Sub-prime impact on India

*While FDI may not be immediately impacted, the expected increase in cost and access to external credit could drive both investment and growth below trend, says **Alok Sheel***

The collapse of Lehman Brothers and the bail out of Bear Sterns, Merrill Lynch, AIG and housing mortgage majors Fannie Mae and Freddie Mac is but the latest wave of the subprime financial crisis that first hit international financial markets in August 2007. In August 2007, India was on a sustained growth path, close to 9 per cent, the rise in trend growth underpinned by a sharp increase in both domestic savings and investments from under 30 per cent of the GDP to over 35 per cent within a space of five years. Wholesale Price Inflation (WPI) was within the tolerance band of 5-7 per cent. Global optimism regarding India's future growth prospects, particularly that of its burgeoning Information Technology (IT) sector, was generating a tsunami of capital inflows that kept the central bank battling on two separate but interrelated fronts: Mopping up excess dollars to prevent appreciation of the rupee and sterilising the monetary fall out of this reserve accumulation to keep inflation in check.

The sub-prime crisis did not affect India directly. Indeed, the initial expectation was that robust growth in China and India would rescue the global economy as emerging markets had 'decoupled' sufficiently from OECD countries. This resulted in an influx of capital, currency appreciation and a stock market boom. However, once the credit storm in western markets combined with the spike in commodity prices to coalesce into a 'perfect storm' of faltering growth and high inflation, the second round effects appear ominous.

The rise in oil prices dealt a severe terms of trade shock that sharply worsened the current account, increasing India's merchandise trade deficit by 50 per cent in April-July 2008 over the corresponding period last year. Although oil prices are now substantially below the July peak, they would need to fall much further to substantially abate the terms of trade shock in view of the sharp depreciation of the rupee. While the impact of the financial crisis on exports has been relatively muted so far, it must be recognised that while adjustments in the financial sector are immediate, adjustments in the real sector are lagged. It is becoming increasingly clear that the asset wealth loss, including housing equity that was a major source of household demand in OECD countries in recent years, combined with prolonged deleveraging and repricing of risk in international markets is leading to demand destruction in these countries.

Growth in the US has been surprisingly robust so far, registering an annualised expansion of 3.3 per cent in the second quarter of 2008. But this was mostly on account of the surge in exports consequent on the depreciation of the dollar and the fiscal stimulus of $150 billion that counteracted the fall in the household demand. The diminishing US trade deficit is weakening the country's role as a global consumer of the last resort. It now appears that both the Euro area and Japan could be headed into recession by way of collateral damage on account of the credit crunch, falling housing prices and contraction of the US trade deficit and demand. It is these fears that seem to have turned the tide in favour of the dollar and against commodity prices. As the impact of the fiscal stimulus and the resurgence of US competitiveness on account of the appreciating dollar runs out of steam, the decline in household demand and consumer confidence on account of the continuing housing crisis is widely expected to drive US growth lower in subsequent quarters. The real test of the 'decoupling hypothesis' would be if, given the downturn and crisis in the US, Europe and Japan, capital were to flow back into emerging markets instead of the traditional haven, namely US treasuries.

While India is not as dependent on external markets as several other developing countries, notably China, this cannot but have a dampening effect on export growth as the US accounts for 15 per cent of India's merchandise exports (compared to 20 per cent in the case of both Brazil and China), while western Europe accounts for another 23 per cent. The dependence on OECD, and particularly on the US market, and on services exports, through which India mostly plugs its yawning merchandise trade deficit, is even greater. Of India's trade deficit of $90 billion in 2007-08, 40 per cent was covered by IT-related invisibles exports to the US and Europe. While the falling rupee could make non-import intensive Indian merchandise exports more competitive, since banking, financial services and insurance (BFSI) are at the centre of the credit storm in western markets, there is likely to be shrinkage in both job opportunities and export revenues in what is the largest outsourcing vertical of India's IT sector.

The combination of current account and inflationary pressures has put the Indian rupee under pressure since capital flows other than FDI are drying up as a consequence of the credit freeze and repricing of risk in western capital markets. There was a net outflow of $3.7 billion of FII from India during April-August 2008. The reduction in capital flows may have made monetary management easier, but the reduction is so sharp that the rupee is coming under heavy pressure, having dipped below Rs 46 to the dollar, even as RBI's foreign exchange reserves have fallen by $20 billion between March 31 and September 5, 2008. The reversal in FII flows has sharply reduced market capitalisation on account of the stock market's dependence on FII flows. Although the current account deficit is eminently fundable in view of the large stock of foreign currency reserves, rupee depreciation at this point will only feed inflationary pressures. Fiscal pressures have moreover led international credit agencies to consider downgrading India's credit rating from investment to speculative grade. Should this occur, the rupee would come under even greater pressure through rebalancing of currency portfolios.

Savings and investment, widely credited for the rise in trend growth over the last few years, are both likely to be adversely affected. The Economic Advisory Council to the PM estimated in July 2008 that the commodity terms of trade shock could administer an additional fiscal shock of up to 4.5 per cent, thereby sharply lowering savings. Although oil prices have fallen sharply since this estimate was made, this would undo only some of the damage especially in view of the depreciating rupee.

While the domestic savings investment gap over the last few years was modest, ranging from 1 to 1.5 per cent of the GDP, Indian companies and public sector enterprises had become increasingly dependent on cheap overseas finance for investment, possibly as a result of monetary tightening at home and rupee appreciation. External commercial borrowings as a percentage of gross capital formation of the corporate and public sectors rose sharply from 3.2 per cent in 2005-06 to 12 per cent in 2006-07 and is likely to be even higher in 2007-08. The dependence on foreign investment, net of portfolio flows, likewise rose from 2.8 per cent to 6.4 per cent. While foreign direct investment is unlikely to be immediately impacted by the credit crisis, the expected sharp increase in the cost and access to external credit could drive both investment and growth below trend.

The writer is a civil servant. The views are personal