contracted in developed countries, exports of India and IT and IT enabled services adversely affected. The decline in exports was almost 40 percent during 2008-09. There was also significant downward trend in exports of software services.

The growth story of Indian economy, prior to global recession was no doubt quite impressive. There was an economic turn-around from earlier Hindu growth rate of 3.5 percent to 7.5 percent average annual growth during the last two decades and 9 percent during 2004-05 to 2006-07 with inflation below 4 percent. This high growth with low inflation phase was, however, brought to a halt in early 2008. During 2008-09, India witnessed a significant decline in the growth from 9 percent to 6.5 percent with rising inflationary phase.

Indian Policy Response

Indian response for recession included both monetary and fiscal policy measures to stimulate growth. The basic assumption was that due to global recession, there was a significant fall in aggregate effective demand. Following Keynesian model, fiscal stimulant was considered essential to stimulate demand. As pointed out by Stiglitz, *today, no one can afford to not be a Keynesian just as till 2007, no one could afford to be seen to be a Keynesian.*

In order to limit the adverse impact of the liquidity crisis and stimulate investment demand in the real

economy, the RBI has used both conventional and unconventional measures such as liquidity adjustment facility (LAF), open market operations (OMO), cash reserve ratio (CRR) and securities under the market stabilization scheme (MSS) - CRR reduced from 9 percent to 5 percent, SLR to 24 percent, repo rate from 9 per cent o 5 percent and reverse repo from 7 percent to 3.5 percent.

The above monetary measure were supported by fiscal stimulus package in the form of tax cuts – exercise duty was reduced from 14 percent to 8 per cent and service tax from 12 percent to 10 per cent, increased expenditure on government consumption – almost 100 percent and investment in infrastructure. The expansionary fiscal stance was mainly to stimulate aggregate demand. As a result of the government's stimulant package, it is now claimed that there is a complete turn-around in the economy and estimated growth during 2009-10 was 7 plus. The economy is now once again stated to be in the higher growth trajectory. Let us examine how credible and sustainable is the foregoing recovery and economic rebound?

Myth of Recession

First let us examine whether India was really in severe recession during 2008-09, which warranted massive stimulant package likewise developed countries? Surprisingly, there is no commonly accepted definition of economic recession. Usually, in deciding whether a particular country is in recession, economists use peaks and troughs of key indicator of economic activity such as real GDP. Other indicators considered are industrial production, trade and capital flows and unemployment. USA and other developed countries witnessed negative growth and significant contraction in all other economic parameters to label their economies under severe recession. Since the developed world contributed more than 60 percent of global GDP and provided markets for imports from developing countries, the world witnessed a negative impact on

growth and significant decline in the world trade. The prolonged global recession in developed countries spread widely and increasingly engulfed other economies.

Whether India has witnessed financial crisis and economic recession to warrant a massive stimulant package is a moot point. There was no balance of payment crisis like 1991. No collapse of any industry. Banking sector was vibrant and had no direct exposure to *toxic or distressed assets*. There was no decline in their profitability. Collapse of stock market was mainly due to FII capital flight and proved to be temporary. There was no liquidity crisis and no break-down in aggregate domestic demand. India has not witnessed negative growth like developed countries. There was a slow-down in the growth but still, India has achieved 6.7 percent growth rate during 2008-09, which is above an average growth rate for last two decades. Similarly, there was a decline in exports but it affected only few commodities such as textiles due to contraction in demand in developed countries. Thus, though growth performance in some sectors affected adversely, Indian economy, broadly and relatively unscathed from global crisis.

In the Indian growth story, the cyclical slow down or volatility in economic growth rates was a common phenomenon. For example, in 1956-57, the GDP growth rate was 5.7 per cent, in the next year 1957-58; it was negative growth of 1.2 percent. In 1958-59, the growth rate once again reached 7.6 percent and thereafter, decelerated. In 1960s, we had growth rate of 8.1 percent in 1967-68 and it declined to 2.6 percent in 1968-69. In 1988-89, our growth was at the peak level of 10.5 percent but it significantly declined to 1.3 percent in 1990-91. In other words, India never witnessed consistently steady growth rate in real GDP. Compared to earlier cyclical changes in growth rates, present slow-down from 9 percent to 6.7 percent was not very significant. To say, India has severe recession

during 2008-09, which warranted massive stimulant package, defies economic logic.

Though recession in the global economy was affecting the Indian economy adversely, there were clear signs of the economy losing steam long before the outbreak of the global crisis. T.N. Srinivasan, an eminent economist from Yale University, has empirically shown that the growth slow-down in the Indian economy had started even before the on-set of crisis and had little to do with it. The peak growth rate of 9.7 percent of GDP and 11.8 percent for manufacturing reached in 2006-07-prior to onset of crisis. Thereafter, every quarter during 2007-08, growth of manufacturing GDP steadily and significantly declined reaching minus 1.4 percent in the last quarter of 2008-09. The deceleration in manufacturing sector, thus, predates global melt-down and nothing to do with global recession¹. This was mainly attributed to declining trend in capital formation to the extent of 8 percent in private sector during 2006-07. Moreover, the growth in manufacturing sector was mainly driven by the domestic demand and not global demand.

In the same vein, the deceleration in agricultural sector cannot be attributed to global crisis. The deceleration in the agricultural sector started since last two decades². No doubt, the global recession contributed to some extent for accelerating the economic slow-down in service sector particularly IT and tourism. Still, the decline in the service sector GDP was not very significant; from 11.2 percent in 2006-07 to 11.1 percent in 2007-08. The decline in the export sector which constituted about 15 per cent of GDP has some impact on GDP growth rate, but only to the extent of 1 to 1.5 percent of GDP growth. Hence, there was a slowdown in the Indian economy and not recession. One cannot be absolutely certain without analytically convincing facts that the global crisis led to recession in the Indian economy.

¹ For detailed analysis of data in this regard, see Mihir Rikshit: India Amidst the Global Crisis in Economic and Political Weekly, March 28, 2009

² It is worth noting that the economic lowdown occurred despite increase in agricultural growth from 3.8 percent in 2006-07 to 5.1 percent in 2007-08.

Credibility of Policy Response

Let us now examine appropriateness and credibility of the crisis-response policies adopted in India? Shocks to aggregate demand or supply could destabilize the economy and therefore would call for stabilizing policy interventions. Fiscal stimulus in the Keynesian framework consists of extreme affirmative government action through the budget to arrest contraction in aggregate demand to boost economic activities. Following developed countries, India adopted easy money and fiscal stimuli policy measures to stimulate demand. The monetary policy measures such as reduction in CRR and SLR has released more than RS. 4,00,000 crore liquidity into the system to avoid liquidity crunch and stimulate private investment. However, it has not resulted in any impact on reviving real sector. Credit off-take in real sector remarkably poor and declined. Banks were parking surplus fund with RBI. It also resulted in massive excess liquidity in the system. The reduction in key policy rates has also not resulted in significant reduction in the banks' lending rates as expected due to what Keynes called *liquidity trap*. In fact, reduction in policy rates provided cheaper credit to government for its consumption.

Unlike china, the fiscal measures adopted in India aimed at stimulating consumption and not infrastructure development. The major components of fiscal stimuli are Sixth Pay Commission recommendations on pay and pension revision, Farmers loan waiver, increase in subsidies and MGREGA. As a result, recurrent public expenditure increased almost 100 percent and fiscal deficit by 166 percent. *Is profligacy in public expenditure a stimulant package?* In fact, India used the stimulant package for mammoth hand-out tailored to capture political power in the election year. The politics dictated stimulant package rather than economic. The excise tax cuts benefited well off section and might not have boosted domestic demand to offset the fall in export demand. The worst affected export and SME sectors particularly textiles were completely ignored.

The fiscal stimulant package has also resulted in the following adverse impact on the economy, which has serious implications:

1. Rise in Fiscal Deficit: With the stimulant package, the fiscal deficit during 2008-09 amounted to about Rs 3,90,953 crore almost equivalent to total government revenue. The fiscal deficit galloped from 2.7 percent to 6.8 percent of GDP and revenue deficit from 1.1 percent to 4.8 percent of GDP for the year 2009-10. If extra budgetary liabilities created in the form of bonds for subsidies to corporate bodies and state deficits are taken into account, India has the fiscal deficit of 14 percent of GDP, which is one of the highest in world and not sustainable. The fiscal consolidation targets set in Fiscal Responsibility and Budget Management Act passed in 2003 have been suspended because of stimulant package. With the increasing profligacy in public expenditure, fiscal adjustment needed to meet the 13th Finance Commission's recommendation is unlikely to be fulfilled. The stimulant package was, thus, made mockery of fiscal consolidation targets.

2. Rise in public debt: With the increase in fiscal deficit, the public debt increased to 78 percent of GDP. India now stands out as one of the most indebted country among emerging economies. Debt sustainability comes increasingly into question as it would result in higher interest payment burden to the government, higher interest rate and crowding out private investment. Moreover, India has same level of debt burden as in Greek, Spain and Portuguese, which are facing debt crisis.

3. Rise in Inflation: The country is now faced with hyper inflation driven by the demand. The inflation based wholesale price index is now 7.8 per cent and expected to reach two digits by this year end. The CPI index increased to 16 percent and food inflation 18 percent. Excess demand created as a result of stimulant package in rural areas resulted in hyper *agflation* in the country.

All these have serious implication on sustainability of recovery and resurgence in the Indian economy in the near future. Moreover, consumption-driven stimulus is like giving patient steroids. Steroids effect is immediate but short term. It has also side effects. The side effects are unsustainable fiscal deficit and public debt and high inflation. The increase in aggregate demand is not met by increase in supply. The recovery driven by one-shot operation of stimulus is short-lived and sooner or later, fiscal stimulus will have to be phased out. The question, then, what will sustain recovery? For developed countries faced with severe recession and decline in aggregate demand, stimulus is quite appropriate as increase in demand can be easily met by excess supply capacity already created. But for India, the answer is not clear. In Indian context, the true rationale for stimulus package should have been like China, for capacity and infrastructure building and capital formation as the country is not faced with the problem of lack of domestic demand.

Recovery and Myth of Resurgence

Let me make it very clear, at the outset, that in India, there are clear signs of increase in economic growth during 2009-10. The economy is expected to grow at 7.2 percent in 2009-10 as against 6.7 percent in 2008-09 mainly due to doubling of manufacturing growth from 3.2 percent to 8.9 percent. Without statistical support, it is difficult to say whether the expansionary fiscal stimulus shorten the duration of recession and promoted recovery in the real sectors. To call it significant recovery or economic turnaround is also contrary to what is really happening in the Indian economy. Unlike USA and other developed economies, Indian economy was not sick. Considering the past performance and decline in export growth due to recession in the developed countries, even 6.7 percent growth rate in 2008-09 was commendable. Moreover, the so called recovery from 6.7 percent to 7.2 percent amounts to nothing more than cyclical in nature and partly aided by the base effect. With year-on-year

comparison, if the previous year's growth was low, the current one even with slight improvement will look more impressive than what it actually is. The benefit of base effect will gradually peter out.

Moreover, the so called recovery is largely driven by combination of fiscal stimulus and inventory adjustments. It is not broad based recovery driven by increase in investment demand. Sooner or later, the fiscal stimulus will have to be phased out and inventory buildup will come to an end. With the phasing out the stimulant package, whether the recovery will be sustained is moot point. Given the many structural problems weighing on the economy, a recovery is mediocre one, not strong one or genuine recovery. *Instead of V-shaped recovery, our recovery appears to be O-shaped - meaning going round and round in circles.*

There are several structural issues limiting resurgence in India's economic growth. Agriculture is in deep crisis. The growth in manufacturing sector is fragile. The demand for capital goods concentrated mainly in auto industry. Indian economic growth is mainly service sector-led. It contributed 70 percent of growth, industry 25 percent and agriculture only 5 percent. Service sector growth is dominated by communications, business services and tourism. With the prolonged global recession, whether the growth in service sector can be sustained is doubtful.

Seventy percent of people live in rural areas and directly or indirectly depend on it for their livelihood. Besides sectoral and regional imbalances in growth, India's poverty level is higher than Sub-Saharan Africa. India has the highest number of people below poverty line. India's standing in human development is abysmal. It ranks 134 out of 182 countries in human development. The global recession has deep scars on export and SME sectors. Trade deficit is widening. USA is not only the origin of crisis but also central to global recovery. The recovery in US and other G-7

countries has been sluggish. Indian exports and IT and IT enabled services can fully recover only after a full-fledged recovery of the global economy.

There are also some emerging disturbing trends. Expansionary policies adopted also contain seeds of future high inflation phase. The emergence of high double-digit food inflation is a major area of concern. With excess liquidity already in the system, the increasing FII capital inflows are destabilizing stock and exchange markets. The country is also in dilemma: with high inflation, high fiscal deficit and excess liquidity, exist or not exist from the stimulant package. By withdrawing the stimulus too soon, the country would face the risk of stalling growth. By withdrawing the stimulus too late, the country would run the risk of facing excess demand and inflation. The calibrating monetary and fiscal policies in the presence of large capital inflows and inflation also require delicate balancing acts, which pose a formidable policy challenge.

Instead of focusing on real problems faced by the economy, unfortunately the policy makers seem to be obsessed with GDP growth - quibbling about growth decimal points, 6, 6.5 or 7 percent or tinkering with CRR and repo rates – whether they should move up by 0.25 percent or 0.5 percent. While Rome burns, our policy makers and media indulge in this type of sterile debate *ad nauseam*.

Conclusion

The skepticism somewhat muddles the picture of recent turn around in Indian economic growth, significantly enough to cast doubt on optimistic scenario portrayed. While *excessive pessimism* requires to be avoided, *misplaced optimism* or *delusional optimism* giving a false sense of confidence is not helpful. Even if the recession is past and recovery in Indian economy started, several longer term structural issues will have to be addressed, if Indian economy is to rebound to solid and sustained robust growth path.

True rationale for the stimulant package should have been, therefore, to address these long term structural issues constraining supply side rather than focusing on aggregate demand issues. For example, the stimulant strategies in the present context should have focused on rural infrastructure to resuscitate the agricultural sector which is in deep crisis and where almost 70 percent of population is still depend on it. With the emphasis on demand side, the stimulant package has overturned whatever gain achieved in the past in fiscal consolidation and inflation control. It has added to the growing and unsustainable fiscal deficits and hyper inflation.

In conclusion, let me say, after four decades of low growth and high inflation, India achieved *high growth trajectory* low inflation, the benefits of which, unfortunately, has now come to an end, thanks to global recession and stimulant package. India now suffers from the ignominy of having one of the highest rate of inflation. If we do not take effective action to crush inflation, not only will high growth be illusive but inflation would generate large social unrest.

References

- Olivier Blanchard, 2009: *Sustaining a Global Recovery, Finance and Development, Vol.46, No.3, Washington.*
- Chandrasekhar C.P. 2008: *India's Sub-prime Fears, Economic and Political Weekly, August, 9.*
- Chithelen Ignatius 2008: *Global Financial Crisis: A long Way from Recovery, Economic and Political Weekly, September, 6.*
- Dodd Randall, 2008: *Subprime: Tentacles of a Crisis, Finance & Development, Vol.44 No.4, December.*
- Dodd R. and Mills P. 2008: *Outbreak: US Subprime Contagion, Finance & Development, Vol.45 No.2, June.*
- Ghosh D.N. 2008: *Navigating the Future in the Midst of Global Uncertainty, Economic and Political Weekly, October, 11.*
- Greenspan Alan, 2008: *The World Must Repel Calls to contain Competitive Markets, The Financial Times*

August 5.

Hoe Ee Khor and Xiong Kee Rui, 2008: *Point of View: Asia-A perspective on Subprime Crisis, Finance & Development, Vol.45, No.2 June.*

Kumar, Arun 2009: *Tacling the Current Crisis, Economic and Political Weekly, March 28.*

Nachane Dilip M. 2009: *The Fate of India Unincorporated, Economic and Political Weekly, March 28.*

Nayak, Pulin B. 2009.: *Between Keynes and Schumpeter, Economic and Political Weekly, March 28.*

Rakshit, Mihir 2009: *India amidst the Global Crisis, Economic and Political Weekly, March 28.*

Ram Mohan T.T 2009: *Impact of the Crisis on Indian Economy, Economic and Political Weekly, March, 28.*

Rao Govinda M. 2009: *The 3rd Stimulant Package and Fiscal Conundrum, Business Standard, March 3.*

Sengupta A.K. 2008: *The Financial Crisis and the Indian Response, The HINDU, October, 24.*

Shetty N. S. 2008: *Global Financial Melt-Down: Whither India, Nitte Management Review, Vol.2, Issue 2 .*

Shiller R.J. 2008: *The Subprime Solution: How Today's Global Financial Crisis Happened and What to do about it, Princeton University Press, Princeton, USA.*

Srinivasan T.N., 2009: *Growth and Inclusive Development, Business Line Sept 25.*

Stiglitz, Joseph, 2009: *Is the entire Bailout strategy Flawed? Lets Rethink This Before It is Too Late Global Research, February 5.*

Tarapore S.S. 2008: *Drowning Liquidity, Business Line, Nov. 7.*

Forthcoming publication

Financial Inclusion and Beyond: Issues and Challenges

A book authored by Dr. N. K. Thingalaya, Dr. M. S. Moodithaya and Dr. N. S. Shetty of the Institute is being published by Academic Foundation, New Delhi. The book deals with the various issues concerning financial inclusion in India. It may be noted here that financial Inclusion, of late, has become an integral part of social banking in India, aiming at inclusive growth. In spite of several attempts to reach out the unreached, the majority of the weaker and vulnerable sections of the community have remained outside the formal financial system. It is also imperative to think beyond financial inclusion. Mere opening of no frills accounts does not mean much to those who have been reached. It is with this concern that this book makes an attempt to understand the various dimensions of financial exclusion in India and suggest remedial action for meaningful financial inclusion.

Several suggestions are made regarding the need for mapping the financial needs of each household and extending the financial services to the needy. One of the innovative suggestions made in this book relates to opening a deposit account in the name of the new born child jointly with the parent, to be retained for at least fifteen years until the child goes to high school. It is emphasized that achieving financial inclusion is an indispensable process and cannot be a short term goal. It requires adoption of innovative models for improving the accessibility and delivery process.

In his foreword to the book Dr. C Rangarajan, Chairman, Economic Advisory Council to the Prime Minister, New Delhi observes: "This book looks at the various dimensions of financial inclusion and comes up with interesting new ideas on how to achieve this goal." The book is scheduled to be released in September 2010.