

India and the Global Financial Crisis Transcending from Recovery to Growth

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India Growth Story

Pleasant and Unpleasant Surprises

Before the crisis:

- What is driving this high growth and how can we accelerate it?

During the crisis:

- Is there a threat to the fundamentals that fuelled India's high growth?

After the crisis:

- When do we get on to double-digit growth?

Four Questions

- 1. Why was India hit by the crisis?**
2. How was India hit by the crisis?
3. How did we respond to the crisis?
4. What is the outlook for India?

Why Was India Hit by the Crisis? (1)

Dismay on two counts that India was hit by the crisis

First

- Indian banking system had no exposure to tainted assets or stressed institutions.
- Indian financial sector has only limited off-balance sheet activities or securitized assets.

Second

- India's growth emanates from domestic demand and domestic investment.
- India's exports are less than 15 percent of GDP.

Why Was India Hit by the Crisis? (2)

Because

- More closely integrated with the rest of the world
- Financial integration as deep as trade integration

Why Was India Hit by the Crisis? (3)

India's Global Integration

(Percentage)

	1998-99	2008-09
(Export+Import)/GDP	19.6	40.7
Two-way (capital+ current) flows/ GDP	44.1	111.9

Questions To Address

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- 2. How was India hit by the crisis?**
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How was India Hit by the Crisis? (1)

Contagion from outside to India

- Financial channel
- Real channel
- Confidence channel

How Was India Hit by the Crisis? (2)

(i) Financial channel

- Drying up of overseas financing
- Capital outflows as part of global deleveraging
- Reserve Bank's intervention in the forex markets

How Was India Hit by the Crisis? (3)

(ii) Real channel

- Slump in demand for exports
- Service exports decelerated
- Remittances from migrant workers may slow (?)

How Was India Hit by the Crisis? (4)

(iii) Confidence channel

- Tightened global liquidity eroded confidence
- This came on top of a turn in the credit cycle

Questions To Address

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How Did We Respond to the Challenge? (1)

Government

- Fiscal stimulus

Reserve Bank

- Monetary accommodation
- Countercyclical regulatory measures

How Did We Respond to the Challenge? (2)

Reserve Bank of India's (RBI) monetary policy response guided by three objectives:

- Ample rupee liquidity
- Comfortable foreign exchange liquidity
- Credit flow to productive sectors

How Did We Respond to the Challenge? (3)

Reserve Bank of India

Conventional measures

- Reduction in policy rates
- Reduction in cash reserve ratio
- Relaxed norms for external borrowings
- Raised interest rate ceilings on nonresident Indian (NRI) deposits

Unconventional measures

- Rupee-dollar swap facility for Indian banks
- Special purpose vehicle (SPV) + refinance window for nonbanking finance companies (NBFCs)
- Refinance window for specific sectors

How Did We Respond to the Challenge? (4)

Government's fiscal stimulus

- Additional capital spending
- Government-guaranteed infrastructure spending
- Cuts in indirect taxes
- Expanded guarantee cover for micro and small enterprises
- Additional support to exports

Evaluating Response to Crisis

- Origins of crisis common

- Evolution of crisis different

Advanced economies – financial to real sector

Emerging economies – real to financial sector

- Response to crisis – country-specific

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4. **What is the outlook for India?**

Outlook for India

- Growth is consolidating
- Agriculture hit by monsoon failure
- Industrial growth getting broad based
- Investment intentions are strong
- Exports and import growth turned positive after 11–12 months
- Domestic and external financing conditions have improved
- Resurgence of positive sentiment

Outlook for India (2)

- Inflation in recent period worrisome
- Triggered by food prices
- But demand side pressures are building up
- Asset prices picking up rapidly
- Structural inflation (?)

Outlook for India (3)

Big Picture

- Growth consolidating and getting broad based
- Supply side inflation pressures abating but only gradually
- Demand side inflation pressures are building up

Challenge for RBI

Manage
the growth-inflation
dynamics

Unwinding Monetary Stimulus

Actions

- Terminated unconventional measures
- Raised statutory liquidity ration (SLR)
- Raised cash reserve ration (CRR)
- Raised policy interest rates

Unwinding Monetary Stimulus

Dilemmas

- How do we calibrate unwinding?
- How do we prevent hard landing?
- Do we give forward guidance?
(neutral rate?)
- Is reversal of monetary accommodation antigrowth?

Projection for 2010–11

Growth for 2010–11 - 8.0 percent +

WPI Inflation - 5.5 percent
(end March 2011)

Risks to Growth-Inflation Outlook

- Global recovery stalling
- Global commodity prices spiking
- Another poor monsoon
- Capital flows beyond absorptive capacity
- Overheating and hard landing

Tasks in Macroeconomic Management

- Short-term: Restore economy to trend growth rate without compromising price stability
- Medium term: Raise the trend growth rate without compromising financial stability

Fifth Question

1. Why was India hit by the crisis?
2. How was India hit by the crisis?
3. How did we respond to the crisis?
4. What is the outlook for India?
5. **What are the tasks for RBI on the way forward?**

Volatile Capital Flows


- Central issue before crisis
- Central issue during crisis
- Central issue after crisis


Challenge of Capital Flows


How do we maximize the benefits
and minimize the costs?

Managing Capital Flows

“No Win Situation”

Do not intervene  Currency appreciation

Intervene but
but do not sterilize  Inflationary pressure

Intervene and
sterilize  Upward pressure on
interest rates

Managing Capital Flows

How do you manage the
impossible trinity?

India's Policy on Capital Account Management

- Pragmatic, transparent, contestable, stable
- Use levers on debt side rather than on equity side for managing flows
- Price-based vs. quantity-based controls
- Tobin tax?

Capital Account Management

- New orthodoxy
- Research required on
 - What type of controls?
 - Under what circumstances?
 - How to implement them?

Exchange Rate Management

- India's policy as stated
- India's policy in practice

Trends in India's External Sector

	2006–07	2007–08	2008–09	2009–10
Current account deficit (percent of GDP)	1.0	1.3	2.4	2.5
Net capital flows (percent of GDP)	4.8	8.7	0.6	3.8
Capital flows in excess of current account deficit (billions of dollars)	36	92	(-) 20	14
Rupee appreciation (+) depreciation (-) vis-à-vis US dollar during the year	2.3	9.0	(-) 21.5	12.9

Note: Numbers for 2009–10 are rough estimates.

Exchange Rate Management

Indian Policy Stance

- Two-way movement demonstrates flexible exchange rate
- No deliberate strategy to build up reserves for “self insurance”
- Reserves comprised of liabilities
- Reserves used to contain volatility arising out of capital reversals

Exchange Rate Management

Indian Policy Stance (2)

- Nominal exchange rate has appreciated
- Real effective exchange rate has appreciated even more
- We tend to be disadvantaged vis-à-vis our trading partners who have fixed exchange rates

Inflation Targetting

- Rise and fall of “inflation targeting”
- RBI not a pure inflation targeter
- Argument in favor of RBI becoming an inflation targeter
- Argument against RBI becoming an inflation targeter

RBI Becoming an Inflation Targeter

Neither practical nor desirable—why?

- Multiple objectives of price stability, financial stability, and growth
- Vulnerability to supply shocks
- Which inflation index to target?
- Inefficient monetary transmission
- Volatile capital flows and managing impossible trinity

Harmonizing Monetary and Fiscal Policy

- Reduction of “fiscal dominance” of monetary policy—global trend
- Gradual reduction of fiscal dominance in India too
- Transition of monetary policy out of fiscal dominance halted, if not reversed, by the crisis

Fiscal Adjustment Way Forward

- Fiscal consolidation important for monetary policy to be effective
- Fiscal consolidation important for a number of other reasons also
- Path to fiscal adjustment
- Quality of fiscal adjustment

Improving Monetary Policy Transmission

Factors inhibiting transmission mechanism

- Small savings program and administered interest rates
- Asymmetric contractual relationship of depositors with banks
- Large government borrowing program
- Illiquid bond markets
- Nontransparent loan-pricing system (benchmark prime lending rate [BPLR])

Evaluation of Monetary Transmission During Crisis

- Transmission did not break down
- Reserve Bank's assurance of "ample liquidity" inspired confidence
- Reduced credit flow was because of decline in credit demand
- BPLR system exaggerates clogs in monetary transmission

Improving Monetary Transmission

New Base Rate (BR) system
to replace BPLR from July 1, 2010

Summing Up

- How India weathered the crisis
- The short term outlook
- Issues in economic management

Conclusion

- Growth drivers that powered India's high growth in the years before the crisis are all intact
- The challenge for the government and for the Reserve Bank of India is to move on with reforms to steer the economy to a higher growth path that is sustainable and equitable