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The Global Financial Crisis and the Developing World

There is no doubt that the period of capitalist globalisation has made the world economy more integrated than ever before, and this has become particularly evident in the course of the current global economic crisis. The past year has made it clear that developing countries are not immune to the storms raging in financial markets in industrial countries, or to the impact of recession in the core of capitalism. As Table 1 indicates, there has been a remarkable degree of global synchronicity in the changes in rate of growth of national income over the past few years.

This is somewhat unusual in the history of global capitalism. For most of the past century, business cycles in advanced economies did not get reflected so sharply in simultaneous movements in developing countries, or were generally confined to only a small set of countries. But recent economic difficulties have been particularly extreme in certain regions, such as eastern and central Europe, which were until recently the “beneficiaries” of large amounts of inflows of speculative finance capital (‘hot money’) that created domestic bubbles not unlike

Table 1: Rates of growth of GDP in constant prices (per cent)

	World	Advanced economies	Developing & transition economies	China	India
2000	4.7	4.0	6.0	8.4	5.7
2001	2.2	1.3	3.8	8.3	3.9
2002	2.8	1.6	4.9	9.1	4.6
2003	3.6	1.9	6.3	10.0	6.9
2004	4.9	3.2	7.5	10.1	7.9
2005	4.5	2.6	7.1	10.4	9.2
2006	5.1	3.0	8.0	11.6	9.8
2007	5.2	2.7	8.4	13.0	9.3
2008	3.2	0.8	6.1	9.1	7.3
2009*	-1.3	-3.8	1.6	6.5	4.5

* IMF projections

Source: IMF World Economic Outlook April 2009 (for all Tables and Charts in this article).

the larger and more dramatic one in the US. But all regions of the developing world have been affected, to varying degrees by this particular crisis. The extent of impact depends not only on the degree of export dependence of developing countries but also – and often more crucially – on the dependence on capital flows, including portfolio investment, bank lending, foreign direct investment (FDI) and also foreign aid. The first section considers the impact upon developing countries in general, particularly those in Asia, while the second section analyses the recent experience of India.

I. THE IMPACT ON DEVELOPING COUNTRIES

Before the crisis many mainstream economists argued that developing Asia would be relatively immune from the adverse effects. Although it is the most globally integrated region of the world economy in terms of trade and capital flows, most countries in the region have also been the most careful to avoid large fiscal deficits, have run surpluses on the current account of the balance of payments and have tried to base their growth on exports rather than speculative bubbles. (India is somewhat of an exception to this.) But even this region has been quite badly affected, with some countries in East and Southeast Asia, like Indonesia and the Philippines, showing declines in total output.

Among developing countries, China and India were supposed to be especially different, and it was argued that their economies are now “decoupled” or delinked from the west and now have their own autonomous growth trajectories. It was even believed that this could make them an alternative growth pole in the world economy. But thus far even China and India have shown similar trends of sharply declining growth rates of GDP, even though they have not turned negative, although it is likely that the Chinese economy may recover more rapidly because of the impact of the fiscal stimulus and other recovery measures that have been instituted.

This sharp and almost immediate transmission of recessionary tendencies is strongly related to the various forms of economic integration that have been generally induced by policy changes across the world, in both developed and developing countries. As a result, there are now several transmission mechanisms operating to spread the crisis from developed to less developed economies and from one geographical region to all others. These transmission mechanisms include exports of goods and services; capital flows; patterns of migration and remittances; sharp changes in world trade prices of important essential items like oil and food. It is important to remember that while these do operate significantly upon developing economies, their impact can be mitigated by domestic policy measures, especially in countries with potentially large domestic markets like India.

The effect of world trade decline

World trade has been sharply affected by the crisis, as is evident from Chart 1. The previous recession of 2001 did cause global exports to decelerate significantly, but they still continued to grow. By contrast, in 2009 global exports of goods and services are projected to fall very sharply. In fact, the projection for 2009 shown in Chart 1 is more optimistic than others: for example, the World Trade Organisation currently predicts that exports will fall by more than 15 per cent in 2009 (WTO 2009).

This quick collapse is largely because, despite all the recent changes in global trade patterns, the United States as well as the European Union to some extent, have remained the most significant sources of external demand for all other countries. In the recent boom, the US

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economy has been the engine of growth for the rest of the world, because its own bubble generated high rates of private spending that involved huge and growing (but ultimately unsustainable) demand for imports from the rest of the world. It was inevitable that this would have to come to an end and the US would have to wind down its external deficits. But since this is happening through the crisis, the collapse in demand for US imports has been particularly sharp. Since most developing countries are now more dependent upon export markets than they were even a decade ago, this sharp decline obviously has dramatic effects upon their domestic economies.

The past year has also made it amply evident that the earlier optimism about China emerging as the alternative engine of growth for the world economy was misplaced, given the sharp fall in China's exports from late 2008 and the stagnation of domestic manufacturing production. 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 their economic crisis was bound to affect both exports and economic activity in China. It is true that China's policy makers have responded by shifting to an emphasis on the domestic economy through expansionary fiscal policy, and moved to some diversification of trade to other countries. But 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 (at less than 4 per cent) is still too small for it to serve as a growth engine on the same scale as the US, which was absorbing around 25 per cent of world imports.

Global trade values decelerated from the middle of 2008 and started falling from late 2008. But what is interesting is that this has reflected declines in both unit values and volumes. In other words, competitive pressures have forced exporting countries to bring down prices in an effort to retain or expand market share, but this has not led to any recovery in export volumes in the aggregate. As a result, trade values are falling even faster than would be determined by the volume index alone. This is significant because it means that developing countries are caught in a double bind, whereby the decline in export volumes affects production and employment adversely, while the decline in unit values of exports cuts the incomes from such exports and has secondary ripple effects on the domestic economy.

Capital flows

One mechanism through which this decline in export unit values has occurred in many developing countries is exchange rate devaluation. This is not the conscious and competitive (beggar-thy-neighbour) devaluation that was associated with earlier global depressions. Nor is it even always justified by the extent of trade or current account deficits of the countries concerned. Rather, in most cases it is an involuntary process reflecting the movements of highly mobile capital, the impact of speculative finance capital flowing back to the US and Europe. And this points to the second major transmission mechanism for the crisis: capital flows, which have shown very sharp reversals away from developing countries. This rapid movement of highly mobile finance capital has been made possible because of policies of financial liberalisation that have been adopted to greater or lesser extent across the developing world. These have made capital markets much more integrated directly through mobile capital flows, and created newer and similar forms of financial fragility almost everywhere. So any global tendency can cause movements of finance in or out of a developing country, even when there is no real change in the “fundamentals” of that economy.

Obviously, the shift of internationally mobile finance capital away from developing countries to the advanced core of capitalism cannot reflect any objective assessment of the relative current and potential future economic prospects of these regions. It is evident that the core economies are even more troubled at present than much of the developing world. But it does point to how imperfect and inefficient the functioning of global capital markets can be.

Of course, this was already evident in the previous boom. The five year period before 2008 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. In the period 2002-2007, the US economy

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received the bulk of financial flows from all other regions (including the poorest regions) of the world, and absorbed around 70 per cent of all global savings.

However, from early 2008 there was a shift in global capital flows. Portfolio investors began repatriating capital back to the US and other Northern markets. This did not reflect a “flight to safety”, for clearly US securities were not that safe anymore either. Rather, it was because of the need to cover losses that were incurred in sub-prime mortgages and other asset markets in the North, and to ensure that the banks and other financial institutions had funds available for transactions as the outbreak of the crisis made bank credit more difficult to access in the US and European economies. This not only reduced capital inflows into developing countries – it also led to sharp falls in stock market valuations. This was especially marked since foreign portfolio investors tend to play a significant role in determining stock price movements in the relatively shallow equity markets of most developing economies. By late 2008, the global credit crunch translated also into a significant decline in bank loans to developing countries, in what has been called “financial protectionism”. The major banks in the US and England, which increasingly came under government control either directly or indirectly, were told to ensure that they lent first to borrowers in the domestic market. As a result, external commercial borrowing by all developing countries as a group actually turned negative in the last quarter of 2008.

The crisis also led to relatively quick reductions in 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. It is worth noting that, 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. To give just one comparison, the total ODA provided to the entire developing world in the past decade is significantly lower than money provided for bailing out just one financial company, the AIG insurance group.

As a result of such movements of capital, exchange rates have depreciated quite rapidly, even in the countries of developing Asia that are more likely to recover faster than the rest of the world economy. Chart 2 shows how both nominal (market exchange rates weighted by trade) and real exchange rates (nominal exchange rates deflated by relative rates of inflation) have moved in the period since January 2007. Nominal exchange rates in Asia as a whole have depreciated quite significantly compared to the peak of July-August 2007 – a decline of 12 per cent over slightly more than a year. Real exchange rates have shown less movement, amounting to 5 per cent appreciation followed by almost equivalent depreciation. These movements may not appear to be large, but in a global context of low and falling tariffs and very low margins in exports, such changes can make a lot of difference to export markets. So developing countries, including those in Asia, face a double challenge as their exchange rates and export volumes collapse together.

Migration and remittances

A major source of foreign exchange that may eventually be 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) declined by around 12 per cent in 2008, and this decline is projected to continue this year. There is also evidence of declining remittances from other countries that relied strongly on them, such as Bangladesh, Lebanon, Jordan and Ethiopia.

However, the pattern is more complex than is often recognised,

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and also depends upon the gender dimension. International migration for work is highly gendered, with male migrants going in dominantly for employment in manufacturing and construction sectors, while women migrants are concentrated in the service sectors, such as the care economy broadly defined (including activities such as nursing and domestic work) and “entertainment”. This affects remittance flows, since the incomes of male migrant workers are more linked to the business cycle in the host economy. Job losses in the North during this crisis have been concentrated in construction, financial services and manufacturing, all dominated by male workers. By contrast, the care activities dominantly performed by women workers tend to be affected by other variables such as demographic tendencies, institutional arrangements, and the extent to which women work outside the home in the host country, and so female migrant workers’ incomes are more stable over the cycle and do not immediately rise or fall to the same extent. So source countries that have a disproportionately higher share of women out-migrants (such as Philippines and Sri Lanka) tend to experience less adverse impact in terms of downturn of remittances. Indeed, in the Philippines, most recent data indicate that remittance flows are still increasing slightly, at an annual rate of around 2 per cent. This does not mean that there will be no impact at all, but the adverse effects will be less and will take longer to work through than if the migration had been dominated by male workers.

It is also intriguing to note that migration may be less affected to the extent that it is undocumented or illegal. Even when labour market conditions in the host economies worsen, such migrants may be unwilling to return home if conditions in their home countries are even worse or if there is little chance of finding a job on return.

Food prices

The recent crisis signalled the end of the commodity boom, which had caused world trade prices of primary commodities to rise significantly between 2002 and 2007. This is bad news for those developing countries dominantly reliant on commodity exports, and good news for commodity-importing developing countries. But the very recent trend did not directly benefit the actual producers. In

2007 and the first half of 2008, there were unprecedented increases 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. Financial deregulation in the early part of the current decade gave a major boost to the entry of new financial players into the commodity exchanges, and allowed unregulated activity in commodity futures markets, which became a new avenue for speculative activity. The result was excessive price volatility displayed by important commodities over 2008 in international markets, not only for food grains and other crops, but also minerals and oil. While speculative behaviour was clearly behind the volatility in commodity prices over the past year, this has not mean that the effects have been confined to financial markets, because these prices directly affect the real economies of developing countries.

The decline in oil prices briefly provided some respite in terms of enabling better inflation control for oil-importing developing countries, although the world trade prices of oil have been rising again recently. But the volatility of food prices continues to have devastating impact. 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. In 2008, the dramatically high global prices of important food items adversely impacted upon national food security for food deficit countries and affected the food security of vulnerable groups within countries. Financial speculation was the major factor behind the sharp price rise of many primary commodities, including agricultural items over the past year. The subsequent sharp declines in prices were also related to changes in financial markets, in particular the need of financial agents for liquidity to cover losses elsewhere. These price changes did not reflect real demand and supply at all, since both scarcely changed over the year. Thus, in 2008-09 global production increased by 5.4 per cent compared to the previous year, while total utilisation increased by only 3.4 per cent (FAO 2009). Global stock holding actually increased during the period that world prices were rising rapidly and then falling.

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Such volatility had very adverse effects on both cultivators and consumers of food. It sent out confusing, misleading and often completely wrong price signals to farmers that caused over-sowing in some phases and under-cultivation in others. Also, while the pass-through of global prices was extremely high in developing countries in the phase of rising prices, the reverse tendency has not occurred as global prices have fallen. Both cultivators and food consumers lost out because of extreme price instability, and the only gainers were the financial speculators who were able to profit from rapidly changing prices.

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 for countries such as Pakistan, Argentina and Ukraine as high as 80 per cent or more (UNCTAD 2008). 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.

Indirect effects

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 (replace word), 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 role of the IMF

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 economic theory. The policies proposed by the IMF were also completely out of sync with the reality of economic processes in developing countries. As a result, the IMF was wrong in almost every emerging market crisis it was 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 it called for larger fiscal surpluses; faced with crisis-induced asset deflation it emphasised high interest rates and tight money policies; to address downward economic spirals it demanded fiscal contraction through reductions in public spending. The countries that recovered clearly did so despite the advice of the IMF, or in several cases because they actively pursued different policies. And the recognition became

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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, recent moves, including by the G20, have once more provided life-support to the IMF. Several governments in core capitalist countries have called for a strengthening of the IMF and have also provided for an additional infusion of funds to enable the IMF to lend more to developing and emerging markets, including on an emergency basis. 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, including Pakistan, Ukraine, Hungary and Iceland. 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, especially because it clearly has very blatant double standards for industrial and developing countries. Contrary to its past prescriptions, countercyclical macroeconomic policy is apparently all right for industrial countries. (IMF 2008:34) 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 and the IMF believes that in developing countries, despite the economic slowdown, there is room for tightening on all fronts, both fiscal and monetary, even in the midst of this crisis. It has already imposed such conditions on the countries which have

approached it for funds, including Ukraine and Pakistan. 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. And over the medium-term, the need is to create a more democratic and less rigid international financial regime.

Part of the problem is that the institutional structure of the IMF and related organisations still reflects imperialist control over the world economy, even though the ground realities are rapidly changing. 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 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 neoliberal economic paradigm that has been dominant for far too long, but also replacing it with more progressive and democratic alternatives.

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II. THE IMPACT ON THE INDIAN ECONOMY

When the global financial and economic crisis erupted in the United States, some mainstream economists and government spokesperson argued that India, along with China, were “decoupled” from the global system and might not be affected. This was based on the belief that India’s recent high growth arose from a low per capita income base and a young population, which meant there was a high participation in India’s labour force and fewer school children and retirees to support. In addition, the “strong” domestic financial sector was also seen to be immune to shocks from the international financial system. However, this argument was wrong, at least partly because it did not correctly identify the causes of India’s previous boom.

The nature of the recent boom

Recent high economic growth in India was related to financial deregulation that sparked a retail credit boom and combined with fiscal concessions to spur consumption among the richest sections of the population. This led to rapid increases in aggregate GDP growth, even as deflationary fiscal policies, poor employment generation and persistent agrarian crisis reduced wage shares in national income and kept mass consumption demand low. There was a substantial rise in profit shares in the economy and the proliferation of financial activities. As a result, finance and real estate accounted for nearly 15 per cent of GDP in 2007-08. This combined with rising asset values to enable a credit-financed consumption splurge among the rich and the middle classes especially in urban areas. And this in turn generated higher rates of investment and output over the upswing. The earlier emphasis on public spending as the principal stimulus for growth in the Indian economy was thus substituted in the 1990s with debt-financed housing investment and private consumption of the elite and burgeoning middle classes. The recent Indian growth story in its essentials was therefore not unlike the story of speculative bubble-led expansion that marked the experience of several other developed and developing countries in the same period.

By the middle of 2008, this process too was reaching its limits. The dependence of GDP growth upon largely debt-fuelled

consumption of a relatively small segment of the population rather than mass demand meant a more limited and ultimately more fragile domestic market. Export growth in software, IT-enabled services and some manufactures remained high but exports were not large enough to counter the domestic slowdown. High rates of investment were driven by expectations of rapid growth of the domestic market as well as very substantial fiscal sops in the form of tax incentives and implicit subsidies, but the latter could not increase beyond a point. As a result, Indian economic growth started decelerating early in 2008, even before the effects of global slowdown were transmitted through sharply declining exports. Real GDP growth, which was 9 per cent in the financial year April 2007 to March 2008, decelerated to 7.6 per cent in both the subsequent quarters. Manufacturing production peaked in December 2007 and fell by 1.4 per cent in the last quarter of 2008-09. So the internal bubble-generated growth process had already begun to slacken when the impact of the global crisis created further adverse pressures.

Changes in the external sector

With the onset of the crisis, one of the routes through which the real economy was affected was a deceleration in exports of goods and services, which had contributed significantly to the earlier boom. Trade to GDP ratios in India increased from 11 per cent in 1995 to 23 per cent in 2006. However, unlike China where much of the export expansion was on account of manufactures, export growth in India was principally due to services. In the merchandise trade area, India's export success was restricted to a few sectors such as garments, chemicals, pharmaceuticals and metals and engineering goods. While the first three categories of exports grew because of dynamism in the global market, the latter two were largely driven by increased demand from China in the period since 2002. In services, however, India became the largest exporter of computer and information services in the international economy in 2005, with a 17 per cent share of world exports (WTO, quoted in RBI 2009). Services in general account for more than half the Indian GDP, and within services, the share of software and IT-enabled services (and the export of such services) has been rising. But such exports were highly concentrated, with 61 per

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cent going to the US and 18 per cent to the UK alone (RBI 2009). Moreover, since the mid-1990s, a rising share of remittances, which was the other major contributor to inflows on the current account of the balance of payments, came from the US, reflecting the growing number of short-term migrants on H1-B visas offering software and IT-enabled services on location. This too could be seen as a form of income from trade in services, largely earned in the US and a few other developed industrial countries

Given these forms of integration through trade, it was only to be expected that the global slowdown would directly affect exports and economic activity in India. Merchandise trade was the first to be affected. Merchandise exports in October-December 2008 were more than 10 per cent lower than their value a year earlier. Import values on the other hand continued to increase, albeit at a slower rate because of falling world oil prices. As a result, the trade deficit for the period from October to December 2008 widened to \$36.3 billion, 40 per cent higher than a year earlier and estimated to be as much as 12.6 per cent of GDP (calculated from data in RBI 2009).

It is true that even though exports of goods declined, exports of services and remittances from Indian workers abroad continued to increase. So, while the trade deficit balance increased to reach 12 per cent of GDP in the period April-December 2008, the total current account deficit was less at 4.1 per cent of GDP. But even this was more than three times the current account deficit ratio of the previous year (Economic Survey 2008-09).

A lag in the effects of the global crisis on net services exports from India was to be expected, given that contracts in software and Business Process Outsourcing services are typically signed for long periods such as two to three years. The effect of the crisis is on the renewal of contracts and the signing of new contracts, and the initial impact on aggregate revenues is lower because of the weight of legacy contracts in the total. The lag is likely to be even longer in the case of remittances because workers who lose their jobs abroad and return home tend to bring their accumulated savings. This windfall effect initially more than compensates for the fall in the remittance flows resulting from lower overseas employment, although eventually such remittances are likely to decline. Already by May 2009, several software and IT services firms in India predicted lower revenue growth, cut back on

recruitment and started laying off workers. Remittance incomes from the US (which accounts for more than 40 per cent of total remittance inflows) are going to be hit by the severity of the recession in the US and recent developments with regard to use of H1-B workers and issue of H1-B visas.

Also, for the first time in two decades, the capital account turned to deficit to around 1.5 per cent of GDP by the last two quarters of 2008-09 (RBI 2009). Investors abroad, who had to meet commitments and cover losses in their home markets, sold out in India and repatriated their capital – as much as \$56 billion net outflow in the period April-December 2008. Foreign banks stopped lending to Indian companies, and even Indian residents took their capital out of India to the extent the regulations allowed. One consequence of the portfolio capital outflow was a collapse of India's stock markets. After the earlier speculation-induced bubble, the reverse tendency of collapse in stock markets was triggered by the exit of foreign investors, who then responded to the stock market decline in a cumulative process. This affected not just stock market valuations but also the external reserve position and the exchange rate. The stock market's woes were associated with greater difficulties faced by corporations in raising money for investment through public offerings of stock. Another consequence of the flight of capital was the rapid and dramatic depreciation of the rupee, by more than 30 per cent vis-à-vis the US dollar in the year to March 2009.

At the same time external commercial lending dried up and even turned negative, reflecting the “nationalist” orientation of lending by supposedly multinational banks of developed countries, which has been evident since late 2008. Even inflows under short-term trade credit declined. This too affected both the exchange rate and domestic credit market conditions. This led to an overall balance of payments deficit for that three-month period of as much as 6.2 per cent of GDP.

The result has been a peculiar situation in the India money market. On the one hand there has been a liquidity trap, such that the credit-worthy investors that banks are willing to lend to have been unwilling to borrow even at low interest rates because of greater uncertainty about markets and economic conditions. On the other hand, small producers and farmers who desperately need working capital and other investment resources have faced a credit crunch

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and found it even more difficult than before to access bank loans.

Employment and prices

These financial conditions have combined with the effects of global slowdown to cause a substantial reduction in the rate of growth and declines in production and employment in certain sectors. By early 2009 the adverse employment effects of the merchandise export decline were evident despite the absence of large survey data on employment. Official surveys have indicated rapid and accelerating job losses in sectors such as textiles and garments, metals and metal products, automobiles, gems and jewellery, construction, transport and the IT/BPO industry (Labour Bureau, Ministry of Labour and Employment, Government of India 2009). While employment declines were predictably higher in the export-oriented sectors, it is noteworthy that these surveys have found growing job losses in activities that cater dominantly to the domestic market as well. In addition to quantity adjustment in the labour market, workers' incomes were also hit, with reports of falling real – and sometimes even nominal – wages of workers in industry and services as well as reduced incomes of self-employed workers who constitute more than half the work force by 2005 (NCEUS 2008).

Agriculturalists, especially those producing export crops whose prices had collapsed, faced growing difficulties on top of their existing financial problems reflecting rising input costs and large burdens of debt. Small scale producers in all sectors are squeezed by the pincer movement of falling demand and credit crunch as even informal sources of credit have dried up. Since these producers account for the bulk of employment in manufacturing and services and typically hire workers on informal casual contracts, their economic difficulties translate directly into reduced employment or falling wages. Surveys of home-based workers reported rapidly declining orders and falling piece-rate wages for work that formed part of wider production chains for both domestic and export markets (AIDWA 2009).

Another important impact of the crisis has been on general living conditions, particular food security of households. While aggregate inflation rates have fallen, , the prices of food and essential medicines have continued to increase. Food prices increased by 8 per cent over

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2008-09, and by nearly 10 per cent in the period January-March 2009, even though aggregate inflation had fallen to 3.2 per cent in those months. Meanwhile unemployment and underemployment have increased, wage incomes have stagnated or fallen and cash crop producers have faced falling prices, reducing the purchasing power for food purchase among ordinary people. Nutrition was already a significant problem especially in rural India and certain backward regions, and this problem has now spread and intensified as a result of rising prices of food and worsening wage and livelihood indicators.

The challenges facing state governments

To a large extent, the worsening condition in terms of provision of basic public services reflects the fiscal crisis of state governments. The central government as well as many states have passed fiscal responsibility legislation that puts limits of 2 per cent of GDP on the fiscal deficit. In the case of state governments, such legislation was more or less forced by the Centre which made it a condition for debt relief, and also limits borrowing by states. However, the fiscal limit of the central government even in the past was generally been honoured more in the breach, through the internationally familiar method of moving several items of expenditure out of the budget, and has been explicitly relaxed during the current crisis.

Unfortunately the state governments do not have similar freedom. The state governments in India's federal system are directly responsible for much of the public expenditure that directly affects citizens, such as on health, education, sanitation and infrastructure such as roads, sewers and commuter transit systems. They have found their tax receipts falling below projections due to the downswing. Since they face hard budget constraints this has constrained their expenditure and reduced essential spending on basic services, not to mention development.

Continuing fragility in the financial sector

It is also worth noting that the global crisis has affected India is its impact on the role played by credit in financing private consumption and investment. Internal financial liberalization in India had resulted

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in a process of institutional change in which the role played by state-owned financial institutions and banks was substantially altered. As regulatory structures for private banks were dismantled over the 1990s, and private banks cornered the most lucrative clients, even public sector banks had to alter their strategies to seek new sources of finance, new activities and new avenues for investments, so that they could shore up their interest incomes as well as revenues from various fee-based activities. So banks linked up with insurance companies and entered other “sensitive” markets like the stock and real estate markets. This led to a relatively rapid transformation of banking in India, with growing exposure of commercial banks to the retail credit market with no or poor collateral, the associated accumulation of loans of doubtful quality in their portfolios, and a growing tendency to securitize personal loans. Rapid credit growth meant that banks were relying on short term funds to lend long. From 2001 there was a steady rise in the proportion of short-term deposits with the banks, with the ratio of short term deposits (maturing up to one year) increasing from 33.2 per cent in March 2001 to 43.6 per cent in March 2008. On the other hand, the proportion of term loans maturing after five years increased from 9.3 per cent to 16.5 per cent. While this delivered increased profits, the rising asset-liability mismatch increased the liquidity risk faced by banks.

These changes were not driven by more credit to the productive sectors of the economy. Instead, retail loans became the prime drivers of credit growth. The result was a sharp increase in the retail exposure of the banking system, with overall personal loans increasing from slightly more than 8 per cent of total non-food credit in 2004 to close to 25 per cent by 2008, with the highest growth in housing loans. A significant (but as yet unknown) proportion of this could be “sub-prime” lending.

These changes in the financial sector point to two further ways in which the current global crisis can continue to affect India. First, the credit stringency generated by the exodus of capital from the country and the uncertainties generated by the threat of default of retail loans that now constitute a high proportion of total advances could freeze up retail credit and curtail demand, as is happening in the developed industrial countries. Second, individuals and households burdened with past debt and/or uncertain about their employment would prefer

to postpone purchases and not to take on additional interest and amortisation payment commitments. Thus, the off-take of credit can shrink even if credit is available, resulting in a fall in credit financed consumption and investment demand. Since growth in a number of areas such as the housing sector, automobiles and consumer durables had been driven by credit-financed purchases encouraged by easy liquidity and low interest rates, this would immediately affect the demand for housing, automobiles and durables. This, in turn would have second-order effects in terms of contracting demand for other sectors and economic activities. As a result, a wide range of industries, services and segments of the labour market are likely to be indirectly affected by the crisis.

A growth slowdown, if it is sharp and severe in terms of its employment effects, could lead to defaults on the accumulated legacy of retail credit. Combined with losses on investments triggered by the growing appetite for risky assets among scheduled commercial banks after liberalisation, this poses a real danger of insolvencies because of an increase in the proportion of non-performing assets in the Indian banking sector.

The government's response

The initial responses of the government focussed on the financial side of the current crisis, with three major components to the first stimulus package adopted in late 2008. These included measures by both the Reserve Bank of India and the government, aimed at reducing interest rates and increasing the access to credit of large and small firms, state governments and individuals. At the same time, access to credit from foreign sources was sought to be enhanced through measures that lifted the remaining constraints on external commercial borrowing. The ceiling on FII investment in rupee-denominated corporate bonds was more than doubled. The slogan appeared to be, "if domestic credit is unavailable or expensive, borrow from abroad." There were also measures aimed at getting state governments and an infrastructure investment fund set up by the central government, the India Infrastructure Finance Company Limited (IIFCL), to borrow more to finance capital, especially infrastructure, expenditure. Finally, there were attempts to spur the demand for automobiles through

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various incentives to buyers and to banks to provide credit for such purchase. So banks and financial institutions were encouraged to lend and different economic actors were invited to borrow and spend. This included borrowing in foreign exchange to finance expenditures in areas like real estate which are unlikely to yield foreign currency revenues that can be used to meet future repayment commitments.

Even if they had worked, such policies would only have strengthened the very same economic tendencies that generated the crisis in the developed countries in the first place. In any case, and perhaps unsurprisingly, by April 2008 it was already evident that these monetary measures all proved to be lacking and did not ease credit conditions in any meaningful way. This was partly because of the liquidity trap characteristics of the situation as the most credit-worthy potential borrowers were unwilling to borrow because of the prevailing uncertainties and expectations of slowdown, and partly because banks also suddenly became more risk-averse. This meant that 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.

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. The real economy is unlikely to be revived through such measures in the absence of a strong fiscal stimulus. It is now increasingly accepted that there is 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 what turned out to be a relatively small fiscal package, involving less than 0.5 per cent of GDP of additional direct public spending. This was combined with various tax cut measures, with estimated revenue losses still less than 1 per cent of GDP.

While the overall fiscal deficit (of central and state governments together) in fiscal year 2009-10 is likely to increase to around 12 per cent of GDP, a large part of it would be the result of tax cuts and subsidies rather than direct spending. There are several problems with relying upon such price-based fiscal measures. To begin with, tax cuts have an impact in terms of supporting economic activity only

if producers respond by cutting their own output prices and such price cuts in turn generate demand responses, or if they enable firms that would otherwise have closed down to survive. But neither is inevitable, nor even very likely given prevailing market structures in India. Across the world, governments are finding that in 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 do not counteract the effect of large losses of export orders as the major markets start shrinking.

Therefore direct public spending would be a far more effective way of dealing with the current slowdown even in India. However, the fiscal stimulus provided thus far has been both too small to have much impact and also not directed towards forms of expenditure that are likely to have high multiplier effects. The two recent Budgets presented by the UPA government (in February and July 2009) have shown that the fiscal strategy is not likely to provide real relief from the crisis to the people. Some of the most critical areas of potential spending have been ignored or neglected in providing budgetary allocations, such as increased resources to state governments, direct investment to ensure mass and middle-class housing, interventions to improve the livelihood conditions of farmers, expansion of the public food distribution system, enlargement of employment schemes and provision of social security.

While monetary policies are not sufficient to address the current economic problems in India, obviously measures to control finance are required, especially to prevent excessive risk-taking that destabilises the real economy. Yet the Indian government appeared to buck the recent global policy trend by moving towards *more* financial deregulation and privatisation of existing public financial institutions. It has announced its intention to increase the sale of public assets, even in these depressed market conditions that will provide very low prices, and also to allow more FDI in insurance, banking and even strategic industries like defence. The strategy seemed to be to once again inflate a credit bubble and attract hot money flows from abroad, so as somehow to prevent growth from slipping sharply. This would be tantamount to generating another speculative bubble to drive the

real economy recovery, regardless of the possibility that this could pave the way for a real financial meltdown in future.

In addition, the government strategy has pushed infrastructural investment financed not only with domestic debt, but also with external commercial borrowing. While infrastructure investment is clearly much needed, relying on external borrowing for such investment not merely adds to the debt spiral, but also involves a currency mismatch, since infrastructure projects do not directly yield foreign exchange revenues and the indirect impact on exports is likely to be positive but difficult to assess. On the other hand, with global interest rates much lower than domestic rates, firms may not adequately take account of exchange rate risks and opt for foreign borrowing whenever available. This could lead to solvency problems if the rupee depreciates sharply, and would strain India's foreign reserve position if the exodus of foreign capital continues.

One of the lessons of the global crisis is that if big financial firms are lightly regulated and permitted to discount risk when seeking profits, then it is likely that the government would eventually have to nationalise them, because letting them fail could have adverse systemic effects. So the neoliberal strategy of deregulation and a minimal role for the state by relying on debt-financed private consumption and investment leads eventually to a crisis-induced retreat from neoliberalism, in the form of nationalisation and state-financed bailouts. As the Indian crisis unfolds, the reliance of the Indian state on encouraging more private debt-financed spending to trigger a recovery is likely to lead to a similar denouement.

An alternative strategy for more sustainable recovery would clearly have to rely on a different basis for future growth. Given that the recent economic expansion of the Indian economy did not provide improved living standards for the bulk of the population, such an alternative strategy seems to be fairly obvious: emphasise wage-led growth, based on fiscal and monetary policies that provide greater stimuli to production for mass consumption in the domestic market. Monetary policy would have to prioritise financial inclusion, in particular enlarging the access of farmers and small producers in the non-agricultural sector to institutional credit and other financial services. In terms of fiscal policy, significantly increased public spending on infrastructure (particularly in rural areas, such as

ensuring universal access to electrification, sanitation and paved roads, for example) and health and education, would not only ease supply constraints significantly but also provide employment with very large multiplier effects. A special package for agriculturalists, to help them cope with the rising costs of cultivation and extremely volatile crop prices, would help stabilise the rural economy. Food grains and essential agricultural commodities procured at remunerative prices should be distributed through an extensive public distribution system at prices that help sustain the minimum required consumption by the poor, so as to ensure price stability without damaging incentives in production, suppressing non-food consumption and worsening poverty. Fiscal measures would also have to provide incentives to shift patterns of both consumption and production to more sustainable directions. Such increased expenditure need not lead to much larger fiscal deficits if the existing loopholes for tax evasion are effectively plugged.

Of course, all this is obviously only possible if the economy is not subject to destabilising flows of capital and sharp fluctuations in imports and exports. A greater degree of management of both trade and capital accounts is therefore a precondition for the successful implementation of such a strategy.

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