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An Analysis of the Global Recession's Causes and Its Impact on Developing Economies, Highlighting India

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Abstract

World Economies have seen many ups and downs even of very drastic nature in the past for several times Great Depression of 1930s was the worst ever tragedy for many countries of the world. Classical economists and the economic philosophy propounded by them had always been in full support of Laissez-faire policy. Govt. intervention in economic activities was totally refuted, as all the economic activities are self determined, which meant that there had always been all the possibilities of all economic resources getting optimally allocated for different uses, leaving no scope of underutilization or overutilization. Besides, it was also advocated that economy shall be under equilibrium, having no possibility of getting shifted to either side. Production is undertaken as per needs of economy. All the factors are well paid, no possibility of underproduction or overproduction, whatever is produces is sold out. Factors are fully mobile, and shall get shifted as per needs, no chances of business fluctuations and business cycles etc. was the economic philosophy. But this was proved futile by Great Depression of 1930s and the classical economic philosophy miserably failed to analyze the situation and occurrence of this tragedy, which engulfed economies of world countries. Market imperfections brought out the failure of market mechanism as advocated by classical school of thoughts, which had ruled world economy for couple of centuries. The present crisis brought out by global recession in 2007, creating worst impact on developed and developing countries in every segment , has posed various challenges before their economies, making the countries concerned to undertake various measures to fight out the impact of the worst ever recession.

This paper shall make an effort to highlight the basic causes of this worst recession, its impact on Us economy, its impact on other developing countries in general and Indian economy in particular, besides the efforts taken by govt. of India to contain the ill-effects of recession and efforts taken to avoid the occurrences such crisis in future.

Key words - Recession, great depression. Overproduction, laissez-faire policy, market mechanism, fluctuations, liquidity crunch, bankruptcy, sub-prime lending , Ninja Loans, imbalance

Introduction

US Economy has been dominating the economies of all other countries of the world and is treated to be the strongest economy in the world. US $ has been accepted by many countries of the world for their international payments. (Almost 70% international payments are made through US $). With acceptance of globalization by various world countries, especially developing countries, there was huge demand for US $ for international capital investment and payments of international transactions, which caused severe liquidity crunch in US economy in 1980s and 1990s. Burst of IT bubble in 2000 pushed US economy to recession. To bring out the economy form this crisis of recession, Federal Reserve had drastic cuts in interest rates, bringing about large increase in liquidity and money supply in the banks. With very cheap availability of credit, the households, even with very poor creditworthiness, borrowed very huge funds for buying cars and houses. The prices of real estate were sharply increasing, benefitting the households as well bankers as well and they believed that the prices of real estate shall continue to rise. Low interest rates and excess liquidity with banks found a profitable proposition for investment in housing and banks were financing even to sub-prime household i.e. people having no capacity to repay.

Banks were so imprudent and irresponsible that they provided **Ninja Loans** (providing loans to households having no assets and source of income) to many households. Everything went well as long the prices of houses were increasing. House -building was undertaken in excess of requirements in the boom period of 2006, started declining the prices heavily and like burst of IT bubble in 2007, the housing bubble burst in September 2007, leading the country to the worst recession, putting the banking system to huge loss, which brought about mergers, closures of banks and financial institutions, intermediaries, investment institutions and so on. The crisis of US spread out to Europe, Brazil, Japan, China, India and all other countries having ties with US economy.

Basic Causes of US Recession-Leading to Global Recession

Though the global recession is a combined effect of various factors, the beginning was surely in US and later spread over to various countries. Some of the factors responsible for US recession, which later on engulfed other economies of the world countries and led to Global Recession :

1. **Sub-prime Lending & Mortgages** – US Banks lent huge funds to people having meager means or no means and no repayment capacity, were given credit for purchase of houses.
2. **Excessive Leverages** – US authorities had permitted leverage to the tune of 12 times more whereas the financial institutions and banks raised it to 40 times more.
3. **Mismatch of Innovations & Regulations** – The freedom with some regulations was given to banks and financial institutions were misused striking imbalance, exceeding the freedom.
4. **Overvaluation of Assets** – The assets should have been assessed on current prices so as to get the idea of extent of risk to investors and participants, but they were overvalued.
5. **Govt.'s failure to control lending business-** In absence of proper control, the lending business became moving business i.e. buying and re-selling of assets and nothing else.
6. **Complex Procedures & Practices of US System –** Weak underwriting standards, unsound risk management, excessive leverages create complexities and vulnerabilities.

Effects of Recession on US Economy

The banks which had provided loans to the household on sub-prime mortgage sold out the mortgage to other banks and investors through CDO (Collateralized Debt Obligations), making it still complex for rating by Credit Rating Agencies. Mr. Niranaj Rajadhaksha states that due to mixing up of hundreds and thousands of independent loans and improper ratings, rubbish were sold out as good stuff. As a result a huge loss was suffered by banks and investment institutions leading to **severe liquidity crunch** in US economy. Top 5 US investment banks increased their **financial leverage** to cope with IT bubble and hence the liquidity was sucked out of market. The liquidity crunch adversely affected consumption demand and investment in the sector, leading to slow-down of economic growth and drop of GDP which pushed US economy to recession

Top-most institutions like **City Bank** had suffered badly. **Lehman Brothers**, a biggest financial institution operating worldwide was allowed to go **bankrupt** by US Treasury Dept in 2008.

Free Market System, which was adopted by the then president Ronald Reagan i.e. **Policy of Complete De-regulation** has miserable failed because of improper co-ordination between financial institutions, banks, investment companies and the Federal Reserve could not control the sub-prime abuses.

US **Stock Market totally crashed** because of liquidity crunch and fall of Lehman Brothers. No new investment was attracted and the old stock was being withdrawn to a very great extent.

US crisis created adverse effect on **flow of credit**, i**nvestment** and **growth** of US economy. All these adverse effects spread over to other economies of the countries and the crisis of US economy became a global crisis within a very short span.

Impact of Global recession on Indian Economy
Indian economy was opened up to foreign capital and foreign trade of goods and services accepting the policy of globalization since 1991 and hence the economy got integrated to US and European economies. The impact of recession on US & European economies would definitely cause impact on Indian economy as well. Following are the effects of world recession on Indian Economy:

- **Crash of Stock Market –** Indian stock market was steadily growing and once it has crossed Rs.22500/- in BSE and Rs.6500/- in NSE and was quite stable. In the last few years. FII's invested in massive scale in equity shares in consumer goods and infrastructural industries. But this recession made the investors to sell out their equity which crashed the stock market. As much as 60% of foreign investment was taken out, repatriating 13000 $, making RBI to inject 250 billion $ out of foreign exchange reserve with RBI to banking network.
- **Depreciation of Indian Rupee –** Capital outflow on massive scale by foreign investors required conversion of Indian Rupee into US $ and requirement of US $ by RBI to inject Foreign exchange in Indian banks operating with foreign exchange, the demand of US $ had upward push and Indian Rupee had to be depreciated. It was Rs. 39.40 for 1 UD$ in Dec 2007 but shot up to Rs. 50.60 in November 2008. It has crossed Rs. 60/- in July 2013.
- **Liquidity crunch in banking sector –** Larger outflow of money in form of US$ depreciated Indian Rupee. To prevent depreciation of Rupee and keeping exchange rate stability, RBI supplied Dollor to banks out of RBI's stock which created liquidity crunch in Indian banking, even at the cost of stopping inter-bank transactions.
- **Impact of GDP/Economic Growth –** Global recession brought about a severe drop in GDP growth of US economy and economies of several other countries. It was quite likely that India shall also suffer on this ground. It is obvious from the fact that GDP growth

dwindled to 6.8% in 2008-09 from 9.3 in 2007-08. Industrial growth from 9.6 to 3.7, agricultural growth from 4.7 to 1.6 and services growth to 9.3 from 10.7%. Industries suffered due to drop in exports as well as domestic demand as well. Fall in IT (BPO) sector was registered to as much as 60%.

- **Unemployment –** There was very severe impact of global recession on the employment of many sectors in India. IT sector and export sectors had very worst setback. IT sector , which was earning 50Billion $ as annual revenue has fallen by as much as 60%, losing lucrative salaries and job opportunities of young persons. BPO, KPO, Export sector again was worst affected by the recession and as many as10 million jobs were lost in this sector alone.
- **Worst suffered segments of global recession -** Though there is impact of recession **on** almost all the segments of the economy, the worst affected segments are **housing, textile, infrastructure, exports, small and medium enterprises, services** etc. are the segments suffered a worst ever setback of global recession
- **Impact on Foreign Institutional Investments –** The inflow of FIIs had been quite attractive before the crisis. Indian economy was growing with the rate of 9.5, 9.6, 9.3 % in the years 2005-06, 2006-07, and 2007-08 respectively and the net Foreign investment was US Million $ 9332, 6707, 16040 during these years but in the year 2008-09 the growth had dropped to 3.2% and FII went to -8857. That means there was huge withdrawal of investments by foreign investors.
- **Impact on Balance of Trade –** As such India has always been in deficit as far as balance of trade is concerned. Barring few instances, right from 1st plan period the balance of payment has been adverse, as the imports of the country and the value of it has always more as compared to exports. Balance of trade was (US Million $) -46075, -59321, -88535 for the years 2005-06, 2006-07, 2007-08 respectively. But it went to -118401 in the year 2008-09 which was direct effect of the recession.
- **Increase of inflation rate –** The inflation rate is constantly increasing over the period. It used to be 5.5% to 6%. It shot up to 12% or more in all commodity prices and shot up to 17% or more in case of food grain prices. The prices of wheat, rice, pulses, edible oil,sugar are continuously increasing. The prices of vegetables and fruits are sky reaching. There is 500% increase in the price of onions and there is no sign of coming down in near future, inspite of assurances of the govt.

There is no sector of the economy left untouched by the recession and there is severe impact on each and every sector but the worst affected sectors have been highlighted above.

Measures Undertaken by Govt. of India

Indian economy and the financial/banking systems in the country are strong enough, with built in controls, to face any such eventualities. But even then, since the impact of global recession was so strong and almost all the economies, which are tied with US economy, including the economies of even developed countries, came under severe impact of US recession and Indian economy too came under influence with whatever degree of severity.

Govt. of India undertook following measures to contain the impact of global recession on Indian economy.

- Govt. of India, to lift the economy out of the recession, announced a package of Rs. 35000/- crores on 7th December 2008 itself, much before the economy goes under the severe impact. The segments of **Housing, Textile, Infrastructure, Export & Small & Medium Enterprises** were given special packages. I.e.
  * Rs. 4000/- crores were provided to NHB for giving soft loans of 8.5 to 9.25% on housing loans
  * Rs. 1400/- crores were given to Technology Up gradation Fund in textiles.
  * Indian Infrastructure Finance Co. Ltd authorized to raise Rs. 14000/- crore through tax free bonds. IIFCL was also authorized to raise Rs. 100000/- crores for highway sector.
  *Announced a fiscal package of 2% interest subsidy on interest rate on exports.
  * Guarantee cover of 50% on Rs. 50 lakh to 1 crore for SMEs.

* RBI Cut the Repo rate to 5.5% and CRR also to 5.5%, in order to boost the investment.

* RBI gave Rs. 5000/- crores to Export-Import Bank, to boost the exports by giving some

benefits to the exporters

- Reality Companies have been allowed to borrow from overseas to help realit6y sector
- India Infrastructure Finance Co. Ltd (IIFCL) allowed to raise Rs. 30000/- crores from tax-free bonds to boost infrastructure. NBFCs can from overseas for infrastructure projects.
- The ceiling on Foreign Institutional Investment(FIIs) has been increased from 6 Billion $ to 15 billion $ in order to make more funds available for corporate bonds.
- Depreciation benefit on commercial vehicles has been increased from 15% to 50% on commercial vehicles, buses for urban transport shall get one time funding.
- Excise duty slashed from 10% to 8% on 24th February 2009 and reduction of 2% service tax.

Conclusion

With these measures, Govt. of India tried its best to keep controls on recession, but miserably failed to contain the sky reaching inflation, especially in food grains and vegetables. The depreciation of Indian Rupee is continued uninterruptedly. The foreign trade deficits, especially on current account, are souring. Unemployment is increasing. FII is getting reduced. Fresh investments are not coming. These are the challenges before the country which requires immediate attention.

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