

## India and Global Crisis

# **The Worst is Over for India: 9% plus Growth Soon, Says Dr Rakesh Mohan**

*(Excerpts from RBI Deputy Governor Dr Rakesh Mohan's address to IMC's 101st Annual General Meeting held on May 11, 2009)*

The current global financial crisis has its roots in the US, Europe and other advanced countries. Its proximate causes include sub-prime lending, faulty distribution models, unsustainable financial engineering and derivatives usage, faulty credit rating by agencies, a lax regulation and large global imbalances in those countries. But the fundamental cause of the crisis was the loose and excessively accommodative monetary policy followed by the US and other advanced economies from 2002-04.

### **Current Account Balance:**

The huge current account balance (CAB) of emerging market economies (EMEs) in terms of percentage of their GDP also led to precipitating the crisis. The CAB of China rose from 1.4% of its GDP in 1994 to 10% in 2008. Simultaneously, CAB of Saudi Arabia rose from -11.7% to 28.9%; and that of United Arab Emirates rose from 8.3% to 15.8%. As against this, the CAB of US deteriorated further from -1% to -4.7% of its GDP.

### **Monetary Policy:**

The loosening and tightening of the US monetary policy has been causing mega cycles of boom and depression in the EMEs over the years.

\* The effective fed rate of funds in the US in Jan 1990 was 8.3%; but it plunged to 3% between Sept 1992 and August 1994. \*Again the US rate rose to 6.5% in January 2001, only to plunge to between 1% and 2% between Dec 2001 and September 2004. \* Between Sept 2006 and Sept 2007, the US rate again peaked to 5%, but sank below 0.2% by September 2008.

Each of these major shifts in US monetary policy correspondingly triggered a global cycle of boom and depression, particularly affecting the vulnerable emerging market economies (EMEs) in Latin and Central America, the East Asian countries, China and India. Extreme volatility in the monetary policy of the US and other advanced economies led to a corresponding volatility in capital flows to EMEs, wreaking havoc in their capital markets.

The present global crisis coincided with one such economic cycle, but a highly complex and phenomenally large one in its magnitude, which was not witnessed since the global depression of the 1930s. Extremely loose monetary policy of the US and EU in the past

few years, their aggregate demand exceeding output, their large current a/c deficits (which are mirrored in large surpluses in China and elsewhere), increasingly lax administration of their financial institutions and large Fed rate cuts in 2007 lending a strong boost to oil, commodity and asset prices together set the stage for the present global crisis.

### **Capital Flows to EMEs**

Between 1980 to 1990, the US capital flow (both FDI and private portfolio investments) to emerging market economies was a maximum of \$25 billion per annum. But between 1990 and 2003, the US capital outflows to EMEs increased to around \$200 billion per annum.

In 2007, the capital outflows spurted to around \$600 billion per annum, only to crash soon. The effect of the sudden reverse flow of capital (particularly of portfolio investments) was a particularly traumatic experience for the EMEs. It had severe implications for their monetary management and financial stability.

### **Worsening Global Outlook:**

The IMF has predicted an extremely bleak economic outlook. It has said that the average economic growth in advanced countries will decline from 1.3% in April 2008 to 0.5% in April 2009. Simultaneously, the growth rate in EMEs will decline from 6.7% to 1.6%; and the world's GDP growth rate will decline from 3.7% to 3.2%. It has also predicted that the global trade volume in goods and services will witness a negative growth (i.e., minus 11%) from 3.7% to 3.2% during the year.

### **Impact on India**

The global crisis has a direct bearing on capital inflows into India. The rate of FDI inflow recorded an increase in 2008-09 compared to the previous year, the FIIs (net) recorded heavy stream of outflows from India in 2008-09 contrary to a healthy rate of inflow in the previous year. Also, during the period, both external commercial borrowings as well as short-term trade credit shrank substantially.

As a cumulative effect, India's real GDP growth declined from 9% (April-Dec 2007) to 6.9% (April-Dec 2008); simultaneously, growth of India's industrial production dwindled from 8.8% to 2.8%; growth of its services sector declined from 10.5% to 9.7%; exports fell from 28.4% to 6.4%; imports plummeted from 40.2% to 17.9%; the Sensex fell from 16,569 to 12,366 and its rupee value depreciated from Rs.40.24 per US \$ to Rs.45.92 per US\$.

### **What are the differences between the financial crisis in US / Europe and India?**

Unlike the US and Europe, India did not face the problems of subprime lending, toxic derivatives, bank losses threatening capital erosion, bank credit crunch and mistrust between banks.

India's problems include a reduction in capital flows leading to a pressure on the balance of payments (BoP), weakened sentiments on stock markets, temporary monetary /liquidity impact on MFs/NBFCs, reduction in flows from non-banking institutions, and perceptions of a credit crunch.

India's problems also include an increased fiscal stress; rise in the oil, fertiliser, food subsidies; pay commission, debt waiver, and NRE, substantial stimulus packages, a worsening GFD to GDP ratio, and large increase in market borrowings.

For coping with the crisis, especially on the fronts of Capital account and financial sector, (a) India has adopted a more calibrated and gradual approach towards opening up. (b) It has been encouraging equity flows. (c) It has been managing debt flows subject to ceilings and some end-use restrictions. (d) It has been progressively liberalizing capital outflows.

### **Financial stability**

For ensuring stability, the banks and other financial institutions in India are regulated according to strict prudential norms in respect of both liquidity and capital. The banks are required to function within the prudential limits of their inter-bank liabilities in relation to their net worth.

The RBI has issued asset-liability management guidelines to take cognizance of both the on- and off- balance sheet items. It has also issued guidelines on Basle II framework besides making dynamic provisioning for operation of the financial market. In respect of NBFCs, it has tightened regulation and stepped up supervision for reducing regulatory arbitrage.

### **The Lessons**

Indian financial managers have drawn precious lessons from the global financial crisis. The lessons include: \* Avoid high volatility in monetary policy \* Appropriate response of monetary policy to asset prices \* Manage capital flow volatility \* Watch for signs of overleveraging \* Active dynamic financial regulation \* Capital buffers, dynamic provisioning \* Look for regulatory arbitrage incentives/ possibilities.

Over the past few decades, India's saving-investment gap has steadily narrowed from - 1.5 to -0.3 with the continuing increase in its real GDP growth. As such, India has been witnessing a secular uptrend in domestic saving and investment. And it has been able to largely finance its investment by domestic savings. It is heartening to note that the growth rate of India's domestic savings is continuing to rise, and so also its scrupulous adherence to fiscal prudence norms.

## **Fiscal Policy**

In the medium-term, a key challenge is to further reduce inflation expectations toward international levels and to maintain a sustained interest rate differential linked to the inflation differential with the rest of the world.

## **Monetary Policy**

Similarly, in the medium term, there is a continuous need to adapt monetary management to the emerging needs of a fast growing and increasingly open economy, to press for financial deepening and increasing monetization. This would include the expansion of monetary aggregates and the task of monetary management – managing such growth without endangering price or financial stability.

In this context, the RBI would be required to take appropriate judgment calls in respect of medium term issues such as: (a) Can we take current account balance as a good guide to evaluate the appropriate level of an exchange rate? (b) To what extent should the capital account influence the exchange rate? (c) What are the implications of large current account deficits for the real economy?

## **External Sector**

Also, in the medium term, optimal response to large and volatile capital flows is a combination of sound macroeconomic policies, prudent debt management, exchange rate flexibility, effective management of the capital account, accumulation of appropriate levels of reserves as self-insurance and development of resilient domestic financial markets. This combination is always country-specific; there is no "one size fits all". As liberalization of debt flows can lead to arbitrage flows, it will be necessary to have appropriately fixed ceilings on debt flows. .

## **Financial Sector**

Commercial banks in India remain robust, and by and large not contaminated by the global crisis. The Committee on Financial Sector Assessment (CFSA) has been engaged in stress testing for assessing stability. At the present juncture, concerns about credit risk remain muted.

## **Conclusion**

India's fundamentals remain strong and its financial sector is robust. Its monetary policy is flexible and has sufficient instruments at its disposal. The Indian corporate sector is not too leveraged, and is undergoing a second round of restructuring, with resultant productivity gains.

The flow of foreign direct investment into India continues to remain buoyant. Productivity of the Indian agriculture sector is increasing. The most heartening aspect of all is that the economic growth of India is almost wholly domestically financed.

In conclusion, the Indian economy should be able to recover rapidly and return to a 9%+ growth path soon, within about six months.