

Duvvuri Subbarao: Impact of the global financial crisis on India – collateral damage and response

Speech by Dr Duvvuri Subbarao, Governor of the Reserve Bank of India, at the Symposium on “The Global Economic Crisis and Challenges for the Asian Economy in a Changing World” organized by the Institute for International Monetary Affairs, Tokyo, 18 February 2009.

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Global outlook

The global economic outlook deteriorated sharply over the last quarter. In a sign of the ferocity of the down turn, the IMF made a marked downward revision of its estimate for global growth in 2009 in purchasing power parity terms – from its forecast of 3.0 per cent made in October 2008 to 0.5 per cent in January 2009. In market exchange rate terms, the downturn is sharper – global GDP is projected to actually shrink by 0.6 per cent. 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.

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

Emerging economies

Contrary to the “decoupling theory”, emerging economies too have been hit by the crisis. The decoupling theory, 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 globalizing world, the “decoupling theory” 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 theory” stands totally 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 that will be addressed

India too has been impacted by the crisis – and by much more than it was suspected earlier. What I propose to do in the rest of my speech is to address the following four 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?

(iv) What is the outlook for India?

Why has India been hit by the crisis?

There is, at least in some quarters, dismay that India has been hit by the crisis. This dismay stems from two arguments.

The first argument goes as follows. 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 securitized assets. In fact, our banks continue to remain safe 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.

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 dependence on external demand is so limited?

The answer to both the above frequently-asked questions lies in globalization. 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 globalization, India's two-way trade (merchandise exports plus imports), as a proportion of GDP, grew from 21.2 per cent in 1997-98, the year of the Asian crisis, to 34.7 per cent in 2007-08.

Second, India's financial integration with the world has been as deep as India's trade globalization, if not deeper. If we take an expanded measure of globalization, 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.

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 investment in India's GDP rose by 11 percentage points. Corporate savings financed roughly half of this, but a significant portion of the balance financing came from external sources. While funds were available domestically, they were expensive relative to foreign funding. On the other hand, in a global market awash with liquidity and on the promise of India's growth potential, foreign investors were willing to take risks and provide funds at a lower cost. 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 and the depth of India's financial integration.

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?

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.

Let us first look at the financial channel. India's financial markets – equity markets, money markets, forex markets and credit markets – had all come under pressure from a number of directions. First, as a consequence of the global liquidity squeeze, Indian banks and corporates found their overseas financing drying up, forcing corporates to shift their credit demand to the domestic banking sector. Also, in their frantic search for substitute financing, corporates withdrew their investments from domestic money market mutual funds putting

redemption pressure on the mutual funds and down the line on non-banking financial companies (NBFCs) where the MFs had invested a significant portion of their funds. 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.

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 synchronized down turn. Service 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.

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. Nevertheless, 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 banks cautious about lending.

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

How have we responded to the challenge?

Let me now turn to how we responded to the crisis. The failure of Lehman Brothers in mid-September 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 forbearance.

Monetary policy response

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.

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 liberalized 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.

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.

Government's fiscal stimulus

Over the last five years, both the central and state governments in India have made a serious effort 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 to fiscal sustainability. However, recognizing the depth and extraordinary impact of this crisis, 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, particularly capital expenditure, 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

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 over US\$ 75 bln 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, faster than it did 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

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. 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?

The outlook for India going forward is mixed. There is evidence of economic activity slowing down. Real GDP growth has moderated in the first half of 2008/09. The services sector too, 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 three months in a row during October-December 2008. Recent data indicate that the demand for bank credit is slackening despite comfortable liquidity in the system. Higher input costs and dampened demand have 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 moderation may be steeper and more extended than earlier projected.

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, and recent trends suggest a faster-than-expected reduction in inflation. 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 support consumption demand and reduce input costs for corporates. Furthermore, the decline in global crude prices and naphtha prices 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.

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 capitalized 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 will be unaffected by the credit squeeze. 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, which should protect the poor and the returning migrant workers from the extreme impact of the global crisis.

RBI's policy stance

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 enable NBFC lending to pick up steam once again.

The government's fiscal stimulus should be able to supplement these efforts from both supply and demand sides.

When the turn around comes

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.