

The Global Financial Crisis, Developing Countries and India

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THE GLOBAL CONTEXT

It is now evident that this is an unprecedented phase in the history of global capitalism. The still-unfolding financial crisis has already moved well beyond the predictions of more pessimistic observers. Several potential “Minsky moments” of pure meltdown in the core capitalist economies appear to have only just been averted, but the dangers persist. Across the world, real economies are being affected by the financial distress in direct and indirect ways, associated with sharply slowing economic activity and rising unemployment. Of course, this particular crisis reflects contradictions at the heart of the capitalist system, including those emanating from its dependence upon inelastic expectations about the value of money, which are inherent to the smooth functioning of capitalism (Patnaik 2008). There is also little doubt that the financial deregulation of the 1980s and 1990s, aided by the incentives to finance provided by successive governments, is essentially responsible for the current mess (Kregel 2008, Crotty 2008).

Several features make this different from the various financial crises that have emerged in different parts of the world, especially in emerging markets, in the phase of globalisation: the origin of the crisis in the core of capitalism, the US economy, rather than in emerging markets that are typically seen to be more vulnerable; the intensity of the crisis, as panic and counterparty risk arising out of complex financial entanglement have made even supposedly healthy institutions look extremely fragile; the rapid and extensive global spread of the crisis to economic agents, sectors and economies that were previously perceived to be relatively immune.

In addition, there are other features that are “new” and therefore mean that the historical analogies that are frequently made (for example, to the Great Depression in the 1930s, or to the collapse of Soviet-style socialism at the turn of the 1990s) are at best very inexact guides to the present or to the immediate future. The current global financial crisis does not exist in a vacuum, but rather is superimposed and intimately related to a broader set of economic processes that were already reaching crisis point. There are several economic imbalances that cannot be sustained and must be addressed in the medium term for effective recovery to be possible.

First, there is the imbalance between finance and the real economy, which has two important aspects. To begin with, the financial sector had stopped playing its basic role of intermediating between savings and investment, and transferring resources from capital-rich to capital poor economies. Instead, financial liberalisation generated a life of its own, with a proliferation of instruments and transactions that expanded often without reference to any real economy requirements. Financial flows then determined both balance of payments and domestic patterns of investment and consumption, by creating asset bubbles that were then associated with consumption booms and drive investment accordingly. The particular combination of open capital accounts (with the related increase in external vulnerability) and export dependence of emerging markets, then led to a situation in which developing countries accumulated reserves based on either current or capital account surpluses. Since these reserves were then largely placed in supposedly “safe havens” such as US Treasury Bills or Wall Street securities, the developing world transferred net financial resources to the North (and particularly to the US) even though

its own requirements for capital remained pressing. The large macroeconomic imbalances between deficit and surplus economies that have emerged as a result obviously cannot continue beyond a point, which means that the US cannot remain the engine of global growth in the same way that it was in the recent past, and that cross-border financial flows also must take new forms and find different trajectories.

In addition, the consumption-led growth based on asset market bubbles led to an immense overhang of debt, especially private debt in the form of personal loans and corporate borrowing. Such over-borrowing is of course a standard feature of the “euphoria” phase of financial cycles described by Kindleberger (1978); however, the scale and rate of expansion of such debt was historically unprecedented. This was especially so in the world’s largest economy, which served as the growth engine for the rest of the world. Outstanding debt in the US now amounts to more than 3.5 times the GDP, most of which is private debt (303 per cent of GDP in 2008). While public debt in 2008 was below the total GDP, it still amounted to nearly \$11 trillion. These excessive debt positions will have to be brought down, by both public and private sectors. In particular private debt – and household debt – will have to be wound down. Some of this is happening already through the housing defaults and other shakeouts being witnessed in the US financial sector, but much more is required and will necessarily occur in the medium term. This will clearly have an impact on aggregate consumption and production patterns. The obvious response is therefore to increase public spending, which is reflected in the projected US government budget deficit of 12.5 per cent of GDP in 2009 (which is likely to be even higher as GDP has probably been overestimated) but this strategy too has limits for the US given the large external public debt overhang. This therefore affects the prospects for and nature of the recovery in the US and in other advanced economies such as the UK. Other countries – including developing and emerging markets that were unlucky enough to follow that same track even though to a much lesser degree, and therefore have high total debt to GDP ratios – are more likely to have painful adjustment measures forced upon them, with associated falls in income and employment. The adverse economic effects of private debt deflation are likely to extend over a protracted period and require ever larger fiscal stimuli to counteract them.

It should also be noted that the recent global boom involved another growing imbalance – that between the nature of economic growth and natural resources. Issues of climate change are only one among the many environmental problem generated by such growth. The boom involved rapacious natural resource extraction, over use and degradation, and has been associated with increasing stress of pollution and congestion especially in developing countries. Soil quality has deteriorated rapidly in many countries, adversely affecting agricultural productivity; water supplies have become more tenuous, polluted and fought over; forests and mineral resources have been pillaged and over-extracted with adverse ecological and socio-economic consequences; pollution, overcrowding and congestion have not only affected production but also quality of life, especially in the rapidly urbanising developing world.

FINANCIAL LIBERALISATION IN DEVELOPING COUNTRIES

Developing countries are no strangers to financial crises, which have marked the history of some regions such as Latin America for more than a century (Eichengreen 1991) but became particularly prevalent since the early 1980s. The proclivity to crisis and to financial boom-bust cycles was especially evident in more financially open and deregulated developing economies. It is now well known that financial liberalisation has resulted in an increase in financial fragility in developing countries, making them prone to periodic financial and currency crises, not just

internal banking and related crises, and currency crises stemming from more open capital accounts. Greater freedom to invest, including in sensitive sectors such as real estate and stock markets, ability to increase exposure to particular sectors and individual clients and increased regulatory forbearance all lead to increased instances of financial failure. In addition, the emergence of universal banks or financial supermarkets increases the degree of entanglement of different agents within the financial system and increases the domino effects of individual financial failures. Indeed, the major financial crises of the recent past in the developing world – the 1982 Latin American debt crisis, the 1994 Mexican crisis, the Southeast Asian financial crisis of 1997-98, the 2001 Argentine crisis - can be described as endogenous market failures resulting from under-regulated and excessively liquid financial markets (Palma 1998).

In addition, open capital accounts generate tendencies whereby capital movements occur because of unpredictable changes in investor confidence (Ghosh and Chandrasekhar 2008). This affects both inflows and outflows in ways that the governments concerned cannot control. One very common conclusion that has been constantly repeated since the start of the Asian crisis in mid 1997 is the importance of “sound” macroeconomic policies, once financial flows have been liberalised. It has been suggested that many emerging markets have faced problems because they allowed their current account deficits to become too large, reflecting too great an excess of private domestic investment over private savings. This belated realisation is a change from the earlier obsession with government fiscal deficits as the only macroeconomic imbalance worth caring about, but it still misses the basic point. With unregulated capital flows, it is not possible for a country to control the amount of capital inflow or outflow, and both movements can create consequences which are undesirable. If, for example, a country is suddenly chosen as a preferred site for foreign portfolio investment, it can lead to huge inflows which in turn cause the currency to appreciate, thus encouraging investment in non-tradeables rather than tradeables, and altering domestic relative prices and therefore incentives. Simultaneously, unless the inflows of capital are simply (and wastefully) stored up in the form of accumulated foreign exchange reserves, they must necessarily be associated with current account deficits. Thus, it was no accident that all the emerging market economies that received substantial financial capital inflows also experienced property and real estate booms, as well as stock market booms around the same time, even while the real economy may have been stagnating or even declining. These booms, in turn, generated the incomes to keep domestic demand and growth in certain sectors growing at relatively high rates. This soon resulted in signs of macroeconomic imbalance, not in the form of rising fiscal deficits of the government, but a current account deficit reflecting the consequences of debt-financed private profligacy.

Large current deficits are therefore necessary by-products of the surge in capital inflow, and that is the basic macroeconomic problem. This means that any country which does not exercise some sort of control or moderation over private capital inflows can be subject to very similar pressures. These then create the conditions for their own eventual reversal, when the current account deficits are suddenly perceived to be too large or unsustainable. What all this means is that once there are completely free capital flows and completely open access to external borrowing by private domestic agents, there can be no “prudent” macroeconomic policy; the overall domestic balances or imbalances will change according to the behaviour of capital flows, which will themselves respond to the economic dynamics that they have set into motion. This knowledge is at least partly responsible for the paradoxical tendency of developing countries across the globe to hold excess reserves, even when they reflect capital inflow, rather than use such resources to increase domestic absorption. This strategy of increasing reserves not only builds a cushion against capital flight in the event of a change in investor confidence, but also prevents the currency from appreciating. But it creates the bizarre global result of financial

liberalisation, that poor countries end up financing the expansion and consumption of the richest economies, especially the US, rather than investing in their own development. That is why the current liberalised system did *not* provide for a net transfer of resources to the developing world. In the past six years, there has been a net flow of financial resources from every developing region to the North, primarily the US, even as global income disparities have increased.

In addition to creating the conditions for greater internal and external fragility, financial liberalisation has generated a bias towards deflationary macroeconomic policies in developing countries. To begin with, the need to attract internationally mobile capital means that there are limits to the possibilities of enhancing taxation, especially on capital. Typically, prior or simultaneous trade liberalisation already reduces indirect tax revenues, and so tax-GDP ratios deteriorate further. This then imposes limits on government spending, since finance capital is generally opposed to large fiscal deficits and fear of capital flight will restrict governments from running deficits in such a context. This not only affects the possibilities for countercyclical macroeconomic stances of the state but also reduces the developmental or growth-oriented activities of the government.

Such a tendency is exacerbated by the fact that financial deregulation can lead to the dismantling of the financial structures that are crucial for growth and development (Chandrasekhar 2008a). While the relationship between financial structure, financial growth and overall economic development is complex, the basic issue of financing for development is really a question of mobilising or creating real resources. In the old development literature, finance in the sense of money or financial assets came in only when looking at the ability of the state to tax away a part of the surplus to finance its development expenditures, and the obstacles to deficit-financed spending, given the possible inflationary consequences if real constraints to growth were not overcome. By and large, the financial sector was seen as adjusting to the requirements of the real sector. But this need not happen when the financial sector is unregulated or covered by a minimum of regulation, since market signals then determine the allocation of investible resources and therefore the demand for and the allocation of savings intermediated by financial enterprises. This aggravates the inherent tendency in markets to direct credit to non-priority and import-intensive but more profitable sectors, to concentrate investible funds in the hands of a few large players and to direct savings to already well-developed centres of economic activity. The socially necessary role of financial intermediation therefore becomes muted. This certainly affects employment-intensive sectors such as agriculture and small-scale enterprises, where the transaction costs of lending tend to be high, risks are many and collateral not easy to ensure. The agrarian crisis in most parts of the developing world is at least partly, and often substantially, related to the decline in the access of peasant farmers to institutional finance, which is the direct result of financial liberalization (Patnaik 2005). Measures which have reduced directed credit towards farmers and small producers have contributed to rising costs, greater difficulty of accessing necessary working capital for cultivation and other activities, and reduced the economic viability of cultivation, thereby adding directly to rural distress. In India, for example, there is strong evidence that the deep crisis of the cultivating community, which has been associated with to a proliferation of farmers' suicides and other evidence of distress such as mass migrations and even hunger deaths in different parts of rural India, has been related to the decline of institutional credit, which has forced farmers to turn to private moneylenders and involved them once more in interlinked transactions to their substantial detriment (Ramachandran and Swaminathan 2005).

It also has a negative impact on any medium term strategy of ensuring growth in particular sectors through directed credit, which has been the basis for the industrialisation process through much of the 20th century. Indeed, it is hard to think of any country that has reached

“developed” status without relying to greater or lesser extent on directed credit. For late industrialisers, the necessity is even more evident, because capital requirements for entry in most areas are high; because technology for factory production has evolved in a capital-intensive direction from its primitive industrial revolution level; because of competition from established producers within and outside the country.

THE IMPACT OF THE CURRENT CRISIS ON THE DEVELOPING WORLD

The past months have made it clear that the developing world is far from immune to the storms raging in financial markets in industrial countries. Stock prices in emerging markets have gone on similar roller coaster rides to those in New York and Europe, in a manner reminiscent of the behaviour of stock indices in the last major international financial upheaval in 1929/30 – the Great Depression. The credit crunch and freezing of interbank lending have been only too evident even in developing countries whose economic “fundamentals” were apparently strong and whose policy makers believed that they could de-couple from the global trends.

This almost immediate diffusion of bad news is partly the result of financial liberalisation policies across the developing world that have made capital markets much more integrated directly through mobile capital flows, and created newer and similar forms of financial fragility almost everywhere (Akyuz 2008). But the international transmission of turbulence is only one of the ways in which the global financial crisis can and will affect developing countries.

A medium-term implication is the impact on private capital flows to developing countries, which are likely to reduce with the credit crunch and with reduced appetite for risk among investors. The past five years witnessed an unprecedented increase in gross private capital flows to developing countries. Remarkably, however, this was not accompanied by a net transfer of financial resources, because all developing regions chose to accumulate foreign exchange reserves rather than actually use the money. Thus, there was an even more unprecedented counter-flow from South to North in the form of central bank investments in safe assets and sovereign wealth funds of developing countries, a process which completely shattered the notion that free capital markets generate net financial flows from rich to poor countries.

The likely reduction of capital flows into developing countries is generally perceived as bad news. But that is not necessarily true, since the earlier capital inflows were mostly not used for productive investment by the countries that received them. Instead, the external reserve build-up (which reflected attempts of developing countries to prevent their exchange rates from appreciating and to build a cushion against potential crises) proved quite costly for the developing world, in terms of interest rate differentials and unused resources. While some developing countries may indeed be adversely affected by the reduction in net capital inflows, for many other emerging markets this may be a blessing in disguise as it reduces upward pressure on exchange rates and creates more emphasis on domestic resource mobilisation.

Similarly, it is also very likely that the crisis will reduce official development assistance to poor countries. It is well known that foreign aid is strongly pro-cyclical, in that developed countries’ “generosity” to poor countries is adversely affected by any reversal in their own economic fortunes. But in any case development aid has also been experiencing an overall declining trend over the past two decades, even during the recent boom. In fact, the developed countries were extremely miserly even in providing debt relief to countries whose development prospects have been crippled by the need to repay large quantities of external debt that rarely contributed to actual growth. Notwithstanding the enormous international pressure for debt write-off, the G-8

countries have provided hardly any real debt relief. When they have done so, they have provided small amounts of relief along with very heavy and damaging policy conditionalities and in a blaze of self-serving publicity. So the speed and extent of the debt relief provided to their own large banks by the governments of the US and other developed countries, even when these banks have behaved far more irresponsibly, has not gone unnoticed in the developing world.

One major source of foreign exchange that is already strongly affected is remittance incomes, especially from workers based in Northern countries. Already, the Inter-American Development Bank estimates that 2008 will be the first year on record during which the real value of inward remittances will fall in Latin America and the Caribbean. Remittances into Mexico (which are dominantly from workers based in the US) in August were already down 12 per cent compared to a year previously, and this will only get worse. There is also evidence of declining remittances from other countries that relied strongly on them, such as the Philippines, Bangladesh, Lebanon, Jordan and Ethiopia. In India, where around half of inward remittances currently come from the US, the same pattern of decline is likely.

Exports of goods and services, like remittances, are going to be affected by the global economic downturn. For most developing countries, the US and the European Union remain the most important sources of final export demand, and as they inevitably tip into recession, exports to these markets will also decline. All the loose talk of China emerging as the alternative engine of growth for the world economy has died down after China's exports contracted in the last two months of 2008 and domestic manufacturing stagnated. Chinese growth, which has pulled along many other Asian developing countries in a production chain, has been largely export-led. The US, EU and Japan together account for more than half of China's exports, and as their economic crisis intensifies, it is bound to affect both exports and economic activity in China. Even if China's policy makers respond by shifting to an emphasis on the domestic economy, for example through expansionary fiscal policy of along the lines suggested by the declared fiscal stimulus of \$340 billion over two years, this is unlikely to generate levels of international demand that will come anywhere near to the meeting the shortfall created by recession in the developed countries. China's share of global imports is still too small for it to serve as a growth engine on the same scale.

Across the developing world, one additional detrimental effect of the current crisis is likely to be the postponement or even cancellation of large investment projects whose ultimate profitability is now in doubt. This will have negative multiplier effects, as cancelled orders and lost jobs further reduce demand. The construction sector has already been hit, and many large projects are being cancelled even in economies that are still growing. The aviation sector is going through a major shakeout, which is evident even in India where there has already been a tendency towards mergers and worker retrenchment. The tourism and hospitality sector, which had emerged as an important employer in many developing countries, is facing cancellations and declining demand across both luxury and middle class segments.

The recent crisis has also signalled the end of the commodity boom, which is bad news for those developing countries dominantly reliant on commodity exports, and good news for commodity-importing developing countries. This follows a period of unprecedented increase in oil and other commodity prices, led largely by speculative investor behaviour. For example, world oil prices, which had increased to nearly \$150 per barrel in early July, fell to less than \$40 per barrel by December 2008. (Brent Crude futures) fell to less than \$70 per barrel from nearly \$150 in early July. One important index of commodity prices, the Reuters-Jefferies CRB index, in early

December was more than 50 per cent below its all-time high in July. While speculative behaviour was clearly behind the volatility in commodity prices over the past year, it is likely that such prices will continue to decline or stagnate at low levels for some time now because of the broader economic slowdown.

This may provide some breathing space in terms of inflation control for importing developing countries, especially oil importers. But the food crisis still rages for possibly a majority of the population of the developing world, and the current global economic crisis will certainly not make it better. While world prices of important food items have also declined in the recent past, they are still too high for many developing countries with low per capita incomes and a large proportion of already hungry people. And retail prices of food have hardly declined in most developing countries. Indeed, the financial crisis may actually make it more difficult for many governments of poor developing countries to secure adequate commodity supplies to meet their people's needs.

These are forces that will affect all or most developing countries, but they will be felt differently in different places. In particular, the extent of financial contagion and possible local financial crisis depends on how far the developing country concerned has gone along the road of financial liberalisation. Countries with large external debts and current account deficits will face particular problems. Already, it is apparent that financial markets are estimating the risk of default (in the form of the price of credit default swaps) for countries such as Pakistan, Argentina and Ukraine as high as 80 per cent or more. Sometimes, as in Kazakhstan and Latvia, it is because of their highly leveraged banking systems. In other cases, as for Turkey and Hungary, it is because of the very high current account deficits. The developing countries that have gone furthest in terms of deregulating their financial markets along the lines of the US (for example Indonesia) have been the worst affected and may well have full blown financial crises of their own. By contrast, China, which has still kept most of the banking system under state control and has not allowed many of the financial "innovations" that are responsible for the current mess in developed markets, is relatively safe. In India, which still has a nationalised banking system and greater degree of regulation, is better off than Indonesia, but recent reforms that the NDA and UPA government have pushed through despite Left protests, along with the growing current account deficit, have rendered the Indian economy more fragile and potentially vulnerable than China.

Of course, developing countries are still bit players in this global drama. This particular financial crisis has so many ramifications mainly because it is occurring in the very core of capitalism, and originated in the US, the country that had the global power and influence to impose its own economic model on almost all of the rest of the world. And the depth and severity of the crisis are likely to signal global political economy changes that will shape the world for the next few decades. Geopolitical shifts are likely to result from such glaring exposure of economic vulnerability in the global hegemon. Large bailouts and the planned Obama fiscal stimulus in the US will lead to a big increased in the US public debt. It will also make it harder for the US to maintain its military dominance, which has been a major source of the strength of the US dollar.

While the drama is still being played out and the ultimate denouement is still unclear, what cannot be denied is that US dominance of world economics and politics is now under severe question, and has suffered a blow from which it may not recover. The changes in the world in the next decade will not be linear or unidirectional, and there are bound to be savage conflicts over resources and much else, but the recent pattern of global imperialism has been severely disturbed. But even more than the geopolitical or economic shift, a bigger shift may come about

from the clear failure of the economic model of neoliberalism. The notions that markets know best, and that self-regulation is the best form of financial regulation, have now been completely exposed as fraudulent. And so this pervasive financial crisis, which is still to fully play out and work through in real economies, may have create a genuine opportunity not only for questioning the economic paradigm that has been dominant for far too long, but also replacing it with more progressive and democratic alternatives.

INTERNATIONAL FINANCIAL ARCHITECTURE AND THE ROLE OF THE IMF

Progressive change will require fundamental changes in the system of organising global finance and the institutions that govern trade and finance. But such changes will not come easily. The global financial and trading system is one that for many generations has been almost exclusively determined by the governments of western former colonial powers, and their writ still runs large in all the global institutions. Thus, the G-7 which leaves out Russia and China, not to mention India and Brazil, still presumes that it has the right to redesign the international financial architecture. The Financial Stability Forum of the Bank for International Settlements excludes any representation from developing countries. The tiny countries of Belgium, Netherlands and Luxembourg, with a total population of less than 28 million, have more votes in the IMF than China, Brazil or India.

The role of the IMF has once more assumed significance in this changed context. It has been some time now since the IMF lost its intellectual credibility, especially in the developing world. Its policy prescriptions were widely perceived to be rigid and unimaginative, applying a uniform approach to very different economies and contexts. They were also completely outdated even in theoretical terms, based on economic models and principles that have been refuted not only by more sophisticated heterodox analyses but also by further developments within neoclassical theory.

What may have been more damning was how out of sync the policies proposed by the IMF have also been with the reality of economic processes in developing countries. The 1990s and early 2000s were particularly bad for the organisation in that respect: their economists and policy advisers got practically everything wrong in all the emerging market crises they were called upon to deal with, from Thailand and South Korea to Turkey to Argentina. In situations in which the crisis had been caused by private profligacy they called for larger fiscal surpluses; faced with crisis-induced asset deflation they emphasised high interest rates and tight money policies; to address downward economic spirals they demanded fiscal contraction through reductions in public spending. The countries that recovered clearly did so *despite* their advice, or in several cases because they actively pursued different policies. And the recognition became widespread among governments in the developing world that IMF loans were too expensive because of the terrible policy conditions that came with them. So returning IMF loans early became something of a fashion, led by some Latin American countries.

In the past few years an even more terrible fate had befallen the IMF: that of increasing irrelevance. From 2002 onwards, the IMF and the World Bank became net recipients of funds from developing countries, as repayments far exceeded fresh loans. The developing world turned its attention to dealing with private debt and bond markets, which is where the action was. Less developed countries found new sources of aid finance and private investment from other sources, as China, Southeast Asia and even India to a limited extent, began investing in other developing countries.

So the IMF was not really a significant player in the international economic scene in the recent past, and the reasons for its very existence were often called into question. However, every crisis is also an opportunity, and the IMF has been quick to seize on the current global financial crisis as an opportunity to increase its own influence, by offering its services to emerging markets. As the crisis spreads and engulfs developing countries, and as global credit markets seize up and create credit crunches, more and more developing and transition countries are going to need access to emergency liquidity. Already several countries have lined up for this and signed agreements with the IMF: Pakistan, Ukraine, Hungary, Iceland. Some European governments have called for a strengthening of the IMF and even implored surplus countries like China to put more money into the IMF's coffers.

But with its current personnel and ideological framework, such strengthening of the IMF will only mean that the conditionalities it imposes will make things much worse for the developing world. The guiding principles of IMF lending are clear: countries in the midst of financial crisis must undergo fiscal contraction, however painful and regardless of whether the crisis was caused by public or private overspending. When the government account is in deficit, it must be reduced or converted into a surplus: when it is already in surplus, that surplus must be increased. This is obviously pro-cyclical and can cause the crisis to spread to the real economy and create a sharp economic downswing, but this is essential medicine and necessary pain to ensure the eventual recovery. Acceptance of these principles explains why so many developing countries have experienced even sharper and more prolonged economic downturns after turning to the IMF.

However, this argument is apparently valid only for developing economies, whose place is low in the international financial pecking order. In the World Economic Outlook for October 2008, the IMF clearly exposes very blatant double standards for industrial and developing countries. Contrary to its past prescriptions, countercyclical macroeconomic policy is seen to be acceptable for industrial countries. "*Macroeconomic policies in the advanced economies should aim at supporting activity, thus helping to break the negative feedback loop between real and financial conditions, while not losing sight of inflation risks...Discretionary fiscal stimulus can provide support to growth in the event that downside risks materialise, provided the stimulus is delivered in a timely manner, is well targeted, and does not undermine fiscal sustainability.*" (IMF 2008:34, emphasis added.) But for developing countries, who have this time been caught in a crisis that is not of their own making, the same advice is not tenable at all. "While emerging economies have greater scope than in the past to use countercyclical fiscal policy should their economic outlook deteriorate ...this is unlikely to be effective unless confidence in sustainability has been firmly established and measures are timely and well targeted. More broadly, general food and fuel subsidies have become increasingly costly and are inherently inefficient." In fact, the IMF believes that in developing countries, despite the economic slowdown, there is room for tightening on all fronts, both fiscal and monetary! "Greater restraint on spending growth, including public sector wage increases, would complement tighter monetary policy, in the face of rising inflation, which is particularly important in economies with inflexible exchange regimes." (IMF 2008: 38)

So the IMF seems to have one rule for industrial countries in crisis, no matter how irresponsible the run-up to the crisis; and another rule for developing countries, even the most prudent and fiscally "disciplined" of them. Given this clearly unbalanced and potentially disastrous approach of the IMF, the need to examine alternative and less destructive sources of emergency finance for crisis-affected developing countries is urgent, as is the need, over the medium-term, to create a more democratic and less rigid international financial regime.

THE CRISIS AND INDIA

When the crisis first broke internationally, within India there was much talk of how the Indian economy is less likely to be affected and how the Indian financial sector will be relatively immune to the winds from the international financial implosion. But it is clear that important elements of the balance of payments and the domestic financial sector have been affected. There are significant implications for domestic banking, which are already reflected in the credit crunch that has dramatically affected access to credit especially for small and medium enterprises. There are effects on some important macroeconomic prices – in particular the exchange rate. And there are direct and indirect effects on employment, with falling export employment generating negative multiplier effects.

Despite all this, Indian policy makers still seem to be caught in some complacent time-warp, whereby they proudly point to the GDP growth rate (now spluttering, but still high by international standards) and to the supposed “resilience” of the domestic financial sector. Of course, neither of these is as positive as the government would like to make out. The current slowdown in GDP is sharper than the government would like to admit, and more significantly it has been accompanied by a much steeper than expected reduction in employment, especially in export sectors. Domestic banking is still generally secure, especially because nationalised banking remains the core of the system, largely thanks to resistance from the Left parties to government attempts to privatise it. Even so, there are clear signs of fragility and inadequacy within the banking sector: the recent rapid growth of often dodgy retail credit, associated attempts to securitise such debt, the emergence of a credit crunch in the face of macroeconomic uncertainty, and the inability or unwillingness of the banking system to provide loans to medium and small borrowers other than in the form of personal credit.

Beyond these implications, the effects of the global crisis have directly impacted upon some important macroeconomic variables. Three such indicators stand out in terms of their quite sudden deterioration since the middle of last year: the decline in the foreign exchange reserves held by the Reserve Bank of India; the fall in the external value of the rupee, especially vis-à-vis the US dollar; and the decline in stock market indices.

Chart 1 shows how foreign exchange reserves, which had been increasing steadily over the past few years, started declining after June 2008. It must be noted that the earlier build-up of reserves did not reflect any real macroeconomic strength, since unlike China it was not based on current account surpluses. Instead, the Indian economy experienced an inflow of hot money, especially in the form of portfolio capital or FII investment. Domestic macro policies combined with the need to prevent exchange rate appreciation to prevent increased domestic absorption of such resources, as a result of which these were largely added to reserves. Since they were based on hot money inflows, it was only to be expected that they would reverse with any bad news, and that is essentially what has happened over the past eight months, with the bad news coming from the US and other developed markets rather than from the Indian economy.

Chart 1: Foreign exchange reserves

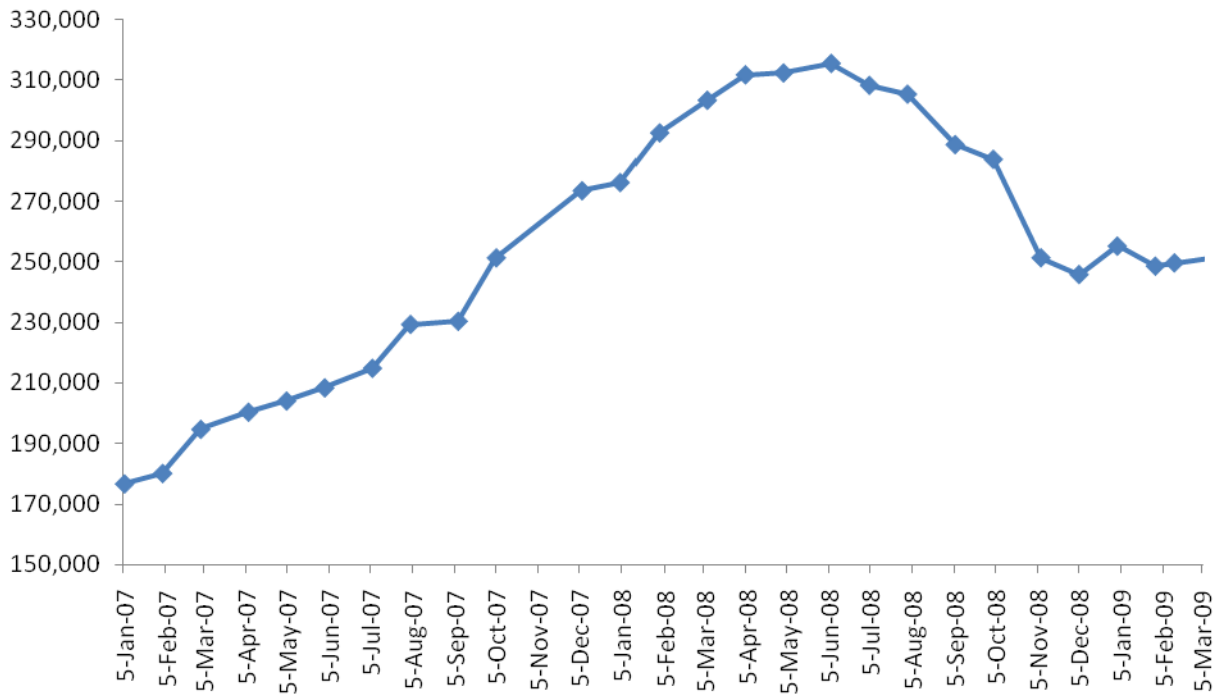
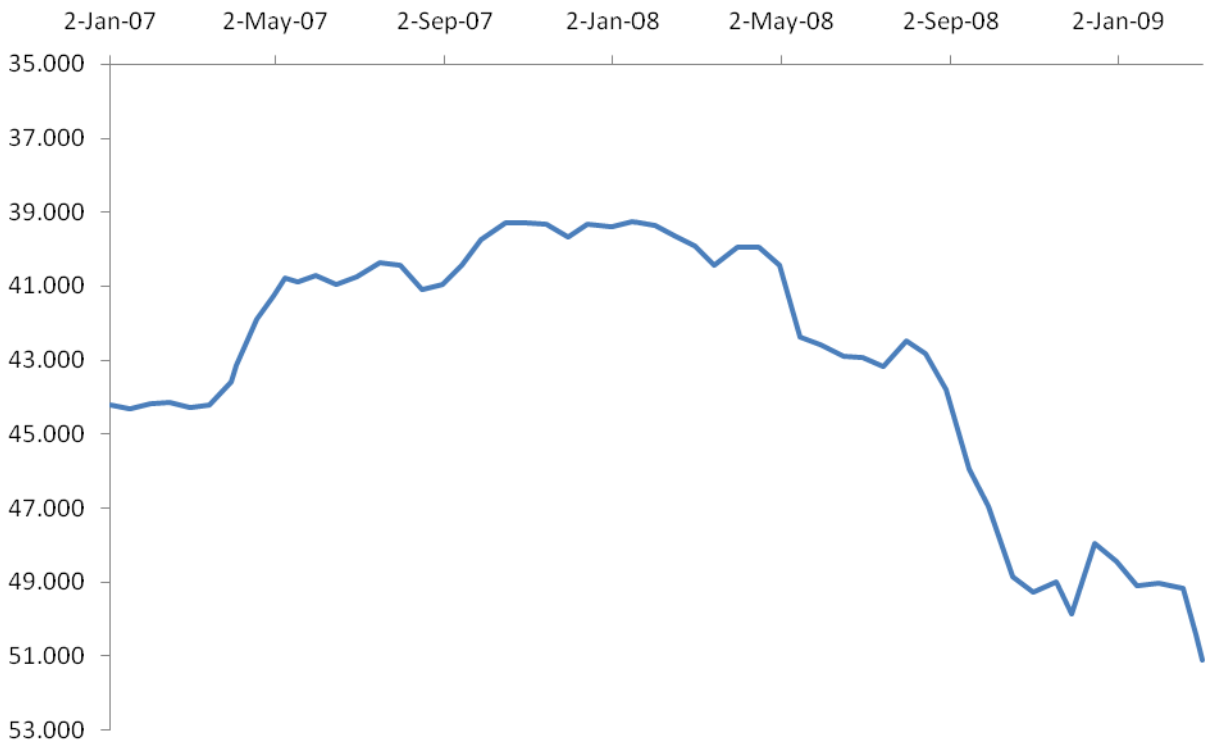
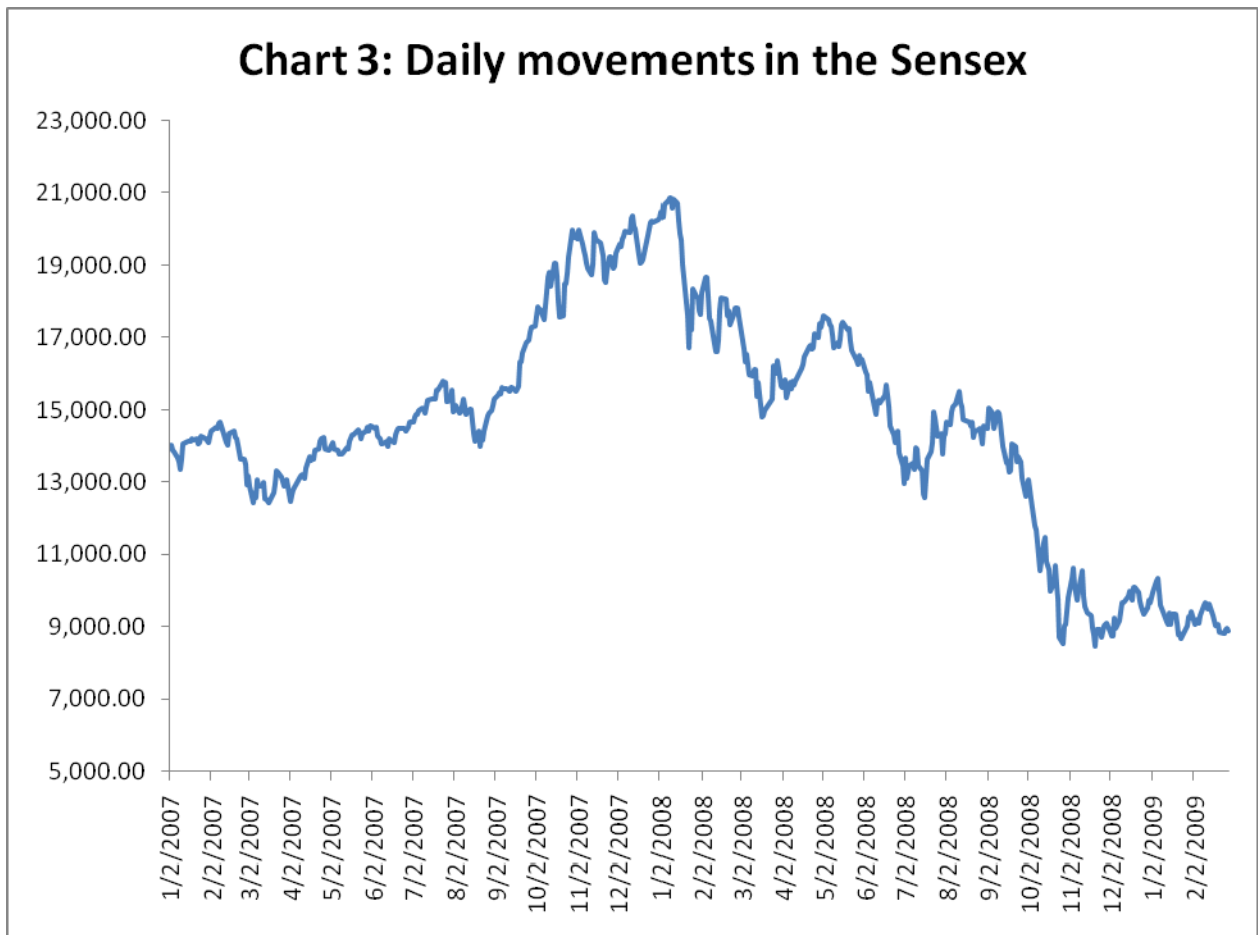


Chart 2: Rupees per US dollar



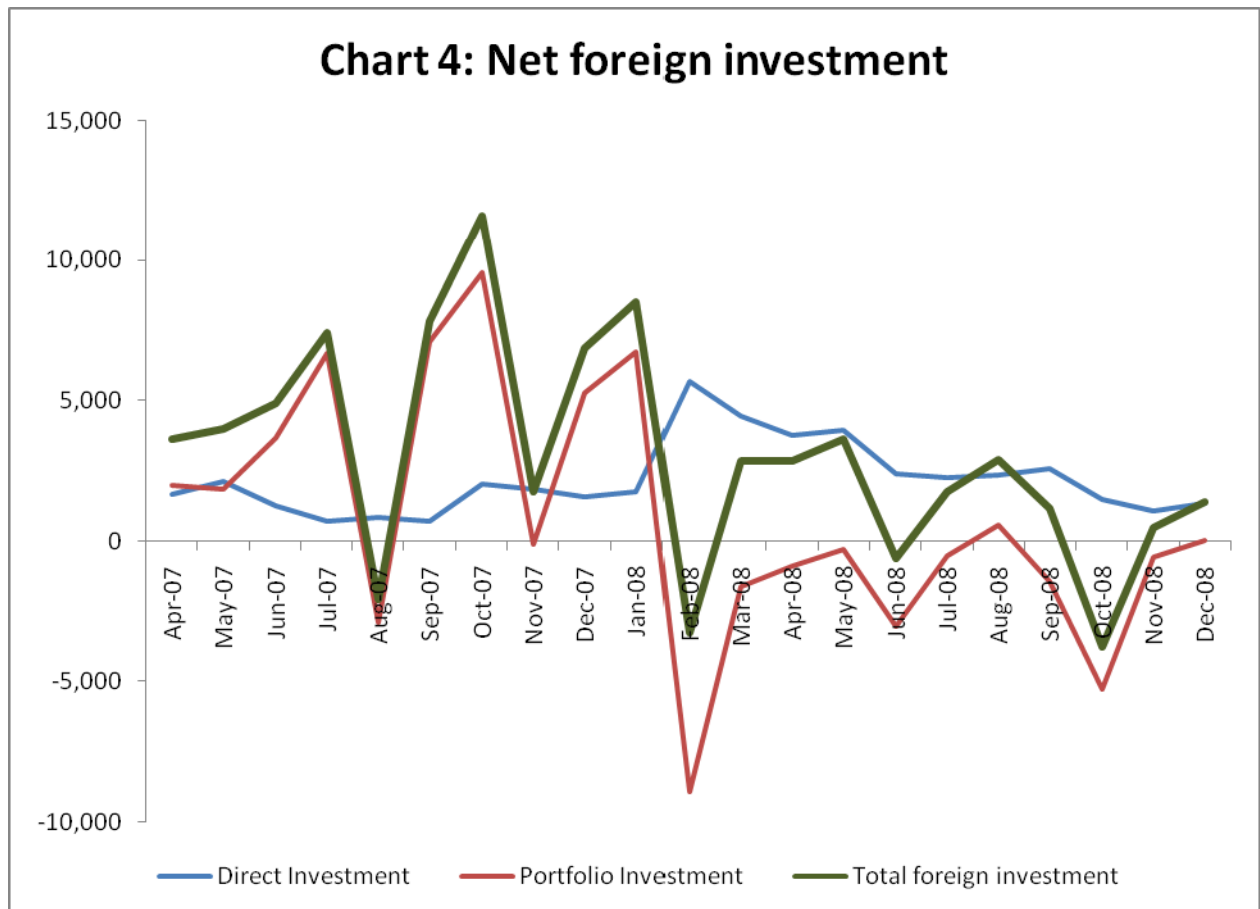
This movement of foreign institutional investors was in turn related to the sudden collapse of the rupee, shown in Chart 2. Early in March 2009 the rupee even breached the line of Rs 51 per dollar, and currently continues to fall. There are those who argue that this depreciation is positive since it will help exports, but conditions prevailing in the world trade market, with falling export volumes and values, does not give rise to much optimism in that context. India currently has a current account deficit including a large trade deficit and also quite significant factor payments abroad. The falling rupee implies rising factor payments (such as debt repayment and profit repatriation) in rupee terms, which has adverse implications for many companies and for the balance of payments.

Associated with all this is the evidence of falling business confidence expressed in the stock market indicators. The Sensex, shown in Chart 3, had reached historically high levels in the early part of 2008, capping an almost hysterical rise over the previous three years in which it more than tripled in value. But it has plummeted since then, with high volatility around an overall declining trend, such that its levels in early March were below the levels attained in December 2005.

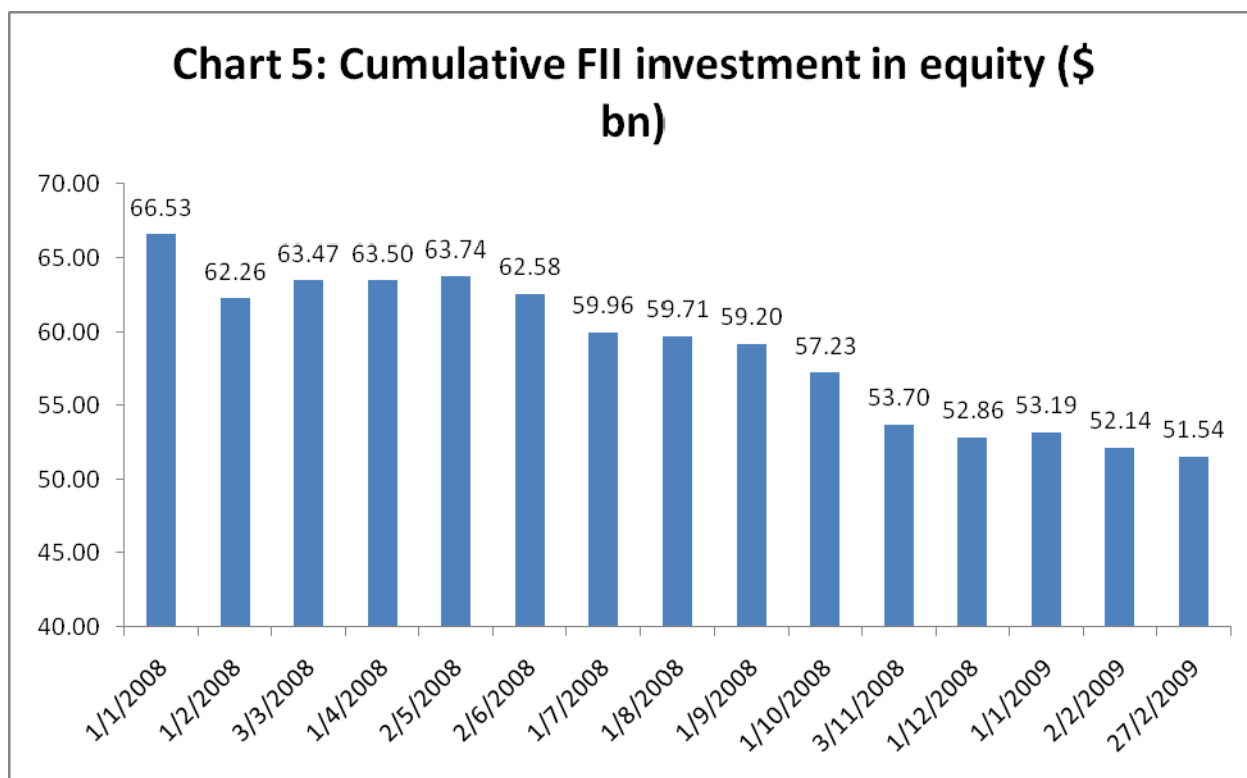


How much of all this is due to the behaviour of foreign investors, rather than domestic investors? Chart 4 tracks the changes in total foreign investment, split up into direct investment and portfolio investment, over the period since April 2007. It is evident that both have shown a trend of increase followed by decline. FDI has been more stable with relatively moderate fluctuations (even though it does include some portfolio-type investments that get categorised as foreign direct investment). It peaked in February 2008 and thereafter has been coming down but

is still positive. Portfolio investment (which includes both FII investment in the domestic share market and GDRs/ADRs) has been extremely volatile and largely negative (indicating net outflows) since the beginning of 2008, and this has dominated the overall foreign investment trend.



As a result, as Chart 5 shows, the cumulative value of the stock of Indian equity held by FIIs fell quite sharply, by 24 per cent between May 2008 and February 2009. This is not likely to be due to any dramatically changed investor perceptions of the Indian economy, since if anything GDP growth prospects in India remain somewhat higher than in most other developed or emerging markets. Rather, it is because portfolio investors have been repatriating capital back to the US and other Northern markets. This reflects not so much a flight to safety (for clearly US securities are not that safe anymore either) as the need to cover losses that have been incurred in sub-prime mortgages and other asset markets in the North, and to ensure liquidity for transactions as the credit crunch began to bite.



Whatever the causes, the impact on the domestic stock market has been sharp and direct. Since the Indian stock market is still relatively shallow, and FII activities play a disproportionately strong role in determining the movement of the indices, it is not surprising that this outward flow has been associated with the overall decline in stock market valuations. As Chart 6 shows, the Sensex has moved generally in the same direction as net FII inflows. In fact movements in the latter have been much sharper and more volatile, suggesting that domestic investors have played a more stabilising role over this period.

Overall foreign investment flows (including not just FII but direct investment) have also, predictably, played a role in determining the level of external reserves. Chart 7 shows the pattern of aggregate net foreign investment and change in reserves since April 2007. Once again the two move together. In this case, however, foreign investment has been less volatile than the change in reserves, suggesting that other components of the balance of payments have been important as well. The changes in external commercial borrowing are likely to have been significant.

In addition, the possibilities of domestic investors moving their funds out should not be underestimated. As Table 1 shows, the recently liberalised rules for capital outflow by domestic residents have led to outflows that are not insignificant, even if still relatively small. Liberalised rules for capital account transactions by Indian residents seem to be increasing the vulnerability that derives from India's dependence on foreign investment flows. This an aspect of India's external payments that policy must address, especially since there are constraints set by WTO membership on using tariffs and quantitative restrictions on reducing foreign exchange outflows that occur on account of imports.

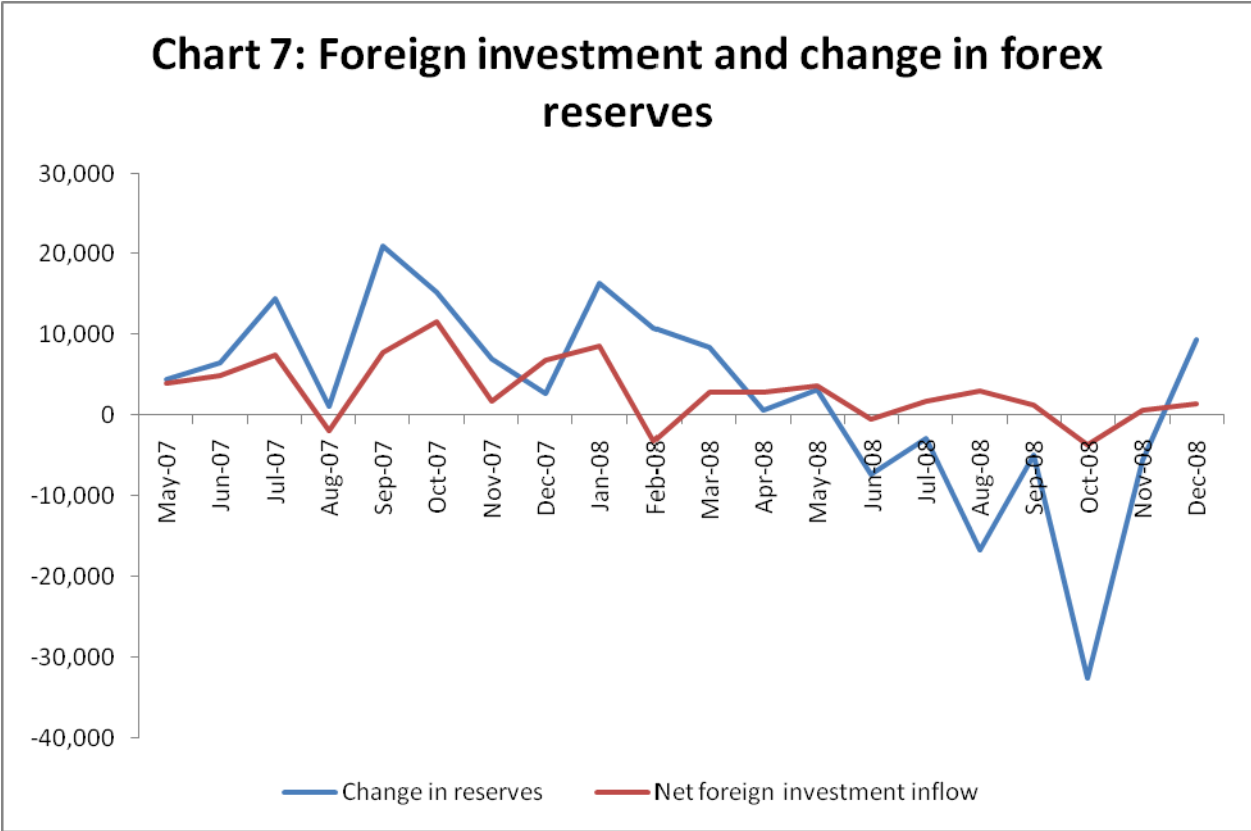
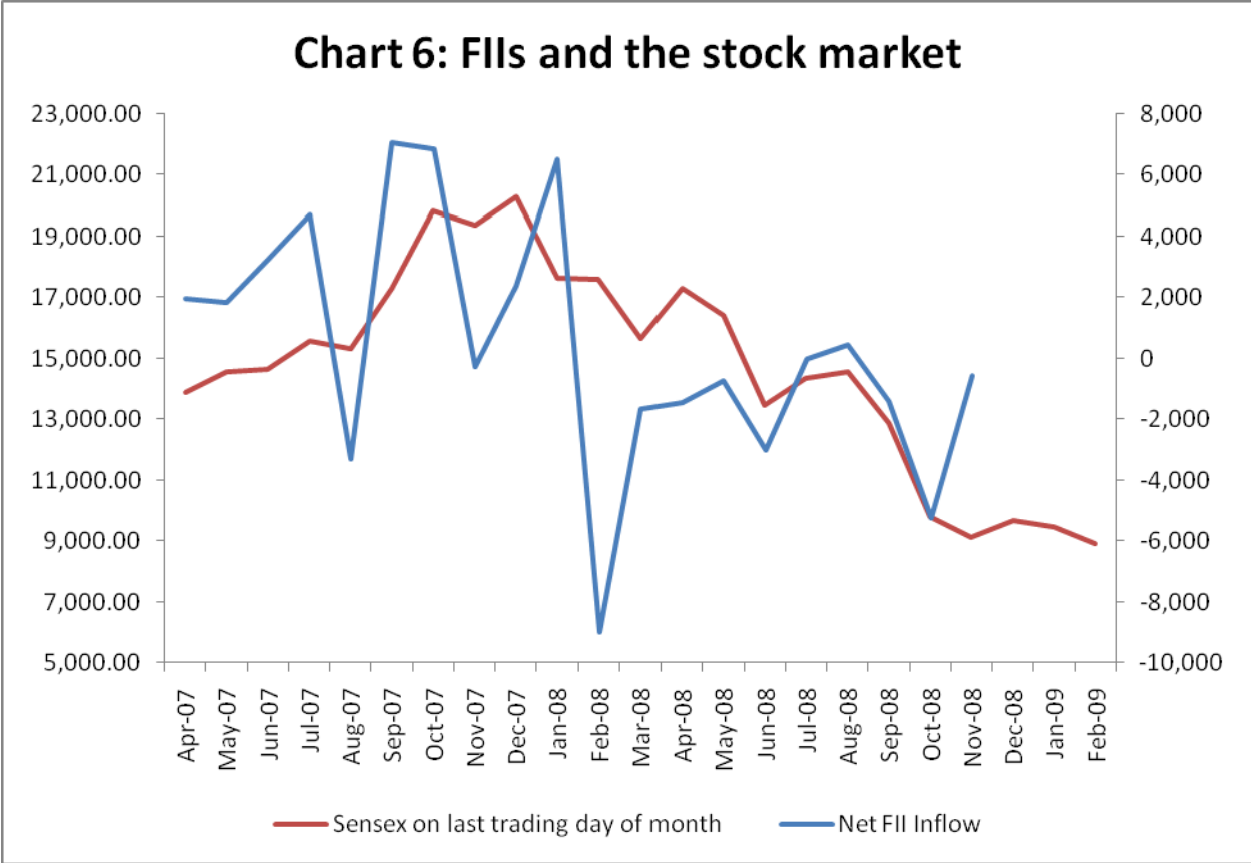


Table 1: Outward remittances under liberalised rules (US \$ mn)

	2004-05	2005-06	2006-07	2007-08	Apr-Jul 2008
Deposits	9.1	23.2	19.7	1	12.8
Purchase of immovable property	0.5	1.9	8.5	39.5	26.9
Investment in equity/debt	–	–	20.7	144.7	54.4
Gifts, donations and others	0	0	23.9	232.3	126.6
Total	9.6	25.0	72.8	440.5	220.7

At the same time, exports dropped sharply, declining by 17 per cent in November 2008 compared to the same month in the previous year. Aggregate growth projections were continuously revised downwards by both official and other analysts, as the expectation that GDP growth would remain above 7 per cent for the year 2008-09 was tempered by the realisation of a likely sharp decline in the second of the year. The impact on employment was immediate: in early December it was estimated that more than 1 million jobs had already been lost, especially in the construction and small-scale export manufacturing sectors. Agriculturalists, especially those producing export crops whose prices had collapsed, faced growing difficulties on top of their existing financial problems. Real – and sometimes even nominal – wages of workers in industry and services have been falling, and the incomes of the self-employed who constitute half the work force are also under threat. Small scale producers in all sectors are being squeezed by the pincer movement of falling demand and credit crunch. Investment projects are being curtailed by the liquidity trap conditions in which banks are willing to lend only to the most secure borrowers, who in turn are unwilling to invest because of greater uncertainty. State governments' tax receipts have fallen and so they are increasingly strapped for cash and unable to meet even essential spending on basic services, not to mention development.

THE INDIAN GOVERNMENT'S RESPONSE

The initial responses of the government focussed on the financial side of the current crisis. There were measures to infuse liquidity into a banking system that had become very constrained by reducing the Cash Reserve Ratio and the Statutory Liquidity Ratio, to reduce interest rates by bringing down repo and reverse repo rates, and to provide some relief to non-bank financial institutions, particularly insurance companies. These were confidence-building measures that became necessary not because the international contagion was spreading to the banking system but because the Indian banking system had (in a less extreme form) several of the fragilities that undermined the US banks. But these monetary all proved to be lacking and did not ease credit conditions in any meaningful way. This was of the liquidity trap characteristics of the situation: banks were unwilling to lend to any but the most credit-worthy potential borrowers, but such potential borrowers were unwilling to borrow because of the prevailing uncertainties and expectations of slowdown. Meanwhile, all other enterprises, even those who desperately required working capital just to stay afloat, found it increasingly difficult to access bank credit even as they faced more stringent demand conditions. Some of the measures seemed to be more designed to push up the stock market than to revive the real economy, but even this was unsuccessful because of dampened expectations of real revival.

In such a situation, reducing interest rates does not solve the basic problem of tightened credit provision, even though it may marginally reduce costs for those who are able to access bank credit. And the real economy cannot be revived through such measures in the absence of a strong fiscal stimulus. It is well known that there is really no alternative to the standard Keynesian device of using an expansionary fiscal stance to create more economic activity and demand, and thereby lift the economy from slump. Even so, the Government of India took an inordinately long time to announce the required fiscal stimulus, and when the much awaited fiscal package was finally announced, it turned out to be relatively small. It allowed for only up to Rs. 20,000 crore of direct additional spending through the Planning Commission in unspecified areas. This would be less than 0.5 per cent of GDP, a tiny fiscal input which is too small to be really countercyclical or even to change the expectations of private agents in any meaningful way.

This direct spending was combined with a tax cut measure, on domestic duties – reducing the ad valorem Cenvat rate by 4 percentage points. But the point about such economic situations is that price responses do not work, and therefore output has to be addressed directly through spending. In any case, even price changes would not necessarily follow, since tax cuts would have an impact in terms of supporting economic activity only if producers respond by cutting prices, and such price cuts generate demand responses. But neither is inevitable. For example, the Government of India cut the administered price of aviation fuel in October 2008, but this was not passed on to consumers by the airline companies, and even two months later only one carrier – the public sector Air India - promised to reduce the aviation fuel surcharge. So that particular measure simply became an additional subsidy to shore up profits of airline companies. Across the world, governments have been finding that in these times of economic uncertainty, tax cuts are much less effective in stimulating activity than direct government expenditure. Similarly, measures that try to provide additional export incentives (such as interest reductions for export credit) to exporting sectors such as textiles, garments and leather would not counteract the effect of big losses of export orders as the major markets start shrinking. What is required was a more serious and systematic attempt to allow these industries to keep producing at technologically efficient levels and shift demand to other markets.

But what is even more significant is what the stimulus package announced in November 2008 left out. Not only was the overall size of the package too small to have much effect, but some of the most critical areas of spending were ignored or neglected. These areas include resource allocation to state governments, direct investment to ensure mass and middle-class housing, interventions to improve the livelihood conditions of farmers and enlargement of employment schemes to provide relief to working people as well as a macroeconomic stabiliser with positive multiplier effects.

The Interim Budget of the UPA government – the last chance to provide some macroeconomic stimulus to counteract the downturn, was even more disappointing. For the first four months of 2009-10, the UPA has proposed hardly any increase in expenditure, along with a recovery of revenues, such that the fiscal deficit is actually projected to come down to 5.5 per cent of GDP compared with the current year. What is even worse is that while the amount of revenue receipts that state governments are projected to receive is even less than was budgeted for the current year, there is hardly any proposed increase in central assistance to state plans compared to the current year. Similarly, there is no evidence of particular attention to employment-intensive sector like construction, which surely could have benefited from a large dose of public investment for affordable housing. The chance of a proper relief package for agriculturists to cope with the price shocks appears to be remote when the total expenditure for the Ministry of Agriculture is projected to be flat. Food has emerged as a critical issue, and central PDS

allocations to the states have been cut at a time when food prices are very high. Yet the allocation for the Department of Food and Public Distribution, which manages the food distribution and accounts for the food subsidy, has actually been *reduced*, falling from an estimated Rs 45,536 crore in the current year to a budgeted Rs 44,744 crore in the coming year! Despite the claim that an impetus would be provided to rural infrastructure through additional spending, the Ministry of Rural Development is actually slated to receive *less* money in 2009-10 than it is getting in the current year.

By the middle of 2008, state governments had already started feeling the resource constraint as their tax revenues were affected by the economic downturn. Yet they are responsible for most of the public services that directly affect people, such as those relating to agriculture and rural development, health, sanitation, education and so on, but unlike the Centre, the States face a hard budget constraint. So the overall conditions of life of the citizenry are likely to be affected. Yet the Centre could so easily have announced some measures to provide fiscal relief to the States to help them cope with the adverse effects of the downturn. Such measures could include reducing interest rates, providing more central funds and most of all relaxing fiscal responsibility norms that are inappropriate for the current situation and which the Centre itself has already discarded.

Similarly, the food crisis has been forgotten in all the excitement about the financial crisis, but food insecurity remains widespread and may even be spreading, given the significant rise in prices over the past two years. While overall inflation has been easing, food inflation in India continues despite large food grain stocks. And the real incomes of workers and cash crop cultivators have not kept pace with this. Poor or inadequate nutrition is already a big problem, which will deteriorate as the downturn worsens. A major positive role of crisis management would be played if it involved the allocation of significantly increased resources towards expanding, universalising and improving the functioning of the Public Distribution System. This would at least partly alleviate the problems of those who are already at the margin of survival, as well as those who could be tipped over into poverty by recent economic processes. Similarly, specific interventions are required to ensure the financial viability of cultivators, especially those who have been hit by falling output prices even as their own costs have kept rising.

The construction industry is a major employer and it has been hard hit already by the downturn. Yet the shortage of affordable housing remains acute across our cities and towns. Part of the problem is that private developers have increasingly focussed on the luxury segment of the market, without addressing this very obvious and basic need. It is important to expand the provision of middle class and mass housing, which is easily possible through public sector organisations, and can even be done through schemes that will be largely self-financing.

While monetary policies are not sufficient to address the current economic problems in India, this does not mean that the financial sector can be neglected. In particular, what is most obvious is that financial sector liberalisation has to be reversed, given the knowledge of the huge imperfections in such markets and the ability of unregulated finance to create massive scams that also destabilise real economies. Across the world, and especially in the major industrial countries, banking and insurance institutions are being effectively nationalised – yet in India there are moves towards more privatisation! The UPA government in mid-December actually placed a bill in Parliament that would raise the cap on FDI in the insurance sector to 49 per cent, along with several other liberalising moves, even though the need is so obvious to exercise strong and effective regulation on insurance companies and prevent private domestic savings from being misused and exported out of the country. Further, the rapid expansion of retail credit since the early 2000s – with very large volumes of often unsecured lending in the form of housing loans,

vehicle loans and credit card debt – provokes concerns about domestic financial fragility, especially as the economic slowdown bites into incomes and employment.

WHAT IS TO BE DONE?

It is more than obvious that the current global crisis provides a real opportunity to initiate and develop alternative policies, both internally and domestically. A change in economic paradigm is essential; without it the international economy will continue to lurch from crisis to crisis and the developing world will not be able to advance and provide basic needs to citizens. The need for more state intervention in economies is now recognised everywhere: the concern now is to ensure that such state involvement is more democratic and more accountable to the people.

Everyone now recognises the need to reform the international economic regime. But the idea should not simply be to fix a system that is obviously broken: we need to exchange it for a better model. That is because, as noted above, the current financial architecture has failed to meet two obvious requirements: of preventing instability and crises, and of transferring resources from richer to poorer economies. Not only have we experienced much greater volatility and propensity to financial meltdown across emerging markets and now even industrial countries, but even the periods of economic expansion have been based on the global poor subsidising the rich. These global failures are so immense that they constitute enough reason to abandon this system. But there are other associated failures in terms of what the regime has implied within national economies: it has encouraged pro-cyclicality; it has rendered national financial systems opaque and impossible to regulate; it has encouraged bubbles and speculative fervour rather than real productive investment for future growth; it has allowed for the proliferation of parallel transactions through tax havens and looser domestic controls; it has reduced the crucial developmental role of directed credit.

So we clearly need a new system, even if the goals remain the same as that of the original Bretton Woods: to ensure currency stabilisation through international monetary co-operation; to encourage the expansion of international trade in a stable way; and to promote development by facilitating productive investment. To achieve this in the current context, four elements are crucial. First, the belief that self-regulation supported with external risk assessment by rating agencies is an adequate way to run a financial system has been blown sky-high. There is no alternative, therefore, to systematic state regulation of finance. Second, since private players will inevitably attempt to circumvent regulation, the core of the financial system - banking - must be protected, and this is only possible through social ownership. Therefore, some degree of the socialisation of banking (and not just socialisation of the risks inherent in finance) is also inevitable. In developing countries it is also important because it enables public control over the direction of credit, without which no country has industrialised. Third, to cope with the adverse real economy effects of the current crisis, fiscal stimulation is essential in both developed and developing countries. Enhanced public expenditure is required to prevent economic activity and employment from falling, to manage the effects of climate change and promote greener technologies (Pollin 2008), and to advance the development project in the South. Fourth, the international economic framework must support all this, which in turns means that capital flows must be controlled and regulated so that they do not destabilise any of these strategies.

In India too, a major change in economic paradigm is required along these lines. But first of all, it is necessary to ensure that Indian economic policy makers remember the basic Keynesian principles that are now back in fashion everywhere else in the world, such as that direct public

spending is the best countercyclical measure, especially in a situation of liquidity trap. Such public spending will be more economically effective and more welfare -improving if it is directed dominantly towards employment schemes, social spending and rural and urban infrastructure for mass use. This will also enable more progress towards meeting developmental goals, but this also requires that government spending be made more democratically accountable and more directed towards altering consumption and production patterns in more sustainable directions.

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