Management of Present Economic Crisis in India with Special Reference to Fiscal Incentives

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The Global Financial Crisis is into its third year now. The crisis began in United States and Europe and it has since affected the rest of the word, including Asia, in a bigger way than was thought at the beginning. This article, after brief a introduction of global crisis, explains its impact on Indian Economy and its management through fiscal policy.

Global Crisis

The world economy collapsed into steep recession in the final quarter of 2008 with global GDP dropping at 6 percent annual rate. This was undoubtedly the sharpest decline in world out put and especially in world industrial production and world trade of the postwar era, with virtually all countries participating in the downturn and many registering record quarterly decline in real GDP. The standard story of the present global recession and financial crises emphasizes the centrality of developments in the United States – especially the expansion and subsequent collapse of the real estate and real estate financing bubble and its impact on an over leveraged United States and global financial system. Others point more broadly to persistently easy monetary policies, very low interest rates and interest rates spreads, and general disregard of growing risks in the financial system as key causes. (Michel Mossa, 2009)

In the winter 2006-07 United States housing price started to fall for the first time in fifteen years. As a result many of the sub prime housing loans (mortgage as they are called) became bad loans. This meant that hundreds of billions of dollars of financial derivatives which were based on their underlying mortgage loans also lost most of their value. Thus, by the summer of 2007 "the house of financial cards" began to collapse and growing number of American and European banks announced huge losses on their mortgage related securities and investments. This process of financial collapse gradually gathered steam and come to boil in September 2008 when major American investment banks (like Lehman Brothers) collapsed and others (such as Merrill Lynch) were saved through mergers with healthier banks. The financial melt-down of September 2008 led to freeze of credit markets in United States and Europe and transmitted the sudden liquidity squeeze throughout the financial world. Governments in these countries launched massive bailouts of their banks and increased government spending to contain the impact of the rest of the economy. Despite trillions of dollars of bail-outs and fiscal stimulus, bank credit continued to be almost frozen, leading to sharp falls in consumer spending, investment, production and foreign trade.

The sharp slowdown in economic activity in the United States and Europe quickly spread across the world through the channels of global credit squeeze and massive drop in demand for goods and services from major exporting nations like China, Japan, Germany and several other Asian countries, including India. In this way the financial crisis in the United States and part of Europe not only damaged production and growth in these counties but led to sharp drops in exports and production through all those countries which for many years had relied on the United States and European markets for their export growth.

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By the beginning of 2009 it had become quite clear that the current global recession is the worst since the Great Depression of 1929-32. Analytically, however, some tend to view that this current crisis is fundamentally different from the Great Depression of 1929 in the sense that the financialisation of global capital as the single most important factor responsible both for its precipitation and its unprecedented severity.

Impact on India

Although the global financial crisis had begun to gain force in the US and Europe by the autumn of 2007, in India it was mainly perceived as rich world problem right up till August 2008. It is true that there had been a steep correction in Indian stock prices in January 2008. But our main concern throughout the first 7-8 months of 2008 was with the sharp increase in inflation because of the commodity price shock that had hit us (and the rest of the world) from early 2008. Infact, the steep increase in global commodity prices of oil, metals, fertilizers, food grains that had accelerated from late 2007 was much more product of the global economic boom during 2002 to 2007 than of any recession in Western Countries, which began in the spring of 2008. Indeed, right through the summer of 2008, there was a widespread view that the economic growth of Emerging Market Economics (EMEs), particularly leading lights and India was "decoupled" from the slowdown in advanced countries of the west. Successive issues of the IMF's WEO reports (2007, 2008) put forth several reasons for "decoupling" from the United States and other advanced countries: The US slowdown was related to factors specific to the US economy, especially corrections in the housing sector, rather than to more generalized factors such as an oil shock or adverse equity market developments; Growth in some of the leading emerging markets was driven overwhelmingly by domestic demand; Trade linkages of the emerging economies with the US had diminished and trade among emerging markets had become more important than in the past;The emerging markets were not savers in the world economy, not borrowers; and Over the past decade, the emerging markets had effected several economic reforms, as a result of which they had become stable and efficient.

The above view seemed to gain some support from the fact that rate of India's economic growth in the first half of 2008/09 was still close to 8%. Yes, this was a little less than the 9% growth that the country had enjoyed in the previous five years but it was still a very rapid rate of economic expansion by global standards.

This sense of complacency and illusion of decoupling from the global slowdown was shattered by the events of September 2008. With the collapse of huge wall street banks and the resulting freeze of bank credit flows in the west, there was an immediate worldwide liquidity crunch and a massive amplification of the recessionary forces in the United States, Europe and Japan. The liquidity shock was immediately felt in India, with foreign institutional investors withdrawing their money, credit for foreign trade vanishing and loans from foreign banks drying up. Even before the end of 2008, exports and industrial output had began to decline (Shankar Acharya, 2008).

The overall growth of GDP at factor cost at constant prices in 2008-09 was 6.7 percent. The growth of GDP at factor cost (at constant 1999-2000 prices) at 6.7 percent in 2008-09 nevertheless represents a deceleration from high growth of 9.0 percent and 9.7 percent in 2007-08 and 2006-07, respectively (Table 1).

Table 1

Rate of growth at factor cost at 1999-2000 prices (per cent)

	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
Agriculture, forestry & fishing	10.0	0.0	5.8	4.0	4.9	1.6
Mining & quarrying	3.1	8.2	4.9	8.8	3.3	3.6
Manufacturing	6.6	8.7	9.1	11.8	8.2	2.4
Electricity, gas & water supply	4.8	7.9	5.1	5.3	5.3	2.4
Construction	12.0	16.1	16.2	11.8	10.1	7.2
Trade, hotels & restaurant	10.1	7.7	10.0	10.4	10.1	7.2
Transportation, storage & communication	15.3	15.6	14.9	16.3	15.5	*
Financing, insurance, real estate & business services	5.6	8.7	11.4	13.8	11.7	7.8
Community, social & personal services	5.4	6.8	7.1	5.7	6.8	13.1
Total GDP at factor cost	8.5	7.5	9.5	9.7	9.0	6.7

Source: Central Statistical Organization.

*Trade, hotels & restaurants, transports & communication (together) grew at 9 per cent in 2008-09.

The deceleration of growth in 2008-09 was spread across all sectors except mining and quarrying and community, social and personal services. The growth in agriculture and allied activities decelerated from 4.9 percent in 2007-08 to 1.6 percent in 2008-09 due to fall in the production of non-food crops including Oil seeds, Cotton, Sugarcane and Jute. The manufacturing, electricity and construction sectors decelerated to 2.4, 3.4 and 7.2 percent, respectively, during 2008-09 from 8.2, 5.3 and 10.1 percent, respectively in 2007-08. The slowdown in manufacturing could be attributed to combined impact of a fall in exports followed by a decline in domestic demand, especially in the second half of the year. Indeed, the high growth in community, social and personal services during 2008-09 was mainly due to an expansionary fiscal policy that was reflected in the demand side of GDP as high growth of Government consumption expenditure.

The slowdown in growth of GDP is more clearly visible from the growth rates over successive quarters of 2008-09 (Table 2).

Table 2
Quarterly estimates of GDP 2007-08 and 2008-09 (Percentage change – y-o-y)

Sector(s)	2007-08				2008-09			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Agriculture, forestry & fishing	4.3	3.9	8.1	2.2	3.0	2.7	-0.8	2.7
Mining & quarrying	0.1	3.8	4.2	4.7	4.6	3.7	4.9	1.6
Manufacturing	10.0	8.2	8.6	6.3	5.5	5.1	0.9	-1.4
Electricity, gas & water supply	6.9	5.9	3.8	4.6	2.7	3.8	3.5	3.6
Construction	11.0	13.4	9.7	6.9	8.4	9.6	4.2	6.8
Trade, hotels, transport& communication	13.1	10.9	11.7	13.8	13.0	12.1	5.9	6.3
Financing, insurance, real estate & bus services	12.6	12.4	11.9	10.3	6.9	6.4	8.3	9.5
Community, social & personal services	4.5	7.1	5.5	9.5	8.2	9.0	22.5	12.5
GDP at factor cost (total 1 to 8)	9.2	9.0	9.3	8.6	7.8	7.7	5.8	5.8

Source: Central Statistical Organization.

The first two quarters of 2008-09, the growth in GDP was 7.8 and 7.7 percent respectively. The growth fell to 5.8 percent in the third and in the fourth quarters of 2008-09 (compared to 9.3 and 8.6 percent in Q3 and Q4 of 2007-08). The third quarter witnessed a sharp fall in the growth of manufacturing, construction, trade, hotels and restaurants. Agriculture growth also turned negative adding a further dampener. On the other hand community, social and personal services showed a large increase from the second quarter, mainly due to a step up in Government expenditure. The last quarter saw an added deterioration in manufacturing due to the deepening impact of the global crisis and a slowdown in domestic demand.

Thus, India like other emerging markets, has suffered a more severe impact than supposed earlier. However according to RBI Governor D. Subbarao (2009) a higher level of financial integration (i.e. a high ratio of total external transaction to GDP) impacts on the economy in three related ways: reducing Indian companies access to overseas finance, lowering domestic liquidity and causing stock prices to fall. In a time of global crisis, consumer and investors are both bound to cut back on spending because of general set back to confidence. The major social cost of a recession is those associated with the enforcement of job cuts, lay-off and significant upheavals in labour markets. All these effect have been in evidence in recent months in the Indian economy.

Indian Policy Response – Fiscal Stimus Packages

Faced by the sharp credit crunch and the sudden slowing down of the economic activity after September, 2008, the Government and Reserve Bank of India responded quite swiftly. The policy measures so far adapted in India may be summed up in a single phrase – easy money and fiscal stimuli.

On the monetary policy front there has been a

flurry of activity – the rapo rate was reduced in a succession of steps from 9% in September 2008 to 5% in March 2009 (with a corresponding reduction in the reverse repo rate from 6% to 3.5%), the CRR was also reduced from 9% to 5% over the same period, where as the statutory liquidity ratio (SLR) was brought down by 1% to 24%. Altogether, it has been estimated that these measures have released more than Rs-4,00,000cr of liquidity into the system. However, the credit off take has been remarkably poor due to low demand (Nachane, D. M 2009). Thus RBI quickly loosened its monetary and credit policies, reversing all the anti-inflationary tightening it had done in the previous four years.

The focus of fiscal policy has changed from fiscal stabilization to providing a growth stimulus. In consequence, there is no longer any talk of meeting the targets under the Fiscal Responsibility and Budget Management (FRBM) Act. The government, for its part, had already pumped up spending (even before September 2008) on plan outlay, Sixth pay commission pay increases, the farm loan waiver, higher spending on National Rural Employment Guarantee Scheme (NREGS) and, of course, much higher subsidies for petroleum products, fertilizers and food grains. These large expenditure increases had been driven mainly by political or populist reasons but, fortuitously, their economic effect was the same as for "fiscal Stimuli" like the once Western Countries had already launched to combat recession. The government subsequently announced three successive fiscal stimuli packages. The three fiscal stimuli announced so far comprise three distinct elements i.e. general tax cuts, fillip to infracture spending, and strengthening bank capital. The three fiscal stimuli packages announced are as follows:

i) Fiscal stimulus I (7, December 2008) mainly comprised on across the board cut of 4% in excise duty.

ii) Fiscal stimulus II (2, January 2009) comprised Rs-20,000cr towards bank capitalization over the next two years, as well as providing greater market borrowing access to state governments and the Indian Infracture Financing Co Ltd (IIFCL)

iii) The Fiscal Stimulus III (24, February 2009) provides a 2% reduction in both the excise duty and the service tax and an extension of the previous excise duty cuts beyond 31, March 2009.

Additional budgetary resources provided as part of stimulus package including increase in plan outlay and various committed liabilities of Government mentioned above contributed to increase the fiscal deficit to 6.8 percentage of GDP in 2009-10 (BE) as compared to 2.5 percent of GDP in BE 2008-09. (Table -3)

Table-3

Deficits of Central Government (as percentage of GDP)

Year	Fiscal	Revenue	Primary
2005-06	4.1	2.6	0.4
2006-07	3.5	1.9	-0.2
2007-08	2.7	1.1	-0.9
2008-09 BE	2.5	1.0	-1.1
2008-09 RE	6.1	4.5	2.5
2009-10 BE	6.8	4.8	3.0

Source: Union Budget documents.

Here it is to be remembered that while fiscal discipline is important for macroeconomic policy credibility and sustainability, flexibility is necessary for managing unexpected shocks to the economic environment. A fiscal policy following both these tenets would help the government intervene during times of economic difficulties without increasing the risk of macro instability. Such a policy could give a government the ability to use the budget as a counter - cyclical policy tool to regulate aggregate demand. Unfortunately, India's fiscal policy appears not to have followed either of these two budget management principles over the past few years.

Global credit crisis has pushed deficit levels from bad to worse. After going through a phase of correction from early 1990s to 1997, the underlying trend has been deteriorating. The fiscal deficit of government of India is likely to remain high at 6.8% of GDP in 2009-10 (BE) after having widened to 6% of GDP in 2008-09 (RE). The fiscal deficit is a measure of how much the government needs to borrow from the market to meet its expenditure in the situation when its revenue is inadequate. And large Government borrowing creates competition for funds, which causes interest rtes to harden. It also adds to public debt. Public debt of Government of India is 60% of GDP in 2008-09 (BE) and is likely to increase further. High interest rates and interest burden, due to increase in public debt, in turn depress economic activity. However, the poor record of public finance management is evident from the data presented in Table-3.

A quick way to estimate the fiscal stimulus would be to simply take the difference in the fiscal deficit for the B.E 2008-09 and BE 2009-10. The figures are 2.5% and 6.8%, respectively. The difference of 4.3% of GDP may be said to constitute the additional fiscal stimulus. However, of this, the increase on account of food, oil and fertilizer subsidies amounts to 2.3% of GDP. It is contended that this merely protects the Indian consumer from increases in international oil price and is not going to stimulate consumption (although in the absence of the subsidy, the consumption would decline). Hence the stimulus in the sense of expenditure that would stimulate extra consumption is amounting to 2% of GDP.

Further more, with the global commodity prices falling sharply the rate of inflation is also dropping quickly in India although food prices were still uncomfortably high. Another important point to note here is that India's banking sector is not significantly exposed to the trillions of dollars of toxic assets that were swirling around global financial and credit markets. Thanks to the RBI's conservative approach to financial liberalization.

The country is still facing a difficult economic situation, the cause of which is not emanating from within its boundaries. However, left unattended, the impact of this crisis is going to affect us in medium to long term. The Government had two policy options before it. In view of falling buoyancy in tax receipts, the Government could have taken a decision to cut expenditure and thereby live within the mandated deficit for the year as per FRBM Rules. This could have resulted in an adverse impact on the growth of the economy in the absence of investments, thereby putting at risk the revival of the economy in the prevailing situation. The second option was to increase public expenditure, even with lower revenue receipts, and stimulate economy by creating demand and maintain the growth trajectory. The Government preferred the second option of undertaking fiscal measures to increase public expenditure in order to boost demand and increase investment in infrastructure. The impact of three fiscal stimuli has started showing results. The growth rate of 6.7% in GDP makes India the second fastest growing economy in the world during 2008-09. The measures taken by Government to counter the effects of the global meltdown on the Indian economy have resulted in shortfall in revenues and substantial increase in expenditures, leading to temporary deviation from the fiscal consolidation path mandated under FRBM Act for 2008-09 and 2009-10. The revenue deficit and fiscal deficit in BE 2009-10 are, as a result, higher than the targets set under FRBM Act and Rules. However, in view of the current situation, the government has already announced 10% cut in non-plan expenditure and other rationalization measures to reduce fiscal deficit.

Now the moot question is: what is the outlook for India's economic development in the next few years against the backdrop of the ongoing global economic crisis? Most analysts expect that the recovery from

this deep global recession will be slow and painful. Against this back ground Indian economy might be able to manage growth of about 7% in 2009-10 and this could gradually accelerate to around 7.5-8% in the following 2 or 3 years, provided that we implement suitable policies. It will require strong policy decisions to gradually shrink the currently massive fiscal deficits; a major step up in investment in the infrastructure sectors of power, roads, water supply and management; reduction of rules and regulations which come in the way of greater job creation, much better policies and programs for education and health; and of course, sustained and broad-based development of our agricultural sector.

Conclusion

In summary, the unprecedented global economic crisis has definitely taken a toll of India's economic performance. Indeed, it has also reduced our potential for economic development in the next 3 to 4 years. However, despite the severity of the global crisis, India's economy has demonstrated considerable resilience. With sound and determined economic policies, we should be able to recover the growth momentum of 7-7.5% in a year or two. Although that will be a little less than our growth performance in 2003-08, it will be better than every other significant economy in today's world. The challenge for our policies and programs is to convert this potential in to performance through reforms. However, the fiscal consolidation process has to be put on the hold temporarily. But there cannot be any fiscal profligacy. In fact most of the countries are actually looking at increasing stimulus for the current financial year in order to provide boost to aggregate demand. Under the present circumstances, the government should continue with the stimulus sops till developed economies and wealthier nations start growing robustly.

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