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The Global Economic Crisis and India: An Analysis (ARI)

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Theme: The unfolding global financial crisis comes in various forms and presents many challenges as well as opportunities, even though it is too early to predict any specific outcome. However, the fact remains that the international system and the concept of power as such is undergoing a shift. This has serious implications for the developing world. The financial crisis presents India in particular with several geopolitical implications.

Summary: Saying that economics and politics are intertwined may be a cliché, but the current global financial crisis brings us face to face with it. The financial crisis experienced by the international system today will have serious geopolitical implications. It has brought in new players like India and China. However, the extent to which the challenges engendered by the crisis can be converted into opportunities by a country like India remains to be seen.

Analysis:

Introduction

Banking and financial crises have been a common phenomenon throughout the modern economic history of mankind. Since the great depression of 1929, the world has witnessed hundreds of such crises and the frequency of the crises has increased over time. According to a World Bank study of 2001, there were as many as 112 systemic banking crises from the late 1970s until 2001. Most of them, including the current one, have shared some common features: they each started with a hasty process of financial sector reforms, which not only created a vacuum in terms of regulations but also deteriorated the basic economic fundamentals though massive inflows of foreign capital and finally ended up with a change in investor expectations and a consequent mess in the financial markets. The financial sector crisis that arose in the latter half of 2007 and was precipitated by the collapse of Lehman Brothers on 23 September 2008 shared most –if not all– of these features. However, what makes the current crisis exceptional is that it broke out at the very epicentre of global capitalism and its contagion spread very quickly to the entire globe. India, being an integrated part of the global economic order, was also exposed to the adverse impact of the global economic crisis.

The Crisis and India

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The impact of the global crisis on India can broadly be divided into three different aspects: (1) the immediate direct impact on its financial sector; (2) an indirect impact on economic activities; and (3) potential long-term geopolitical implications. Fortunately, India, like most of the emerging economies, was lucky to avoid the first round of adverse affects because its banks were not overly exposed to subprime lending. Only one of the larger private sector banks, the ICICI, was partly exposed but it managed to counter the crisis through a strong balance sheet and timely government action. The banking sector as whole maintained a healthy balance sheet and, over the third quarter of 2008 –a nightmare for many big financial institutions around the world–, India's banks reported encouraging results and witnessed an impressive jump in their profitability.

However, the indirect –or second-round– impact of the crisis has affected India quite badly. The liquidity squeeze in the global market following Lehman Brothers' collapse had serious implications for India, as it not only led to massive outflows of Foreign Institutional Investment (FII) but also compelled Indian banks and companies to shift their credit demand from external sources to the domestic banking sector. It thereby exerted pressure on domestic market liquidity, thereby giving rise to a credit crunch. Coupled with the ensuing loss of confidence, this increased the risk aversion of Indian banks, hurting credit expansion in the domestic market.

Additionally, given the recession in the developed world, the demand for Indian exports in their major markets has almost collapsed. Merchandise exports shrank by more than 17% from October 2008 to May 2009. The decline in exports has accelerated, with a drop in May 2009 of 29.2% compared with May 2008. Likewise, exports of services are also facing a steep downturn. In the third quarter of 2008-09, growth in services exports declined to a mere 5.9%, compared with 34% in the same period a year back. Earnings from travel, transport, insurance and banking services have contracted, while the growth of software exports declined by more than 21 percentage points. The real shock came in the fourth quarter of 2008-09 when services exports contracted by 6.6% over the same period a year back.

The impact of the global crisis on the real economy became evident in the second half of 2008-09 when, giving the lie to optimistic official pronouncements, the Indian economy grew by a modest 5.8%, significantly below the 9.0% recorded in the same period of 2007-08, and after having achieved GDP growth of 7.8% in the first half of 2008-09. At the sectoral level, robust growth in community, social and personal services (up 17.5%) and financial, real estate and business services (up 8.9%) enabled the services sector to maintain healthy growth despite the sharp decline in trade, hotel, transport and communication services. The secondary sector in general and the manufacturing sector in particular performed extremely poorly. In the wake of a decline in domestic and export demand, the manufacturing sector contracted by 0.3%, while growth in construction slowed down significantly from 8.3% to 5.5%.

The geopolitical impact, which is likely to be the most significant for India, is still unfolding. With the global financial crisis as a backdrop, there is a growing sense of insecurity in the international system. Predictions that point to an increase in conflicts over the world, particularly over resources, are being made repeatedly. With the onset of the financial crisis, roughly a quarter of the states in the international system are already experiencing low level instability, such as government changes. Destabilisation could be one of the most severe spill-over effects of the global financial crisis for developing countries. The likely effect could be that many sectors in developing societies will receive fewer funds, leaving local governments to re-think the allocation of resources between health, education, economic development and other areas. This will inevitably create growing disparities, tensions and unrest, all of which could be aggravated by problems related to corruption and poor governance. The prevailing food crisis could lead to an even more serious effect of the financial crisis.

Thus, as these scenarios make clear, the crisis is creating new flash points for unrest and conflict. Furthermore, as a result of financial constraints the deployment of peacekeeping operations is already being hindered and is likely to become even more of a burden –making it a low priority for the US, EU, NATO and UN–. In such a situation, the image of a more unstable –almost Kaplanesque– world is starting to grip the imagination of many.

The economic crisis currently facing the world will have the greatest toll on countries that are already at the limits of economic endurance. There could be an increase in what are termed ‘failed’ and ‘failing’ states, along with greater possibilities of radicalisation in the international system, combined with an expansion of conflict zones in various parts of the world. Although this might suggest an extremely grim scenario, the fact is that India’s neighbourhood is one of the most susceptible to it.

In any case, India has long-standing border disputes with at least two of its neighbours in South Asia –Pakistan and China– and faces the threat of militant terrorist organisations operating from Pakistani territory. Furthermore, Bangladesh, another of India’s South-Asian neighbours, is suspected of being a shelter for militants who have repeatedly caused extensive damage in India. Therefore, although India has escaped the financial crisis without much damage, it can be argued that because of its geopolitical location in South Asia, the consequences of the global financial crisis could become severe.

It is useful to look at China to understand what the geopolitical implications of the global financial crisis could be for India. Even though China has US$2 trillion in foreign currency reserves at its disposal, the global financial crisis has caused widespread poverty, unemployment and inequality. China’s growth was largely due to the Open Door Policy initiated in 1978, as a result of which it became the manufacturing platform of the world. China largely depends on exports for its growth, making the maintenance of high growth levels one of its foremost foreign policy priorities. Chinese exports mainly go to the Western World, primarily the US and the EU. However, given the global financial crisis, demand for Chinese goods in the US and EU has severely declined, hitting the manufacturing sector of the Chinese economy in a drastic manner. Unemployment is one of China’s chronic maladies, and is at present so severe that predictions suggest that it could even lead to the collapse of the regime if the problem is tackled not in a timely and appropriate manner. This would have a serious impact on India, which requires a stable China in the region, as it could lead to political instability, growing radicalism, widespread migration, changing demographic trends and a deteriorated economic partnership between India and China.

Besides the threat of a regime change in China, the probable effects of the global financial crisis in Asia could include perceptions of renewed energy scarcity. This could lead countries to take action to ensure their future access to energy supplies. In a worst-case scenario even interstate conflicts would be possible, although action short of war would also have serious geopolitical implications. Maritime security concerns have lead to naval build-ups and modernisation efforts, such as the development in India and China of blue-water naval capabilities.

With respect to Pakistan, political instability and turmoil in Pakistan have always resulted in an adverse impact on India. Terrorism has always been a major hurdle in the bilateral relations between the two states. The repercussions of the Mumbai terror attack have still to be settled. The current civilian government in Pakistan is in its infancy and terrorism is one of its most critical challenges.

According to several analysts, Pakistan is one of the best examples of a state where economic pressure is feeding unrest and threatening the government. Growth has stalled, while food and fuel prices have risen drastically, classic ingredients for radicalisation. Besides, Pakintan's external sources of finance –foreign aid and remittances– are now under considerable pressure.

Apart from this, another source of concern regarding Pakistan is its border with Afghanistan. The global financial crisis has made the US less keen to intervene militarily, having an effect on NATO's current operations in Afghanistan as well as on the future of the alliance. In any case, the financial crisis has serious implications for the Afghanistan-Pakistan strategy because of the simple fact that the financial crisis will absorb a significant share of steadily decreasing resources for a considerable time in the near future. Thus, tackling terrorism in the face of a global financial crisis, with reduced aid from the US, could have grave implications for India. A stable and democratic Pakistan is in India's interest. The economic problems arising from the crisis could lead to funds being diverted from the fight against terrorism to providing temporary relief to Pakistan's citizens. However, should the Pakistani government not come to the rescue of its citizens its legitimacy would be undermined and a power vacuum could ensue in which elements detrimental to Indian interests might arise, such as another military dictator.

Similarly, Bangladesh needs foreign direct investment (FDI) of up to 28% of its GDP, which is almost US$415 billion every year to reduce poverty in the country.[1] However, FDI is likely to slow down considerably. Likewise, foreign aid from the G-7 countries is likely to dwindle. India faces similar threats of a radicalisation in Bangladesh, that could lead to the growth of militancy in India's North-Eastern territories. In any case, the separatist United Liberation Front of Asom (ULFA) is suspected of using Bangladeshi territory as a haven. Increasing militancy is a direct outcome of greater poverty and unemployment, and the worsening of either in any of India's neighbours will have adverse effects on India itself. The flow of illegal migrants from Bangladesh to the states of the North-East in general and Assam in particular has been a burning political issue in the region. Faced with a negative economic scenario the number of people migrating could drastically increase, leading to huge backlashes and undermining the North-East's already fragile political stability.

Democracy in Nepal is at a very early stage of development. The present state of economic hardship, in which the population is desperate for –even radical– solutions, the Maoists have a prime opportunity to increase their political clout in Nepal. Should this occur, China's influence in Nepal's internal affairs would increase, with long-term economic and strategic implications for India, given Nepal's historical role as a buffer state.

[1] See B.H. Rashid (2008), 'How Does Global Financial Crisis Affect Bangladesh', *www.sydneybashi-bangla.com/.../Harun_Global%20financial%20crisis%20and%20*.

Hence, what is required at this juncture is a very high degree of collaborative engagement between the major states of the world and the region to tackle these multiple crises, even though domestic preoccupations might seem to demand more attention at this time.

However, the implications of such a scenario in India's neighbourhood are not altogether negative. Among other things, such a scenario creates a larger strategic space and India will have more room for manoeuvre in managing its relations with a more diverse set of powers, and with a greater flexibility than before.

It is in India's interest to encourage the trend towards a more diffuse and diversified international order. This, in any case, fits in well with India's preferences for a multi-polar world, including a multi-polar Asia. India's efforts should thus concentrate on building coalitions with other powers who share the same objectives. This basically means that a more energetic pursuit of relations with countries like Russia, Brazil, South Africa and Mexico is in India's best interests. The EU and some of its individual members, like France, could be useful political and economic partners for India.

In Asia, India needs a deeper engagement with Japan and Indonesia, and the cultivation of a more nuanced diplomacy towards China. Chinese and Indian positions on multilateral trade, climate change and several other global issues are similar. However, there are competitive aspects between the two countries as well, which have to be managed with prudence and firmness. Thus, India needs to go beyond the defensive and survival-first strategies that currently dominate its thinking.

At least for some time to come the impact of the global financial crisis will be a diminished market overseas, as a result of the revival of protectionism. Similarly there will be reduced prospects for attracting investment inflows from major capital-exporting countries. The cumulative effects of all these phenomena will be the destruction of employment and a rise in poverty within India itself. However, the government is using both fiscal stimuli and an easy monetary policy to prime the economy. Schemes like the National Rural Employment Guarantee Act (NREGA), which lead to both asset creation and employment generation in rural areas, provide a safety net for the rural poor.

Amidst the unfolding global financial crisis, India held its 15th Lok Sabha elections, which resulted in the triumph of the Congress and its allies, who together won 262 of 543 seats. The people of India showed their faith in the Congress, leading Manmohan Singh to his second term of office as Prime Minister.

Although the exact reasons of the Congress's victory remain a matter of political debate, it is clear that amidst the uncertainties prevailing in the international and domestic economy and polity, the masses voted for stability and continuity. Manmohan Singh played an instrumental role as Finance Minister in rescuing India from the BOP crisis in the early 1990s and the voters seem to have put their faith in his government to tide the country through these troubled times.

Moreover, the 'Look East' policy that India had been following since the 90s finally culminated into something specific with the signing of the India-ASEAN Free Trade Agreement. This is a step in the right direction as only a diversified range of trade partners can help the country mitigate the risks associated with international trade.

Given the global financial crisis, India faces both opportunities and challenges. For instance, it could exploit the opportunity created by the crisis to consolidate its economic interaction with its neighbours. Without a politically stable and economically prosperous neighbourhood, India will find it difficult to foster its regional and global interests. As the economic crisis hits India's more fragile neighbours –such as Bangladesh, Pakistan, Sri Lanka and Nepal– it could push for a South-Asian Economic Recovery Initiative, which could lead to a higher degree of economic integration and cooperation in the region.

Conclusion: India's geopolitical location is such that the financial crisis presents it with many challenges as well as opportunities. The extent to which India will be able to tackle the challenges and make the most of the opportunities is impossible to predict at present. At this juncture, India needs to think unconventionally to deal with an unconventional crisis. It must take care of not just its domestic affairs but also those of its neighbourhood to be able to implement its growth and development policies. The expectations of a G-2 world order comprising the US and China has raised concerns in India, but the fact remains that a solution to the global financial crisis cannot be reached without taking India on board. India is the most successful example of a democracy in South Asia and is an Asian giant in its own right. Thus, what it now requires, at a time when power shifts are likely, is to employ its strengths in making the most of the crisis to be able to not just emerge from it unharmed, but also to acquire a geopolitical standing which will enhance its world position in the near future.

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