INTERNATIONAL JOURNAL OF INNOVATIVE RESEARCH & DEVELOPMENT

ISSN 2278 – 0211 (Online)

US Economic Recession and Lessons for India

Dr. Shefali Dani
Head of the Economics Department
GLS (J P Shah) Institute of Business Administration, Ahmedabad, India

Abstract:
This paper analyses the US economy from the globalization perspective and the lessons it offers for Indian economy. U.S. is one of the world's wealthiest nations, with abundant natural resources, a well-developed infrastructure, and high productivity. Yet, it sparked off global recession due to sub-prime crisis in 2008. Though sub-prime crisis has been often considered to be the reason for global recession, the fact is that the seeds of recession were sowed in early 2000s. Unfortunately, the Indian economy is also radiating the same kind of warning signals. India's current account deficit is increasing; imports are escalating, intensifying inflation, and depreciating currency; these parameters indicate the inherent weakness in the Indian economy. Therefore, the question is how India should deal with the impending economic crisis. Are there any do's and don'ts for Indian economy? More so, are there any measures that can put the Indian economy on the fast track? This paper is not just an attempt to answer such questions but has tried to look into the sector-specific weaknesses of India.

Keywords*: The US Economy, Indian Economy, Deficit, Banking System, Financial System*

1. Introduction

Globalization has squeezed the world and international trade has widened its boundaries. No country in the world can remain aloof in terms of internal demand of various goods. It has to depend for trade, skill, knowledge, financial aid and other elements. Thus any financial happenings in one country will have its effects on the other countries. The most severe effect of recession on any country results into financial crisis and economic recession.

1.1. Overview of US Subprime Crisis

We felt the impact of US economic crisis tremendously in 2008. But this crisis had started taking shape in early 2000s, when the American Financial Policy makers formulated policies on the basis of faulty assumptions (Horwitz, 2000). These assumptions are as under.

- Housing prices would appreciate forever.
- Free and open financial markets would direct funds to the most profitable and productive uses.
- Credit risk can be easily calculated and managed.
- Trade deficits and over consumption are always sustainable.
- Regulatory system for banking and derivate markets is not required.

2. Causes of US Economic Recession

2.1. Weaknesses in financial system and governance

Subprime lending had led to credit crisis and decline in real estate prices. The subprime lending practice is actually a way of giving loans to such people who do not qualify at the market rate of interest due to various risk factors like low income level, employment status, size of down payments made, credit history and so on. This practice began in 1974 by Community Re-investment Act under which banks and non-banking financial organizations were mandated to provide home loans to the lower income people. This activity gained momentum under Clinton and Bush administration whose priority was to provide house at affordable price to all the people.
The US Department of Housing and Urban Development's mortgage policies stoked the trend towards issuing risky loans (Higgs, 2006).

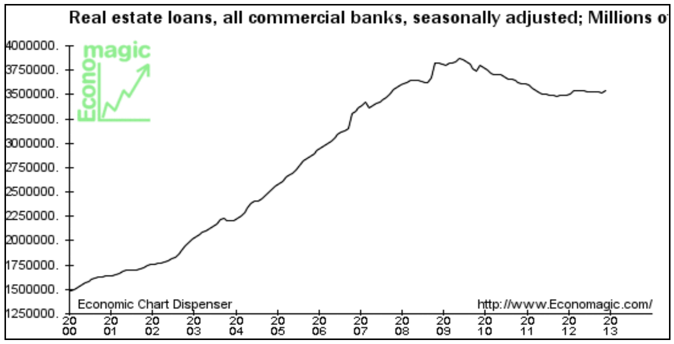

Figure 1

The subprime loans were given to illegal immigrants, jobless persons and people without any asset or income. Such borrowers rarely repaid the loans. The share of sub prime mortgages to total organizations increased from 5% ($35 billions) in 1994 to 20% ($600 billions) in 2006. Again the difference between the prime loan and sub prime loan declined from 2.8 % in 2001 to 1.3 % in 2007. This resulted in the increase in demand for subprime loans.

2.2. Lack of Regulations and faulty financial system

There had been no regulation over mortgage bankers and hedge funds. The mortgage bankers kept lending loan without examining whether borrowers could repay. The use of automated loan approvals allowed loans to be made without appropriate review and documentation. In 2007, 40% of all subprime loans resulted from automated under writing. In addition, mortgage brokers in some cases received incentives from lenders to offer subprime loan to those with credit ratings that merited a confirming loan (Countrywide Extends Its Automated Underwriting System, 2004)

The Federal bank was least concerned about the housing bubble. It is noteworthy that the Federal Reserve contributed to the rise in home prices earlier in the decade by lowering the interest rate. The private banks were in soup when the housing prices started declining and the investors stopped buying sub prime backed securities. This halted the ability of private banks to extend subprime loans.

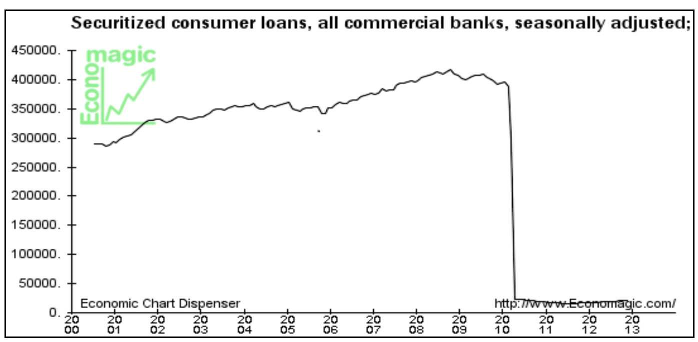

Figure 2

The private banks were simply cash strapped. This resulted into subprime crisis which affected not just the U.S but also the world. Consequently, the foreign investment in such securities started fleeing the country. There was no or relatively little regulatory control over the private banks which formed an important element in the financial system and were later responsible for the crisis (Jeppe Druedahl, 2010)

2.3. Continuing decline in the value of the US dollar in international money market

The fortune of European economies and other developing economies became the misfortune of American economy. Number of events happened simultaneously. Interest rates of other developing economies grew higher. They offered better returns on investment. As a result foreign investors started losing interest in America as the sole investment friendly country which can be seen in the following figure.

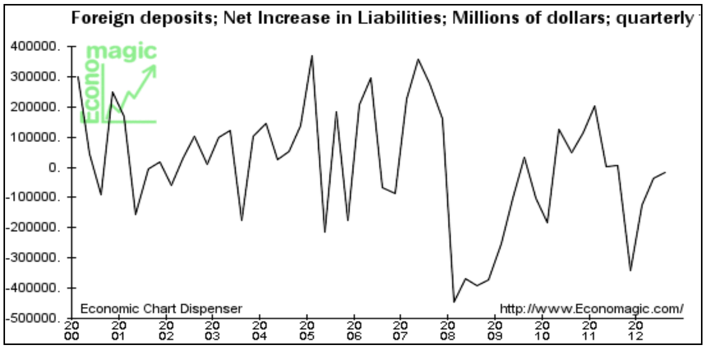

Figure 3

The Euro, which was introduced in 1999 by decade, established itself as the alternative reserve currency for foreign central banks. As a result the demand for dollar decreased (Jeppe Druedahl, 2010).

In the early 2000s, the petroleum prices started increasing. As a result it took more dollars to buy a barrel. This increased the government expenditures. This led the American government to print dollars incessantly which in return increased the supply of dollar. This lessened the value of each new dollar printed.

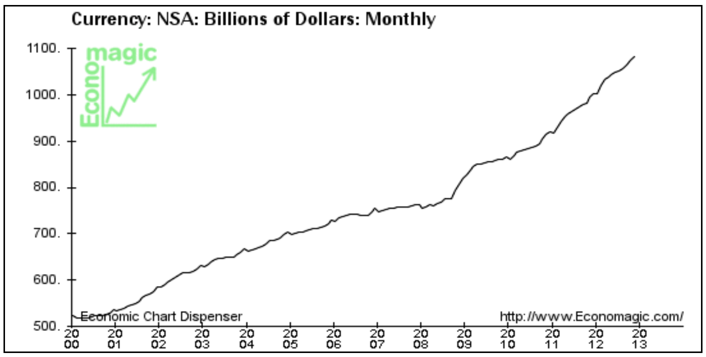

Figure 4

2.4. Current account deficit and inflow of funds

Country's trade and financial transactions with other countries are recorded in the Balance of Payment (BOP) account. BOP consists of two sub accounts. Current account and Capital account. Current account consists of trade balance, while capital account shows capital flow in a country. For every country Current account balance + Capital account balance = 0.

The faulty trade and globalization policies encouraged unlimited imports which in turn increased current account deficit. The steep hike in imports has been due to increased consumption and the policy of out sourcing goods and services to low wage markets (Garrison, 2001).

It can be said that if there is huge current account deficit then there would huge capital inflow in capital account. There were several reasons responsible for huge capital inflow in the US. The US had been conventionally the favorite destination of the foreign investors taking into consideration its global competitiveness and stability. In case of the US, huge current account deficit was financed by inflow of funds from fast growing economies of Asia and oil producing countries. Such inflow of fund resulted into easy availability of credit facility within the country, which triggered housing bubble. Again net capital inflows increase net foreign debt (Tony Lawson, 2009). A rising level of net foreign debt is a warning that the debt could become unsustainable in the future. This happened in the US due to subprime mortgage crisis. Before crisis the US paid more to its foreign creditors than it received from abroad (Garrison, 2001).

3. India on the Path of Bankruptcy

3.1. Weak Financial System

The following are the reasons for deteriorating economic condition of India:

3.1.1. Increase in Fiscal Deficit

The government expenditure over years has exceeded its income. This has resulted into increase in fiscal deficit which can be seen from the above mention figure.

3.1.2. Increase in Non planned expenditure

Increase in fiscal deficit is because of increase in non planned expenditure. There has been a marginal increase in planned expenditure but non planned expenditure is soaring high. It should be noted that non planned expenditure components include interest payment, subsidies and defense. Among these components interest payment eats up the major chunk of non planned expenditure, which is largely due to extensive borrowing from the market, banks and financial institutions, for purposes of development and other needs, and consequent growing burden of debt services. According to 2010-11 budget interest payment was expected to rise to 24% of total revenue expenditure (G. Carchedi, 2010)

3.1.3. Increase in public debt

	1950-51	**2002-03**	**2010-11**
Public Debt	2,054	10,80,300	28,98,799
(a) Internal	2022	10,20,690	27,36,753
(b) External	32	59,610	1,62,045
Other liabilities	511	4,78,600	10,45,799
Total Public Debt & Other Liabilities	2,565	15,58,900	39,44,598

Table 1: Public Debt and other Liabilities of the Central Government (Rs. Crores)
Source: Indian Economy by Datt & Sundharam 63rd Revised Edition

The above mention table shows that the public debt of Indian government has constantly been on rise. In the initial stage the government borrowed for financing development schemes. But now the government is forced to borrow in order to meet its current revenue expenditure (David Colander, 2010)

3.1.4. Devaluation of rupee.

Since 1975, the rupee was depreciating in value because of relatively high rate of inflation within India and consequent decline in the internal purchasing power of the rupee. The depreciation of the rupee in terms of US dollar and other major currencies before 91-92 was due to mounting deficit in India's balance of payments which were worsened by liberal import policy and the devaluation of the rupee forced on India by IMF as one of the conditionality clauses for helping India (Buchanan and Wagner, 2000)

Year	**Exchange Rate**
2002-03	48.39
2003-04	45.95
2004-05	44.93
2005-06	44.27
2006-07	45.28
2007-08	40.24
2008-09	45.91
2009-10	47.41

Table 2: Rupee- US Dollar Exchange Rate (Rupee per US dollar)
Source: RBI, Handbook of statistics on the Indian Economy 2009-10

3.2. Increase in Inflation

Inflation has been a matter of worry for the government of India in the past few years. The range of growth of prices has occurred many times in the past and the Government did manage to control them but this time government has not been able to control inflation and prices are rising unabated. It should be noted that a strong inflationary trend has set into the Indian economy due to collective impact of the following reasons:

The government has adopted the policies of declaring minimum support price to encourage the cultivation of food grains; but such system has resulted in distortion in crop pattern. It is noteworthy that effective minimum support price mechanism is applicable to wheat, rice, and sugarcane. As a result, the cultivation of other agricultural produces like pulses, coarse grains, and oil seeds is by and large neglected. As a result, edible oil, pulses, and many such items have to be imported which adds pressure on the current account deficit. Again, 'price support programmes and control of agricultural prices have generally worked in favor of middlemen and traders and rarely benefiting urban consumers at the expense of the rural folk'(Costas Lapatvitsas, 2010)

Even after sixty years of independence, the government has not been able to develop an effective supply management mechanism. Consequently, Imbalance between ever-increasing demand and inadequately rising supply keeps rising, contributing to spiraling inflation.

The problem of government's inability to curb corruption has increased the flow of black money in the economy. Such amassed black money is used in hoarding and black marketing essential goods like pulses, cereals, edible oils, sugar and so on.

The government makes an immense contribution in furthering inflation. The Government's upward revision of prices such as those of petrol, diesel, coal and so on contribute in spiraling inflation. As a matter of fact, every fresh tax gives the trading class an opportunity to raise the prices; this rise in prices hardly commensurate with the tax imposed (Hayek, 1966)

3.3. Increasing dependence on foreigners by allowing FDI in basic sectors

In the recent years, there has been an added emphasis given to inviting foreign investment in basic sectors. In fact, it is conveniently believed that foreign investment will bring our economic miseries to an end. But this is a very naive assumption. The foreign investment inflows in our country have been highly volatile in nature and are hardly used for industrial expansion. According to R Nagraj in his article Foreign Direct Investment in India in the 1990s: Trends and Issues, 40% of the inflows seem to have been use for acquiring existing industrial assets, and their managerial control. A large number of MNCs are using the route of acquisition of existing enterprises by using foreign fund to enter our country (Hayek, 1975). Again such FDI inflows have been in certain regions only. This has intensified regional imbalance. The smaller projects do not receive a good proportion of FDI inflows. Such trend makes the inflows a not very useful resource. There is also a danger of such inflows being withdrawn at the time of economic crisis (Tony Lawson, 2009).

The government's decision to allow FDI in multi brand retailing will not only destroy our unorganized service sector but also the manufacturing and agriculture sectors. The government's intension to encourage service sector without implementing industrial and agricultural reforms, in the long run will ruin the economy completely (Hayek, 1975).

3.4. External Debt

	1991	**2002**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**
Long term debt	75.3	96.1	108.2	116.3	119.6	144.2	178.7	181.2
Short term debt	8.5	2.7	4.4	17.7	19.5	28.1	45.7	43.4
Short term debt as percentage of total debt	10.2	2.8	3.9	13.2	14.0	16.3	20.4	19.3
Concessional debt as share of total debt (%)	45.8	35.9	35.8	30.7	28.4	23.0	19.7	18.7
External Debt as %of GDP	28.7	21.1	18.0	18.1	16.7	17.5	18.1	20.5
Debt service payments as % of current receipts	35.3	13.7	16.1	5.9	10.1	4.7	4.8	4.4

Table 3: India's increasing external debt is a matter of concern (US dollar, billion)
Source: Indian Economy by Mishra & Puri 28th Revised Edition

On evaluating the above mention table, it becomes known that debt service payments form a big chunk in external debt. The data has another story tell. It shows that the government of India is unable to raise resources from internal sectors. The increased interest payment also indicates that the failure to use the aid in such a way that adequate resources for the repayment of debts are generated. The increased short term debt is indicative of higher imports and lower exports. Such situations result into imbalance in payment – warning signal for the economy (Arnold, 2007).

4. Lessons for India

The ups and down in macro economic variables is a normal phenomena for any country. In case of crisis affected countries GDP rate was high, macro economic variables were in the good position prior to crisis. Due to internal or external forces sudden fall in theses economic variables led to financial crisis. What lessons India should learn from these countries to avoid sudden fall in economic variables or to protect country from crisis that other countries faced?

4.1. For banking sector

The Indian banks are regularly monitored and controlled by RBI. However increase in bank outstanding, credit card outstanding, increase in credit deposit ratio is a future cause of concern and needs attention.

<u>4.1.1. Increase in credit card outstanding</u>

According to RBI data released 86.3% rise in credit card receivables is a cause of concern for bankers. As some banks offering equated monthly scheme to encourage people to spend, banks were liberal in dolling out cards to as many people as possible. Credit card outstanding rose 43.6% in 2007-08 and 87% till May 2008.

<u>4.1.2. Increase in personal loan</u>

The share of Personal loan in total bank loan is nearly 17% in 2008. This personal loan for real estate is estimated to grow by 46.3%. Personal loan also can be used to repay other loans. This leads to fall into vicious debt trap.

4.2. Control household spending

The following chart shows that as personal disposable income increases, household consumption, saving and investment are increasing. Increase in consumption is more in proportion to saving and investment.

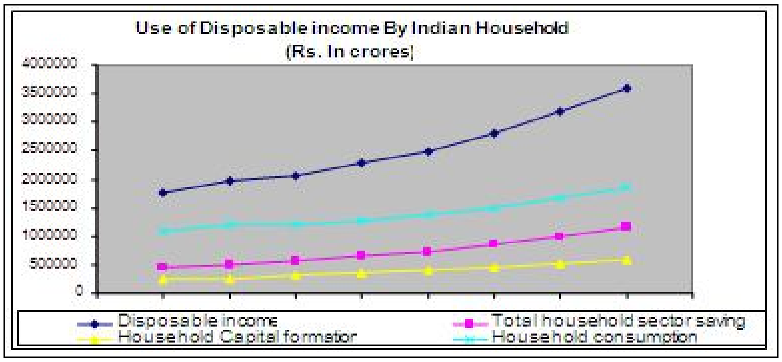

Figure 5

Source: Data from economic survey issues and the graph prepared by the researcher

If people are not encouraged to save and invest, increase in disposable income will increase consumption and prove to be inflationary. This may lead to huge current account deficit, real estate bubble and more outflow of domestic capital in other markets.

The other effect of increase in personal disposable income is loss of government tax revenue. For the development of a country government spending on different projects is increasing which results into huge fiscal deficit. To finance it government has to borrow more. This will increase its public debt.

4.3. Proper surveillance on inflow of fund

As we have seen that the root cause of American crisis was huge inflow of fund which was not utilized in proper manner. In case of India we have seen that fluctuation in inflow has created problem. Of late, the government of India has been encouraging and inviting lots of foreign investment without charting a plan how to utilize the foreign fund. More ever there is no curb over corruption. Under such circumstances too much of dependence on foreign fund will be harmful for Indian economy.

5. Recommendations

- The government should pay attention to power and irrigation sectors on priority base. If this is done only than industrial production and agricultural production will take off. The government decisions to back out from power and irrigation projects need to be reconsidered as it has started affecting industry and agriculture.
- Instead of service sector, agriculture and industry should be given be given importance. However, such encouragement should not be at the cost of any one sector. For instance, fertile land is given away to industry. This should be avoided.
- Incentives should be given to stimulate production of all essential agricultural goods. For that, the system of MSP should be reformed in such a way that no distortion in crop pattern takes place.
- The government should devise such price policy that a consistent relationship between agricultural prices, prices of manufacturers and the prices of various services is well maintained. At the same time, speculation and future trading in essential commodities should be banned. A proper policy framework should be crated to ensure that India becomes food bowl of the world.
- The government needs to curb inflation. Because of rising inflation, consumption of many manufactured goods has declined. As the demand declines, the manufacturers are forced to decrease production as well. Industrial production has also declined due to shortage of raw materials, power, transport, and so on.
- The steep rise in inflation has been largely due to the fiscal indiscipline of the government. The government has always adopted a policy of deficit budgeting, revenue deficit and fiscal deficit. Such policy has actually pushed up prices. The increase in government expenditure has largely been due to agricultural subsidies.
- Such subsidies should be phased out gradually. Populist measures like pay commission, hike in dearness allowances, loan waiver, etc. should be strictly prohibited.
- Tax to gross domestic product ratio should be increased. Huge Employment opportunities should be generated. Labour market reforms should be undertaken.
- Different economic policies are giving an indication of increase in consumption and discouraging saving. From the data of different countries, it is evident that unproductive public consumption is a root cause of precipitating financial crisis. So more thrust should be on individual saving and saved money should be utilized for country's various development projects.
- The government needs money to spend and so it needs to borrow. As we know borrowing can be internal as well as external. External borrowing can create problems as we have seen that it is the root cause of crisis in the countries and it also precipitates huge outflow of money in foreign currency. The internal borrowing is definitely a better option which can be

achieved by promoting and encouraging savings. The money collected should be earmarked only for infrastructure development, the byproduct of this measure is that interest paid on the saving remains in the country. By this government is achieving its goal of infrastructure development and encourage public to save money which ultimately results into reduction in unproductive consumption.

- Personal loan should be given judicially or definite restrictions should be put on personal loan to reduce personal loan outstanding and to curtail unproductive consumption.
- In case of BOP account, policy maker should channelize the capital inflows into productive sectors which contribute to the growth of the economy and productivity.
- Measures should be taken to increase FDI and FII flow with certain regulations in place which will avoid sudden outflow of foreign currency. Thus part of the reserve fund also can be utilized for infrastructure development.
- Current account deficit should be reduced by decreasing imports and encouraging exports.

6. Conclusion

After analyzing reasons for US economic recession, it can be stated that the external as well as internal factors combined together resulted into recession in the country. The American economy suffered more because of rising petroleum prices, strengthening of developing economies which became preferred destinations for global investors, as well as the growing dominance of the Euro which resulted into the weakening of the Dollar. In case of India, the internal factors are more responsible for the impending economic disaster. India as a nation has little contribution to the world economy and so the impact of external economic variables on Indian economy is little. This impending economic disaster can be averted by adhering to financial austerity and abstinence from populist measures by all political parties. If this is done then India shall definitely become the growth engine of the world's economy in the decades to come.

7. References

1. Arnold, C. (2007). Economists Brace For Worsening Subprime Crisis .
2. Beckworth, D. and G. Selgin (2010) 'Where the Fed Goes Wrong: The "Productivity Gap" and Monetary Policy', manuscript, 20 April, http://econfaculty.gmu.edu/pboettke/workshop/ Spring2010/Beckworth2.pdf.
3. Buchanan, J. M. and R. E. Wagner (2000 [1977]) Democracy in Deficit: The Political Legacy of Lord Keynes, Indianapolis: Liberty Fund.
4. Costas Lapatvitsas, Financialisation and capitalist accumulation, Research on Money and Finance, February 2010 Countrywide Extends Its Automated Underwriting System. (2004). Retrieved 2008, from Information week : http://www.banktech.com/data-and-analytics/countrywide-extends-its-automated-underwriting-system-/d/d-id/1289867?
5. David Colander etc "The financial crisis and the systemic failure of academic economics". February 2009
6. G Carchedi, The return from the grave: or Marx and the present crisis, April 2010. M Roberts, The Great Recession, op cit chap 42.
7. Garrison, R. (2001) Time and Money: The Macroeconomics of Capital Structure, New York: Routledge.
8. Hayek, F. A. (1966 [1933]) Monetary Theory and the Trade Cycle, New York: Augustus M. Kelley.
9. Hayek, F. A. (1975 [1939]) Profits, Interest, and Investment, Clifton, NJ: Augustus M. Kelley.
10. Higgs, R. (2006) 'Regime Uncertainty: Why the Great Depression Lasted So Long and Why Prosperity Resumed after the War' in Depression, War, and Cold War: Studies in Political Economy, Oakland, CA: The Independent Institute.
11. Horwitz, S. (2000) Micro foundations and Macroeconomics: An Austrian Perspective, New York: Routledge.
12. Jeppe Druedahl., What is overproduction?, unpublished draft. March 2010
13. Tony Lawson, Contemporary economics and the crisis, real-world economic review, no 50, September 2009