Variorum, Multi- Disciplinary e-Research Journal
Vol.-01, Issue-IV, May 2011

Global Crisis and the Indian Economy

Dr. S.N. Raut : Associate Professor & Head,Deptt.of Com.Shri Shivaji College,Akola (M.S)

Abstract

The paper tries to argue that terms such as "recession" and "crisis" are blown out of proportions in the current context. First, it simulates alternative growth scenarios for major sectors and demonstrates that industrial recession of some kind would not affect the overall growth prospects as long as the service sector does not shrink substantially.

Second, it reiterates the point that local bubbles may not be contained without adverse exogenous shocks. Excessive liquidity may generate bubbles, distort real rates of return and may damage efficient allocation of capital. Thus recession driven withdrawal of liquidity may bring such returns in line with the fundamentals.

Third, it tries to make the point that a substantial part of the working population, around 90% is absorbed outside the formal or the organized sector. It is essential that one looks at the impact of the slowdown on the informal economy.

Introduction:

Indian Economy in the context of the ongoing and possibly weakening global recession. If the industrial sector has to be the true culprit for a disastrous impact of GDP growth, and then should have a substantial recession in the industrial sector, which is impossible. Since the shares are likely to change drastically, service sector growth rate holds the key for overall response. If one traces the movements of stock prices and real estate market, it would be hard not to appreciate the existence of price bubbles. Only in very recent times our investment rate crossed over the 30% mark while over the last decade the stock market has grown by leaps and bounds. Whether future earnings per share are rightly predicted by current movement in stock prices is a simple exercise to check for unaccounted for exuberance. It is a well known fact that the annual inflation in housing market for quite a few years has been way out of line with the average inflation rate.

Section I

Till 2007-08 the Indian economy has witnessed a rising and high rate of growth of GDP, which has slowed down in the year 2008-09 due to global financial crisis. What started off as US subprime lending crisis in the US housing market turned into a global financial crisis and then to a global economic crisis. Though the developed countries like Japan, US and UK, due to this global financial crisis are witnessing recession in their economies, India is witnessing a positive and significant growth rate although lower than 9%. Rate of growth of GDP in 2007-08 was around 9% and it was around 7.8% in first half of the year 2008-09. But the third quarter of 2008-09 has registered a growth rate of 5.3% as unveiled by the Central Statistical Organisation (CSO). Agricultural sector has registered a negative growth rate of –2.2% and manufacturing growth rate contracted to –0.2% in the third quarter. But agriculture has done well in last two years. Services sector registered 9.3% growth rate, which is a very small change from what it has registered in the second quarter. Different sectors have been impacted differently by the recession. In the popular media and policy circles industrial recession has been hailed as the true

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signal of crisis. However a given decline in GDP growth rate can be decomposed into alternative sectoral growth rates. We consider alternative scenarios to overall argue that GDP growth rate is likely to be pretty insensitive to industrial recession.

Agriculture and Allied Activities

In the year 2007-08 the farm sector comprising of agriculture, forestry & fishing, registered a growth rate of 4.5 percent. Economic Advisory Council to the Prime Minister estimated it to be around 3 percent in the year 2008-09. But in the third quarter of 2008-09 it has contracted to 2.2%. In the past, crisis in agrarian economy had hit hard the economic growth; as a result India witnessed some of its bad years. However, as share of agriculture in GDP dropped over time, bad impact in this sector did not affect the overall GDP growth that much. Looking at the past data on rate of growth of agriculture, we can observe that the rate has been fluctuating to a large extent and in many years it had registered negative growth rate. For last couple of years the rate of growth averaged 4 percent. Its share in GDP has been falling over the years and this is due to relatively higher expansion in other sectors.

Industry

GDP in the industrial sector averaged 8 percent in the year 2007-08 and declined to 5 percent in the first quarter of the year 2008-09. The Index of Industrial Production (IIP) registered a negative index in the month of October 2008. The global economic crisis had its adverse effect on industrial sector especially in manufacturing, mining and electricity. In fact in the third quarter of 2008-09, manufacturing growth rate contracted to –0.2%. Dampened demand, funding constraint and uncertainty surrounding the crisis have adversely affected Indian corporate margin & business confidence and thus growth.

Services

This is the most important sector for Indian economy as its share in the GDP has been rising significantly since 1950-51 and currently its share in the GDP is averaged 63 percent. This sector comprises of trade, hotels, transport, storage, communication, financing, insurance, business services, real estate, community, social and personal services and construction. In the fiscal year 2007-08 this sector has registered a growth rate of 10.7 percent, which has come down to 9.3% in the third quarter of 2008-09 and the relative difference is very small. This decline is due to falling growth rate of construction, trade and hotels. But there is a rapid increase in the growth rate of community, social services & personal services, which has posted a robust growth rate of 17.3 percent against 5.3 percent in the same period a year ago. Financing, insurance, real estate & business services also grew at a high rate of 9.5 percent. Therefore it can be said that it is the service sector, which is giving major boost to the economic growth of our country.

Section II

Existence of bubbles is difficult to trace and estimate. Yet few will disagree that bubbles are realities both in the sphere of capital market as housing market. A general proposition concerns the movement in real rates of return for specific assets in a regime of excess growth of liquidity beyond a long term trend. Over the last decade there has been huge accumulation of foreign exchange reserves and consequent growth in money supply, sometimes more than 20% per annum (RBI sources). While it is more or less confirmed that over the long run growth of money supply matches inflation rate and thus real rates should be similar across sectors, there can be significant short-term anomalies where returns may diverge substantially.

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Section: III

This section tries to find an aggregative relationship between the formal and the informal segments of the Indian economy. Preoccupations and possibly obsession with the GDP growth often undermine certain salient features of our economy. These features have to be kept in perspective while evaluating the impact of global recession on the economy and its constituents. Let us highlight such features.

A. Agriculture commands 20% of GDP, provides occupations to 60% of population primarily engaged in farm and non-farm rural sector.
B. More than 90% of total work force around 360 million are employed in the unorganized sector characterized by all or some of the following features – unrecorded, unorganized economic activities, non-compliance with labor and other regulations, highly dependent on relatively unregulated markets, no access to formal credit markets etc.
C. Some and possibly a large number of such activities may not be linked to the contracting traded sectors. Although a recent UNCTAD report suggests thatexport sector does accommodate a significant number of informal workers.

Conclusions:

When whole sale prices were up by around 15% housing prices were higher by around 50% annually at least in the metropolitan areas. The demand for housing was also fueled by bank credit with entire banking sector disbursing a significant proportion of credit to the mortgage market. Was the rising price a true reflection of "real" activities? Is real return of around 35% to 40% reflective of true profitability of the sector? These are issues one has to confront. If there is bubble and excess liquidity either through foreign capital inflow and windfall gains in stock markets and strong credit infusion from the banks have been fuelling a bubble, what can be reasonable way out? This brings us to the issue of sectoral repercussion of monetary policy and capital inflow. Sectoral bubbles will distort relative prices and induce further accumulation in the inflated sector. If the forces within the economy are not adequate to control for the artificial rise in prices, external shocks become essential to restore the balance.

The impact of the so-called recession on the informal sector of the economy which absorbs around 90% of the total work force. The transmission effect from the rest of the world becomes weaker if a large part of the economy remains insulated from external shocks. It is overall well recognized high growth since the 1990 has benefited the skilled segment of the economy to a grater extent relative to the unskilled sector. While the effect on poverty and low income group has been more or less positive, it goes without saying that, the "non-traded" segment of the economy provides jobs to millions of people and such a segment is possibly doing well. For example while wholesale prices went on a downward spiral, consumer prices have explained healthy inflation rates. Rural farm and non-farm sector, which provide income to 60% of population, have not done badly given a reasonable growth in agriculture.

ISSN 0976-9714

Variorum, Multi- Disciplinary e-Research Journal
Vol.-01, Issue-IV, May 2011

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