India - Managing the Impact of the Global Financial Crisis*

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Introduction

1. Less than a year ago, much of what has happened in the Indian economy since last October would have been hard to anticipate. I recall, around this time last year, the most frequently asked questions (FAQs) were, what are the factors that put India on a high growth trajectory and what can we do to remain there? Today, the FAQ is, when and how do we get back on to the high growth trajectory? The sharp turn around in the FAQs summarises in a nutshell the impact of the global financial crisis on India.

Global Outlook

2. The global economic outlook deteriorated sharply over the last quarter. In a sign of the ferocity of the down turn, the IMF marked down, yet again, its estimate for global growth in 2009 to a range of (-) 1.0 to (-) 0.5 per cent, the first global contraction in 60 years. With all the advanced economies – the United States, Europe and Japan - having firmly gone into recession, the contagion of the crisis from the financial sector to the real sector has been unforgiving and total. Recent evidence suggests that contractionary forces are strong: demand has slumped, production is plunging, job losses are rising and credit markets remain in seizure. Most worryingly, world trade – the main channel through which the downturn will get transmitted on the way forward – is projected to contract by 2.8 per cent in 2009, the fastest pace of shrinkage in the last 80 years.

3. Policy making around the world is in clearly uncharted territory. Governments and central banks across countries have responded to the crisis through big,

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aggressive and unconventional measures. There is a contentious debate on whether these measures are adequate and appropriate, and when, if at all, they will start to show results. There has also been a separate debate on how abandoning the rule book, driven by the tyranny of the short-term, is compromising medium-term sustainability. What is clearly beyond debate though is that this Great Recession of 2008/09 is going to be deeper and the recovery longer than earlier thought.

Decoupling Hypothesis and Emerging Economies

4. Contrary to the 'decoupling hypothesis', emerging economies too have been hit by the crisis. The decoupling hypothesis, which was intellectually fashionable even as late as a year ago, held that even if advanced economies went into a downturn, emerging economies will remain unscathed because of their substantial foreign exchange reserves, improved policy framework, robust corporate balance sheets and relatively healthy banking sector. In a rapidly globalising world, the 'decoupling hypothesis' was never totally persuasive. Given the evidence of the last few months – capital flow reversals, sharp widening of spreads on sovereign and corporate debt and abrupt currency depreciations - the 'decoupling hypothesis' stands invalidated. Reinforcing the notion that in a globalized world no country can be an island, growth prospects of emerging economies have been undermined by the cascading financial crisis with, of course, considerable variation across countries.

Questions to be Addressed

5. India too has been impacted by the crisis, and by much more than we had earlier thought. Against this background, what I propose to do is to address the following questions:

(i) Why has India been hit by the crisis?

(ii) How has India been hit by the crisis?

(iii) How have we responded to the challenge?

6. The answers to the above three questions form the basis for the fourth, and perhaps more important question.

(iv) What is the outlook for India?

Why Has India Been Hit By the Crisis?

7. The ferocity with which the global crisis hit India dismayed many. And this dismay stems from two analytical strands.

8. The first analytic goes something like this. The Indian banking system has had no direct exposure to the sub-prime mortgage assets or to the failed institutions. It has very limited off-balance sheet activities or securitised assets. In fact, our banks continue to remain sound and healthy. So, the enigma is how can India be caught up in a crisis when it has nothing much to do with any of the maladies that are at the core of the crisis.

9. The second reason for dismay is that India's recent growth has been driven predominantly by domestic consumption and domestic investment. External demand, as measured by merchandise exports, accounts for less than 15 per cent

of our GDP. The question then is, even if there is a global downturn, why should India be affected when its reliance on external demand is so limited?

10. The answer to both the above causes of dismay lies in globalisation. Let me explain. First, India's integration into the world economy over the last decade has been remarkably rapid. Integration into the world implies more than just exports. Going by the common measure of globalisation, India's two-way trade (merchandise exports plus imports), as a proportion of GDP, increased from 21.2 per cent in 1997-98, the year of the Asian crisis, to 34.7 per cent in 2007-08.

11. Second, India's financial integration with the world has been as deep as India's trade globalisation, if not deeper. If we take an expanded measure of globalisation, that is the ratio of total external transactions (gross current account flows plus gross capital flows) to GDP, this ratio has more than doubled from 46.8 per cent in 1997-98 to 117.4 per cent in 2007-08.

12. Importantly, the Indian corporate sector's access to external funding has markedly increased in the last five years. Some numbers will help illustrate the point. In the five-year period 2003-08, the share of corporate investment in India's GDP rose by 9 percentage points. Corporate savings financed a little more than half of this, but a significant portion of the balance financing came from external sources. While funds were available domestically, foreign funding was perceived to be less expensive than domestic financing. On the other hand, in a global market awash with liquidity and on the promise of India's growth potential, foreign investors and lenders were willing to take risks and finance investment in India. Last year (2007/08), for example, India received capital inflows amounting to over 9 per cent of GDP as against a current account deficit in the balance of payments of just 1.5 per cent of GDP. These capital flows, in excess of the current account deficit, evidence the importance of external financing to the corporates and the depth of India's financial integration.

13. So, the reason India has been hit by the crisis, despite mitigating factors, is clearly India's rapid and growing integration into the global economy.

How Has India Been Hit By the Crisis?

14. The contagion of the crisis has spread to India through all the channels – the financial channel, the real channel, and importantly, as happens in all financial crises, the confidence channel.

15. Let us first look at the financial channel. India's financial markets - equity market, money market, forex market and credit market - had all come under pressure from a number of directions. First, as a consequence of the global liquidity squeeze, Indian corporates found their overseas financing drying up, forcing corporates to shift their credit demand to the domestic banking sector. Also, in their search for substitute financing, corporates withdrew their investments in domestic money market mutual funds (MFs); consequently, non-banking financial companies (NBFCs) where the MFs had invested a significant portion of their funds came under

redemption pressure. This substitution of overseas financing by domestic financing brought both money markets and credit markets under pressure. Second, the forex market came under pressure because of reversal of capital flows as part of the global deleveraging process. Simultaneously, corporates were converting the funds raised locally into foreign currency to meet their external obligations. Both these factors put downward pressure on the rupee. Third, the Reserve Bank's intervention in the forex market to manage the volatility in the rupee further added to liquidity tightening.

16. Now let me turn to the real channel. Here, the transmission of the global cues to the domestic economy has been quite straight forward – through the slump in demand for exports. The United States, European Union and the Middle East, which account for three quarters of India's goods and services trade, are in a synchronised down turn. Services export growth is also likely to slow in the near term as the recession deepens and financial services firms – traditionally large users of outsourcing services – are restructured. Remittances from migrant workers too are likely to slow as the Middle East adjusts to lower crude prices and advanced economies go into a recession.

17. Beyond the financial and real channels of transmission as above, the crisis also spread through the confidence channel. In sharp contrast to global financial markets, which went into a seizure on account of a crisis of confidence, Indian financial markets continued to function in an orderly manner. Furthermore, our banks have continued to lend. However, the tightened global liquidity situation in the period immediately following the Lehman failure in mid-September 2008, coming as it did on top of a turn in the credit cycle, increased the risk aversion of the financial system and made some banks cautious about lending.

18. The purport of the above explanation is to show how, despite not being part of the global financial sector problem, India has been affected by the crisis through the adverse feedback loops between external shocks and domestic vulnerabilities.

How Have We Responded to the Challenge?

19. Let me now turn to how we responded to the crisis. The failure of Lehman Brothers in mid-September 2008 was followed in quick succession by several other large financial institutions coming under severe stress. This made financial markets around the world uncertain and unsettled. This contagion, as I explained above, spread to emerging economies, and to India too. Both the Government and the Reserve Bank of India responded to the challenge in close coordination and consultation. The main plank of the Government response was fiscal stimulus while the Reserve Bank's action comprised monetary accommodation and counter cyclical regulatory measures.

Monetary Policy Response

20. The Reserve Bank's policy response was aimed at containing the contagion from the outside - to keep the domestic money and credit markets functioning normally and see that the liquidity stress did not trigger solvency cascades. In particular, we targeted three objectives: first, to maintain a

comfortable rupee liquidity position; second, to augment foreign exchange liquidity; and third, to maintain a policy framework that would keep credit delivery on track so as to arrest the moderation in growth. This marked a reversal of Reserve Bank's policy stance from monetary tightening in response to heightened inflationary pressures of the previous period to monetary easing in response to easing inflationary pressures and moderation in growth in the current cycle. Our measures to meet the above objectives came in several policy packages starting mid-September 2008, on occasion in response to unanticipated global developments, and at other times in anticipation of the impact of potential global developments on the Indian markets.

21. Our policy packages included, like in the case of other central banks, both conventional and unconventional measures. On the conventional side, we reduced the policy interest rates aggressively and rapidly, reduced the quantum of bank reserves impounded by the central bank and expanded and liberalised the refinance facilities for export credit. Measures aimed at managing forex liquidity included an upward adjustment of the interest rate ceiling on the foreign currency deposits by non-resident Indians, substantially relaxing the external commercial borrowings (ECB) regime for corporates, and allowing non-banking financial companies and housing finance companies access to foreign borrowing.

22. The important among the many unconventional measures taken by the Reserve Bank of India are a rupee-dollar swap facility for Indian banks to give them comfort in managing their short-term foreign funding requirements, an exclusive refinance window as also a special purpose vehicle for supporting non-banking financial companies, and expanding the lendable resources available to apex finance institutions for refinancing credit extended to small industries, housing and exports. Reflecting the rapid turn of events that could impair assets down the line, we reversed the counter - cyclical regulatory measures introduced in 2006.

Government's Fiscal Stimulus

23. Over the last five years, both the Central and State Governments in India have made serious efforts to reverse the fiscal excesses of the past. At the heart of these efforts was the Fiscal Responsibility and Budget Management (FRBM) Act which mandated a calibrated road map towards fiscal sustainability.

24. The depth and extraordinary impact of this crisis, however, clearly indicated the need for counter cyclical public spending. Accordingly, the Central Government invoked the emergency provisions of the FRBM Act to seek relaxation from the fiscal targets and launched two fiscal stimulus packages in December 2008 and January 2009. These fiscal stimulus packages, together amounting to about 3 per cent of GDP, included additional public spending, government guaranteed funds for infrastructure spending, cuts in indirect taxes, expanded guarantee cover for credit to micro and small enterprises, and additional support to exporters. These stimulus packages came on top of an already announced expanded safety-net for rural

poor, a farm loan waiver package and salary increases for government staff, all of which too should stimulate demand.

Impact of Monetary Measures

25. Taken together, the measures put in place since mid-September 2008 have ensured that the Indian financial markets continue to function in an orderly manner. The cumulative amount of primary liquidity potentially available to the financial system through these measures is about Rs.390,000 crore or 7 per cent of GDP. This sizeable easing has ensured a comfortable liquidity position starting mid-November 2008 as evidenced by a number of indicators including the weighted average call money rate, the overnight money market rate and the yield on the 10-year benchmark government security. Taking the signal from the policy rate cut, many of the big banks have reduced their benchmark prime lending rates. Bank credit has expanded too, but slower than last year. However, Reserve Bank's rough calculations show that the overall flow of resources to the commercial sector is less than what it was last year. This is because, even though bank credit has expanded, it has not fully offset the decline in non-bank flow of resources to the commercial sector.

Evaluating the Response

26. In evaluating the response to the crisis, it is important to remember that although the origins of the crisis are common around the world, the crisis has impacted different economies differently. Importantly, in advanced economies where it originated, the crisis spread from the financial sector to the real sector. In emerging economies, the transmission of external shocks to domestic vulnerabilities has typically been from the real sector to the financial sector.

27. Countries have accordingly responded to the crisis depending on their specific country circumstances. Thus, even as policy responses across countries are broadly similar, their precise design, quantum, sequencing and timing have varied. In particular, while policy responses in advanced economies have had to contend with both the unfolding financial crisis and deepening recession, in India, our response has been predominantly driven by the need to arrest moderation in economic growth.

What is the Outlook for India?

28. The outlook for India going forward is mixed. There is clear evidence of economic activity slowing down. Real GDP growth has moderated modestly in the first and second quarters of 2008/09, and sharply in the third quarter. The services sector, which has been our prime growth engine for the last five years, is slowing, mainly in construction, transport and communication, trade, hotels and restaurants sub-sectors. For the first time in seven years, exports have declined in absolute terms for four months in a row during October 2008 - January 2009. Recent data indicate that the demand for bank credit is slackening despite comfortable liquidity in the system. Dampened demand has dented corporate margins while the uncertainty surrounding the crisis has affected business confidence. The index of industrial production has shown negative growth for two recent months and investment demand is decelerating. All

these factors suggest that growth will moderate more than we had earlier thought.

29. In addressing the fall out of the crisis, India has several advantages. Some of these are recent developments. Most notably, headline inflation, as measured by the wholesale price index, has fallen sharply though consumer price inflation is yet to moderate. Clearly, falling commodity prices have been the key drivers behind the disinflation; however, some contribution has also come from slowing domestic demand. The decline in inflation should revive and support consumption demand and reduce input costs for corporates. Furthermore, the decline in global crude prices and naphtha prices, if sustained, will reduce the size of subsidies to oil and fertilizer companies, opening up fiscal space for infrastructure spending. From the external sector perspective, it is projected that imports will shrink more than exports keeping the current account deficit modest.

30. There are also several structural factors that have come to India's aid. First, notwithstanding the severity and multiplicity of the adverse shocks, India's financial markets have shown admirable resilience. This is in large part because India's banking system remains sound, healthy, well capitalised and prudently regulated. Second, our comfortable reserve position provides confidence to overseas investors. Third, since a large majority of Indians do not participate in equity and asset markets, the negative impact of the wealth loss effect that is plaguing the advanced economies should be quite muted. Consequently, consumption demand should hold up well. Fourth, because of India's mandated priority sector lending, institutional credit for agriculture has remained unaffected. The farm loan waiver package implemented by the Government should further insulate the agriculture sector from the crisis. Finally, over the years, India has built an extensive network of social safety-net programmes, including the flagship rural employment guarantee programme. These uniquely Indian versions of automatic stabilizers should protect the poor from the extreme impact of the global crisis.

RBI's Policy Stance

31. Going forward, the Reserve Bank's policy stance will continue to be to maintain comfortable rupee and forex liquidity positions. There are indications that pressures on mutual funds have eased and that NBFCs too are making the necessary adjustments to balance their assets and liabilities. Despite the contraction in export demand, we will be able to manage our balance of payments. It is the Reserve Bank's expectation that commercial banks will take the signal from the policy rates reduction to adjust their deposit and lending rates in order to keep credit flowing to productive sectors. In particular, the special refinance windows opened by the Reserve Bank for the MSME (micro, small and medium enterprises) sector, housing sector and export sector should see credit flowing to these sectors. Also the SPV set up for extending assistance to NBFCs should ease the financing constraints of NBFCs. The Government's fiscal stimulus should be able to supplement these efforts from both supply and demand sides.

When the Turn Around Comes

32. Over the last five years, India clocked an unprecedented nine per cent growth, driven largely by domestic consumption and investment even as the share of net exports has been rising. This was no accident or happenstance. True, the benign global environment, easy liquidity and low interest rates helped, but at the heart of India's growth were a growing entrepreneurial spirit, rise in productivity and increasing savings. These fundamental strengths continue to be in place. Nevertheless, the global crisis will dent India's growth trajectory as investments and exports slow. Clearly, there is a period of painful adjustment ahead of us. However, once the global economy begins to recover, India's turn around will be sharper and swifter, backed by our strong fundamentals and the untapped growth potential. Meanwhile, the challenge for the Government and the RBI is to manage the adjustment with as little pain as possible.