American Crisis and India

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There is concern in the investing community about the recent swings in the share markets. Question is whether the decline seen in mid-January will deepen? The basic reason for the decline is crisis in the US economy. Indian and American economies are interlinked in two ways-through trade in goods and flow of capital. The demand for Indian exports declines as the American economy sinks. But India certainly gains from cheaper imports in the same measure. Garment exporter suffers because his orders are cancelled but software engineer makes merry because he gets Windows software cheap. The combined effect of exports and imports on the economy is nearly *zero*. However, share markets respond to the woes of exporters who are listed on the bourses and not to the gains of consumers. Thus there is a negative impact on Indian share markets although there is little impact on the economy.

The interlinkage through capital flows is tricky. There is an outflow of capital from India in the short run as the American economy sinks but there is greater inflow towards India in a long term. Global Banks incur losses as troubles of the American economy deepen. Loans given by them to American homeowners are not repaid. They have to resort to sale of shares in the Indian markets to raise money to meet these losses in the US. The decline in Indian share markets in the last two weeks started with such a sell off by foreign banks.

But the long term impact on Indian share markets is entirely different. Till recently the US economy was considered a "safe haven' by global investors. This confidence has been shaken by a steady decline of the dollar in the last two years. Investment in that economy has now become very risky. The interest earned on US Treasury Bonds is wiped out by the capital loss accruing from decline of the dollar. Till few years ago black money was flowing from India to the US because dollar was rising. Now the opposite is taking place. The Government of India is concerned that global black money is being invested in Indian share markets. The recent clampdown on Promissory Notes was made to prevent such inflows. The decline of the dollar has forced global investors to look for another place to invest their capital. The Saudi royal family, for example, is earning huge amounts from the sale of oil due to high prices that are prevailing. Till recently they were investing this income in New York. But this will now flow to Mumbai and Indian share markets will glow. Remember the Indian share markets have been scaling new heights as the US economy has been sinking in the last two years. Surely, Indian share markets jitter every time bad news comes from America.

The question is whether the American crisis has seen its worst or it will deepen? The US Federal Reserve Board has cut the interest rates by a steep 0.75 percent on January 22. There is an expectation that the US economy will stabilize as a result. Will such measures succeed? It is unlikely. They do not remove the basic weakness of the American economy.

The first weakness is in the service sector. Previously the US was leading in software production and new designs etc. This supremacy is now being challenged by Indian companies like TCS, Infosys and Wipro. Many leading companies are transferring their Research departments to India because wages are low here. Similar trend can be seen in many areas like clinical trials, translation, architectural designing, telemarketing and publishing and printing. This weakness can only marginally be managed from devaluation of the dollar. It is rooted more in the moribund nature of the US education system.

The second source of weakness is in the auto loans and credit cards. Another crisis like that in the subprime housing sector is in the making. The present troubles started here. The US Federal Reserve Board encouraged people to take loans to buy houses. The consequent demand from the housing sector kept the US economy chugging for about three years. But the borrowers could not repay their housing loans because of decline in salaries and wages due to international competition. The loans went into default. Banks seized the houses but had to sell them at much lower prices and had to book huge losses. A similar crisis is in the making in the auto loans sector. Car majors are extending loans to borrowers. The loans backed by security of an automobile are considered 'safe' much like a subprime housing was considered safe. The borrowers are likely to default on these auto loans and also credit cards just as they did on housing loans.

The third source of weakness is high oil prices. Americans love big and fast cars. They have to import huge quantities of oil to keep them running. This is a big drain on the American economy especially in view of the rising oil prices. The American economy is more energy intensive than, say, India. They consume more oil per dollar of income generated. Consequently, high oil prices have a greater negative impact on that economy. The adverse impact on India is reduced for another reason. The oil-rich Arab countries are making grand projects like hotels on artificial islands. The manpower for these projects is supplied in large measure by India. These workers send remittances back home. Thus part of the money spent by the world in buying Arab oil flows to India. The negative impact of high oil prices is partly cancelled by remittances for India but not for America.

The fourth source of weakness is the expenditure that country has taken upon itself by acting as the global policeman. The US is incurring huge expenditures in wars in Iraq and Afghanistan. There seems to be no end to these in sight.

For one thing US economy will continue to decline for the next decade or so because that country lacks awareness of the depth of these problems. The long term decline of US economy will be reflected in the rise of India. However, the decline of the US economy is likely to take place in sharp spurts like one witnessed last week. One may see decline in the Indian share markets during such short term events. But this will be followed by a long term rise much like the mountaineer climbs down into a valley only to scale a yet higher peak. □□□