HOW TO GAIN FROM AMERICAN CRISIS

Bharat Junjhunwala

Deputy Governor of Reserve Bank Dr Rakesh Mohan is a worried man these days. Speaking at the International Monetary Fund in April, 2007 he expressed concern that US subprime loans crisis could lead to problems for India's exporters: "The current slowdown has been triggered by the adverse development in the subprime segment of the housing sector... The trouble in the subprime sector could permeate into other segments of the housing sector. In such a scenario, consumption demand, which has been steady thus far, could get affected." Another concern of his is that Europe and Japan must make up for the slack in the world economy due to the decline in American fortunes. Mr Mohan is unable to break the shackles of US-oriented growth that India has followed till recently. Basically, decline of America is beneficial for India. Indian effort should be to break the US economy so that India's weight increases quickly and strongly. The slack left by America should be taken by India. It is sad, therefore, that Mr Mohan is lamenting that America is not able to consume more of India's resources and Europe and Japan, rather than India, should rise to stabilize the world economy. It is indeed unfortunate that wise men are lamenting that Western countries are not doing enough to keep Indians poor!

The origins of present crisis lie in the bursting of the dot.com bubble in 2002. World capital abandoned the US dollar and started flowing into Euro and Yen and Rupees and Renminbi just as water finds other channels if the main river course is obstructed. The American economy should have gone into a recession then because its buoyancy was dependent on continued inflows of world capital. That decline did not happen, however. The US Federal Reserve Board cleverly increased the rate of interest payable on US Treasury Bills while providing incentives for giving loans in the housing sector. This had twofold effect on the US economy. The increase in interest rates on T-Bills led to continued inflow of world capital into the US. On the other hand, people were lured by cheap domestic interest rates into borrowing for buying a house. This led to increased demand in the housing sector and propelled the US economy for nearly five years.

There are limits to enjoying good life by taking loans, however. American companies were burdened with high interest rates. They became uncompetitive in the global markets. But this was not visible because global capital was flowing in and new houses were being built in the domestic economy. But the day of reckoning had to come. Slowly the US dollar declined and the purchasing power of US consumers was eroded. They had to spend more for imported clothes and food and had less money left to make loan payments. In the result, one-fourth of all poorer borrowers in Detroit are in default. 10,000 out of 84,000 single-family houses in Cleveland have been seized by the banks and are lying vacant.

American Banks suffered heavily. They place the property loans given out by them in a CDO (collateralised debt obligation). This CDO is sold to other banks much like Indian Banks secure refinance from SIDBI or NABARD against loans given to Small Scale Industries and farmers. In this way the tendons of the property loans permeate the entire world banking system. No wonder, shares of major bank Bear Sterns have fallen 28 percent, Royal Bank of Scotland 21 percent, Deutsche Bank 18 percent, Citibank 14 percent and so on.

The question for India whether these problems will lead to less demand for Indian products in the developed countries and exodus of foreign investors from equity markets. In all probability it will not happen. Rather this crisis will be beneficial for India just as problems of the British during the Second World War became beneficial for India.

India's weight in the global economy increases in tandem with decline of the US. India will provide a better attraction than the US. A trader does not load his goods in a sinking ship. Thus private investors have virtually stopped investing in the US economy. Most capital inflow into the US is today coming from developing country governments of China, India and oil-rich West Asian countries. There are limits to how far these developing countries will hand out their economic sovereignty to the US on a silver platter. Thus, the flow of world capital will increasingly be towards India, not away from it. But there may be temporary hiccups. The decline in Indian share markets is of this nature. But the Sensex has nearly touched 16,000 after the banking crisis has unfolded in the US. Tendency of the banks is to look inwards in times of crisis just as a tortoise clams up when in trouble. But it does not stay that way for a long time. This holds for the world capital as well. Soon they will have to decide where to put their money. India will shine and US will sink in this assessment. Thus the flow of capital to India should soon pick up again.

The second route of impact of this crisis on India's economy is through reduced exports. True Indian exports to the US will suffer because American consumers have lesser purchasing power to buy Indian goods. But that does not mean that total exports will be affected. America is presently paying for imports from India with the money obtained from the Reserve Bank of India from the sale of US Government Bonds. Money is coming back as payment for exports. This money can be invested by Reserve Bank in South Africa or Brazil or Indonesia. These countries will then be in a position to import Indian goods. The net impact is that Indian exporters will only have to change the direction of their exports to countries that gain from the US crisis.

Wise economists like Mr Rakesh Mohan should reconsider their US-centric approach. They seem to believe that collapse of the US will lead to collapse of the world economy. Nothing like that is to happen. Just as collapse of the Dutch and Portuguese in the eighteenth century and collapse of the British in the twentieth century did not lead to a collapse of the world economy so also the collapse of the American economy now. There is no reason to fear the fallout from the US crisis.

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