1 THE THEME OF THE REPORT

Genesis and the Nature of the Crisis

1.1 The world economy experienced a sustained period of growth with only moderate fluctuations coupled with low inflation, a phenomenon popularly termed as the 'Great Moderation' till the precipitation of the recent global crisis. This prolonged period of macro-economic stability was essentially attributed to efficiently functioning markets and the benefits of globalisation. However, what remained hidden within these overall signs of prosperity were the immensely complex financial systems and the systemic risks they entailed due to the policy of 'benign neglect' followed by authorities. In addition, some structural imbalances had also developed in the world economy in terms of mismatches between savings and investments and production and consumption across nations that manifested in the widening current account imbalances in some part mirrored with surpluses in others, misalignment in exchange rates and booming asset prices. These developments had to unwind at some point of time and when the unwinding began, they manifested themselves in the form of the worst ever global financial crisis since the 'Great Depression' of the 1930s.

1.2 The speed and intensity with which the US sub-prime crisis that appeared in mid-2007 transformed itself into a global financial crisis and then into a global economic crisis has attracted the attention of all. In the postmortem analysis, a number of micro and macroeconomic factors have been listed in the literature as the proximate causes of the crisis – role of easy money, financial innovations and global imbalances on the one hand to regulatory loopholes both at the national and global level on the other. At the fulcrum of the crisis was too much of leverage. Easy credit combined with under-pricing of risks both by the households as well as financial intermediaries created bubbles in real estate, energy and other sectors that had to face a disorderly unwinding. The recent crisis has necessitated the need to revisit the global regulatory and supervisory structures and perimeters against the backdrop of rapid financial innovations. The analysis of the various causes of the crisis has evolved a whole new debate on the relevance of various economic tenets and has challenged the economic doctrine that assumed the self correcting mechanism of the markets. There is also a view which holds responsible the policy frameworks and growth strategies pursued by economies in the various regions.

1.3 A comparison of the recent crisis with the various episodes of crises in the past reveals that some semblance can be found amongst them with regard to the underlying causes. As in the past, the main causes of the recent crisis are linked to systemic fragilities and imbalances that contributed to the inadequate functioning of the global economy. Leading up to the crisis, these factors became more pronounced due to major weaknesses in financial regulation, supervision and monitoring of the financial sector and inadequate surveillance and early warning. These, together with over-reliance on market self-regulation, overall lack of transparency with distorted incentive structure led to excessive risk-taking, unsustainable high asset prices, irresponsible leveraging and high levels of consumption which were fuelled by easy credit and inflated asset prices. In terms of impact, however, the recent crisis seems to be more widespread than many other previous episodes and is considered to be closest to the Great Depression of the 1930s. The estimates of output loss place this crisis above most of the episodes in the past with majority of the advanced and emerging market economies facing the downturn as a result of the rapid transmission of the crisis from the epicenter to the periphery. In fact, the same forces of globalisation and international finance that had led to developments in poorer countries over the past decades also carried with them the seeds of contagion, which resulted in the international transmission of shocks.

1.4 As a result, the so-called 'decoupling theory' which was in full force just before the recent crisis, came under question in an increasingly interdependent world. The crisis that emerged in the US spread to other advanced economies quickly and at a later stage spread to emerging and developing economies through various channels - financial, trade and confidence - despite their relatively sound macroeconomic fundamentals and policy frameworks. Thus, the established views on the efficiency of markets and the role of public policy both came under severe criticism, which posed new challenges for the discipline of economics. More fundamentally, the old debate on the 'role of finance in economic growth' has again come to the centre stage, while the potential costs and benefits of financial globalisation have become the focus of policy discussions in international fora. At the same time, the adequacy and efficacy of the current international financial architecture to prevent and manage global crises has resurfaced again.

Manifestation of the Crisis

1.5 Almost all segments of the global financial markets experienced tremors of the financial crisis, though at variant degrees. Interbank markets in advanced economies were the first to be affected with severe liquidity crisis as banks became reluctant to lend to each other on fear of counterparty risks. Subsequently, the crisis spread to the money markets as manifested in abnormal level of spreads, shortening of maturities, and contraction, or even closure, of some market segments. In the wake of credit and money markets witnessing a squeeze and equity prices plummeting, banks and other financial institutions experienced erosion in their access to funding and capital base, owing to accumulating mark to market losses. Stock markets in EMEs, on the other hand, bore much of the heat of the crisis as equity markets all over the world witnessed high volatility, and suffered sharp decline in prices and turnover. Commodity prices, which reached record highs during the initial stages of the crisis witnessed a sharp reversal in trend since the collapse of Lehman Brothers in September 2008. The depth and spread of the crisis can be gauged from the successive revisions in the estimates of write-downs, decline in trade and finally the contraction in economic activity.

1.6 In the backdrop of large scale disruptions in international financial markets and deteriorating macroeconomic conditions, financial institutions also suffered significantly. Commercial banks suffered from decline in profitability and large mark to market losses. The crisis almost sidelined the investment banking industry, while the financial performance of the monoline insurers and hedge funds were impacted severely. The banking systems of emerging market economies, on the contrary, showed relative resilience during the crisis on account of their limited exposure to the toxic assets and the regulatory and supervisory measures taken to strengthen their balance sheets in the aftermath of the East Asian crisis.

1.7 The increasing globalisation and trade integration have brought enormous economic and financial benefits to the EMEs, but have also widened channels through which a slowdown in economic activity in advanced economies could spread to the EMEs. Initially, it appeared that EMEs were better positioned to weather the storm created by the global financial meltdown on the back of substantial foreign exchange reserve cushion, improved policy frameworks and generally robust banking sector and corporate balance sheets. However, any hope about EMEs escaping unscathed could not sustain much after the failure of Lehman Brother in September 2008 and ensuing rise in the global risk aversion; EMEs were also adversely affected by the spillover effects of the macroeconomic turbulences created by global financial meltdown. The EMEs were affected through contraction in world trade especially during the second half of 2008. Net private capital flows to EMEs also reversed reflecting global deleveraging and risk aversion on the part of investors, which led to tightening of external financing conditions. Finally, their growth was also impacted.

International Responses to the Crisis

1.8 The crisis evoked unprecedented policy responses, both domestically and internationally. Amidst the deteriorating global financial environment, the authorities, particularly in the advanced countries recognised at an early stage that they needed to respond bravely and act swiftly. The national Governments and central banks in several countries resorted concomitantly with a variety of both conventional and unconventional policy actions to contain systemic risk to shore up the confidence in the financial system and arrest the economic slowdown. The policy responses-regulatory, supervisory, monetary and fiscal during the crisis have been unparalleled in terms of their scale, magnitude and exceptional coordination across various jurisdictions. The responses included varying combinations of monetary and fiscal measures, deposit guarantees, debt guarantees, capital injections and asset purchases, which were coordinated globally.

1.9 Monetary authorities in the industrial world were the first to take a plunge by resorting to an aggressive monetary easing; so much so that policy rates reached to record lows. To contain the crisis of confidence and ease financial conditions, central banks ventured even further by using their balance sheets in unconventional ways. The governments across the countries responded by way of massive bail outs and capital injections to resolve the problem of insolvency and stabilise the financial system. The unprecedented scale of economic slowdown accompanying the financial crisis also led to activation of counter-cyclical fiscal policy of magnitudes, least seen in the past.

1.10 As the crisis unfolded, the resolution mechanisms that came to the fore had to contend with new and complex web of financial world involving credit default swaps, special investment vehicles and hence differed radically from the responses undertaken in the previous such episodes. Supervisors and standard setting bodies around the world increasingly got engaged in strengthening the standards governing bank capital, liquidity, risk management, incentive compensation, and consumer protection, and so on. The emphasis on scaling up the supervision with greater macro prudential focus, through enhanced consolidated supervision and the development of new supervisory tools began gathering momentum.

1.11 Although advanced countries turned their policy attention on restoring normalcy and strengthening financial regulation/ supervision and EMEs began dealing with the collapse of trade and the capital outflows, restoring growth emerged as the common thread of policy response among both the categories. It was for the first time that EMEs turned out to be active partners in finding meaningful resolution mechanisms to a global problem. A distinguishing feature of the current financial crisis is that despite being global in nature, there appears to be a clear divide between the advanced countries and the emerging market economies (EMEs) in terms of impact and policy responses. For advanced countries, the policy priority has been to strengthen financial regulation and supervision. In the EMEs, dealing with the collapse of trade and the outflow of capital occupied the policy attention.

1.12 The forceful and coordinated policy actions have been successful in extinguishing the initial damages and averting a global financial collapse. Although the policy responses could avoid the worst financial and economic outcomes, the policymakers and academia are still grappling with the design and conduct of appropriate policies to arrest the possibility of such events in the future. Moreover, the unconventional measures, while helping in stabilising the financial system, have posed several challenges and risks.

1.13 More recently, in the wake of the financial stress triggered by Greece, comprehensive support measures have been announced focusing on preserving economic and financial stability within the Euro Area. The belief that sovereign states can borrow without any limits has been once again called into question after the problem in Greece. This is a reminder that fiscal space is finite and cannot be extended indefinitely. It is being now realised that the Euro Area has to supplement its strict entry norms regarding fiscal discipline with continuous fiscal surveillance so as to detect vulnerabilities well in time.

Impact and Policy Responses in India

1.14 Until the emergence of global crisis, the Indian economy also passed through a phase of high growth driven by domestic demand - growing domestic investment financed mostly by domestic savings and sustained consumption demand. In fact, consumption and saving are well balanced. Services sector, led by domestic demand, contributed to the stability in growth. Concomitantly, inflation was also generally low and stable. This overall improvement in macroeconomic performance in India was attributed to the sequential financial sector reforms that resulted in an efficient system of financial intermediation, *albeit* bank-based; the rule-based fiscal policy that reduced the public sector's drag on private savings; and forward looking monetary policy that balanced the short-term trade-off between growth and inflation on a continuous basis, while also pursuing the objective of financial stability. Additionally, the phased liberalisation of the economy to trade and capital flows along with a broadly market driven exchange rate regime enhanced the role of external demand in supporting the growth process, simultaneously exposing the economy to the forces of globalisation. In the process, India became increasingly integrated with the world economy and maintaining financial stability assumed importance in the hierarchy of public policy; in fact, it emerged as an important objective of monetary policy in India even before the current crisis. This is evident from the counter-cyclical monetary policy and macro-prudential financial regulations that were in force during the boom phase just before the crisis.

1.15 In these circumstances, the Indian economy benefited from global integration and had also exhibited remarkable resilience to various adverse external developments – the east-Asian crisis (1997-98), the dot.com crisis (2000-01), *etc.* However, during the current global crisis, India was impacted like most other emerging markets, despite hardly any direct exposure to the troubled assets in the epicenter of the financial crisis. In fact, the contagion spread through all the channels – trade, finance and confidence.

1.16 During the initial phase of the crisis, the impact on the Indian financial markets was rather muted. In fact, banks dominated the financial system and their negligible engagement in the off-balance-sheet activities and illiquid securitised assets, which remained at the heart of current global financial crisis in advanced economies, protected India from early turmoil in international financial markets. Nonetheless, India could not remain unscathed and the global developments affected the financial and real activities in the second half of 2008-09. India's financial markets - equity market, money market, forex market and credit market - all came under pressure from a number of directions.

Lessons from the Crisis and Future Challenges

1.17 Several lessons could be drawn from the crisis to identify the future challenges in the global financial system. A number of important issues have emerged relating to the prevention and management of crises which allows us to draw relevant lessons for both market participants and policy makers. The analysis of underlying factors – whether macroeconomic or microeconomic in nature - responsible for evolving and intensifying the crisis - raises issues about the role of public authorities, *viz.,* central banks, supervisor/regulators and governments in safeguarding financial stability. The crisis has certainly doubted the efficacy of the existing institutional framework and available policy instruments at the national as well as international levels in ensuring global financial stability.

1.18 It also raised questions on the functioning of financial markets and institutions, in particular their capacity to price, allocate and manage risk efficiently. Thus, the lessons to be drawn from the recent crisis are not only manifold but also for a diverse set of authorities entrusted with the task of maintaining financial stability being most applicable for the advanced economies besides a broader relevance for EMEs. Looking ahead, devising a calibrated exit from the unprecedented monetary accommodation globally, which has already started in some countries, is one of the most important challenges. In this context, the timing and the amount of reversing become very important.

1.19 It is not yet known whether the business cycle synchronization that was evident just before the crisis and monetary policy synchronization that emerged in response to the crisis, will give way to similar synchronization in the exit strategies. It is therefore timely to reflect upon the global crisis - the past, present and future – to make an objective assessment of its impact on the Indian economy and to draw policy lessons to ward-off any recurrence of crisis like situation in future, and in the event of a crisis to deal with it more effectively. Accordingly, the theme of this Report for 2008-09 has been titled as “Global Financial Crisis and the Indian Economy”. The Report undertakes an in-depth analysis of causes and consequences of the crisis, compares and contrasts the present crisis with past crises, analyse the effectiveness of the conventional and unconventional policy responses to the crisis at the global level. From the Indian perspective, the Report covers in detail the manifestation of the crisis in India, the nature of policy responses undertaken and their impact in limiting the adverse impact and the broad lessons that emerge from the crisis at the domestic as well as international level.

Chapter Scheme of the Report

1.20 The Report includes seven chapters including this one. Chapter 2 titled “Genesis and the Nature of the Crisis” traces the genesis and nature of the crises which has affected both the developed, emerging and developing world over the last century and a half, when they have often arrived with fierce force and departed with important lessons for the policy makers. This chapter discusses the causes of the current financial crisis while simultaneously highlighting the debate as it has evolved on the various contributing factors of the crisis, besides covering the crisis in a historical perspective by giving a comparison between the present crisis with the earlier episodes of crisis of similar nature. The Chapter also covers the genesis of the recent crisis in Greece.

1.21 The chapter 3 on “Manifestation of the Crisis” attempts at analysing the impact of the crisis on the various sectors of the global economy, such as financial markets, financial institutions, international trade, international capital flows, remittances and the real economy.

1.22 The chapter 4 on “International Responses to the Crisis” discussed the measures taken by the international community during the present financial crisis against the backdrop of the conventional crisis management strategies. The chapter also provides the policy responses to financial crisis in a historical perspective. The monetary policy and the fiscal policy responses along with the issues on fiscal monetary coordination are covered. The responses from the multilateral institutions are also presented. The actions taken relating to financial sector policies to reduce the chance of recurrence of financial crisis of such a magnitude are elucidated in the chapter.

1.23 After discussing the genesis, manifestation and policy responses of the crisis in the global context in Chapters 2,3, and 4 respectively, the next two Chapters 5 and 6 cover impact of the global financial crisis on the Indian economy and the policy responses of the authorities. In Chapter 5 on “Impact and Policy Responses in India: Financial Sector”, the impact on the India’s financial sector is analysed in detail. In the following Chapter 6 on “Impact and Policy Responses in India: Real Sector”, the impact on the real sector of the Indian economy through trade, services, capital flows are analysed.

1.24 In examining the impact of the financial crisis on the financial sector, the Chapter 5 analyses the evolving global integration of the Indian economy through trade and financial channels over the years. The impact of the crisis on various financial markets and respective policy measures has been delineated. The spillover effects travelling to the banking sector, mutual funds and non-banking finance companies and policy measures to counter their impact have been examined in detail. The policy responses to the crisis by the Government of India and the Reserve Bank are also discussed in the chapter.

1.25 Chapter 6 covers the impact through trade and capital flows channel, which finally penetrated into the real sector of the economy. In this chapter, a perspective is given on various channels of transmission of global shocks to the real sector. The analysis of the impact emanating from trade and financial channels are discussed elaborately and ultimately the impact on the saving, investment and growth are covered in the chapter.

1.26 The Chapter 7 on "Lessons from the Crisis and Future Challenges" draws lessons from the crisis to identify some of the future challenges. The chapter covers lessons for the central banks, for the financial regulation and supervision, for fiscal policy and for the international policy coordination followed by the role of international financial institutions. Issues coming out of global imbalances and macroeconomic management are also covered in this chapter. Finally, this chapter brings out the lessons and challenges for EMEs and India.