

Impact of The Economic Crises on India in 2008-09

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Introduction:

The crisis started with the subprime mortgage sector in the US, its genesis can be traced to excessively loose monetary policy in the US during 2002-04. Low interest rates encouraged the search for higher yield and consequently created large global imbalances. Coupling this environment with other factors such as lax lending standards, excessive leverage and under pricing of risk led to a crisis that quickly spread to global financial markets. In the case of India, there was no direct impact from the crisis as India had little exposure to toxic assets that afflicted Western countries' financial institutions and foreign banks' presence in India is circumscribed. However, following the Lehman failure, there was a dramatic change in the external environment, which caused capital outflows from India in late 2008 requiring urgent fiscal and monetary policy responses. India has weathered the storm relatively well compared to other countries. It is therefore important to understand why this was the case. Dynamic provisioning by the banking system provided buffers against negative shocks and strong balance sheets with transparency in bank operations prevented any crisis in inter-bank money markets or the banking system as a whole. Additionally, India's approach to a gradual opening of the capital account and financial sector proved to be beneficial in shielding the financial system from drastic external shocks. The Reserve Bank of India has therefore taken both monetary and regulatory actions to prevent and contain the impact of the global financial crisis. As the debate now turns towards designing regulation of the financial system to maintain financial stability, we should also consider what can be learned from India's approach of preemptive policy towards large

volatility in capital flows and imbalances and in financial regulation.

The intensification of the global financial crisis, following the bankruptcy of Lehman Brothers in September 2008, made the economic and financial environment very difficult for the world economy, the global financial system and for central banks. The fall out of the current global financial crisis could be an epoch changing one for central banks and financial regulatory systems. It is, therefore, very important that we identify the causes of the current crisis accurately so that we can then find, first, appropriate immediate crisis resolution measures and mechanisms; second, understand the differences among countries on how they are being impacted; and, finally, think of the longer term implications for monetary policy and financial regulatory mechanisms. These are all large subjects and one cannot hope to do full justice to them in one paper. A legion of both policymakers and scholars are at work analyzing the causes of the crisis and trying to find both immediate and longer term solutions (for example, the de Larosiere Report (2009), the Turner Review (2009), the Geneva Report (2009), the Group of Thirty Report (2008), the IMF Lessons paper (2009b) and the United Nations Report (2009)). I can only attempt some conjectures, raise issues and identify some possible directions in which we should move. What I attempt to do here is to provide my interpretation of the unfolding of the present global financial crisis; how it is affecting us; why the Indian financial sector has been able to weather the crisis relatively well; the analytics of our policy response; and, finally, some implications of its longer lasting effects.

Genesis of Global Financial Crisis:

The proximate cause of the current financial turbulence is attributed to the sub-prime mortgage sector in the USA. At a fundamental level, however,

the crisis could be ascribed to the persistence of large global imbalances, which, in turn, were the outcome of long periods of excessively loose monetary policy in the major advanced economies during the early part of this decade (Mohan, 2007, Taylor, 2008). Global imbalances have been manifested through a substantial increase in the current account deficit of the US mirrored by the substantial surplus in Asia, particularly in China, and in oil exporting countries in the Middle East and Russia (Lane, 2009). These imbalances in the current account are often seen as the consequence of the relative inflexibility of the currency regimes in China and some other EMEs. According to Portes (2009), global macroeconomic imbalances were the major underlying cause of the crisis. These saving investment imbalances and consequent huge cross-border financial flows put great stress on the financial intermediation process. The global imbalances interacted with the flaws in financial markets to generate the specific features of the crisis. Such a view, however, offers only a partial analysis of the recent global economic environment. The role of monetary policy in the major advanced economies, particularly that in the United States, over the same time period needs to be analysed for arriving at a more balanced view. Following the dot com bubble burst in the US around the turn of the decade, monetary policy in the US and other advanced economies was eased aggressively. Policy rates in the US reached one per cent in June 2003 and were held around these levels for an extended period (up to June 2004). In the subsequent period, the withdrawal of monetary accommodation was quite gradual. An empirical assessment of the US monetary policy also indicates that the actual policy during the period 2002-06, especially during 2002-04, was substantially looser than what a simple Taylor rule would have required. "This was an unusually big deviation from the Taylor Rule. There was no greater or more persistent deviation of actual Fed policy since the turbulent days of the 1970s. So there is clearly evidence that there were monetary excesses during the period leading up to the housing boom" (Taylor, op.cit.). Taylor also finds some evidence (though not conclusive) that rate decisions of the European Central Bank (ECB) were also affected by the US Fed monetary policy decisions, though they

did not go as far down the policy rate curve as the US Fed did.

Excessively loose monetary policy in the post dot com period boosted consumption and investment in the US and, as Taylor argues, it was made with purposeful and careful consideration by monetary policy makers. Accommodative monetary policy and the corresponding existence of low interest rates for an extended period encouraged the active search for higher yields by a host of market participants. Thus capital flows to Emerging Market Economies (EMEs) surged in search of higher yields, but could not be absorbed by these economies in the presence of either large current account surpluses or only small deficits, largely ending up as official reserves. These reserves were recycled into US government securities and those of the government sponsored mortgage entities such as Fannie Mae and Freddie Mac. Thus, while accommodative monetary policy kept short term interest rates low, the recycled reserves contributed to the lowering of long term interest rates in the advanced economies, particularly the United States. Such low long term interest rates contributed to the growth of mortgage finance. As might be expected, with such low nominal and real interest rates, asset prices recorded strong gains, particularly in housing and real estate, providing further impetus to consumption and investment through wealth effects. Thus, aggregate demand consistently exceeded domestic output in the US and, given the macroeconomic identity, this was mirrored in large and growing current account deficits in the US over the period (Table 1). The large domestic demand of the US was met by the rest of the world, especially China and other East Asian economies, which provided goods and services at relatively low costs leading to growing surpluses in these countries. Sustained current account surpluses in some of these EMEs also reflected the lessons learnt from the Asian financial crisis. Furthermore, the availability of relatively cheaper goods and services from China and other EMEs also helped to maintain price stability in the US and elsewhere, which might have not been possible otherwise. Thus measured inflation in the advanced economies remained low, contributing to the persistence of accommodative monetary policy.

Table 1: Current Account Balance (per cent to GDP)

Country	1990-94	1995-99	2000-04	2005	2006	2007	2008
China	1.4	1.9	2.4	7.2	9.5	11.0	9.8
France	0.0	2.2	1.2	-0.4	-0.5	-1.0	-2.3
Germany	-0.4	-0.8	1.4	5.1	6.1	7.5	6.4
India	-1.3	-1.3	0.5	-1.3	-1.1	-1.0	-2.2
Japan	2.4	2.3	2.9	3.6	3.9	4.8	3.2
Korea	-1.0	1.9	2.1	1.8	0.6	0.6	-0.7
Malaysia	-5.2	1.8	9.8	15.0	16.0	15.4	17.9
Philippines	-4.0	-2.8	-0.7	2.0	4.5	4.9	2.5
Russia	0.9	3.5	11.2	11.0	9.5	6.0	6.1
Saudi Arabia	-11.7	-2.4	10.6	28.5	27.8	24.3	28.6
South Africa	1.2	-1.3	-0.7	-4.0	-6.3	-7.3	-7.4
Switzerland	5.7	8.8	10.8	13.6	14.4	9.9	2.4
Thailand	-6.4	1.0	4.2	-4.3	1.1	5.7	-0.1
Turkey	-0.9	-0.8	-1.6	-4.6	-6.0	-5.8	-5.7
U.A.E	8.3	4.6	9.9	18.0	22.6	16.1	15.7
U.K.	-2.1	-1.0	-2.0	-2.6	-3.3	-2.7	-1.7
United States	-1.0	-2.1	-4.5	-5.9	-6.0	-5.2	-4.9
Memo:							
Euro area	n.a.	0.9@	0.4	0.5	0.4	0.3	-0.7
Middle East	-5.1	1.0	8.3	19.3	20.9	18.2	18.3

Source: World Economic Outlook Database, October 2009, International Monetary Fund (2009c).

The emergence of dysfunctional global imbalances is essentially a post 2000 phenomenon and which got accentuated from 2004 onwards. The surpluses of East Asian exporters, particularly China, rose significantly from 2004 onwards, as did those of the oil exporters (Table 1). In fact, Taylor (op. cit.) argues that the sharp hikes in oil and other commodity prices in early 2008 were also related to the very sharp policy rate cut in late 2007 after the subprime crisis emerged. It would be interesting to explore the outcome had the exchange rate policies in China and other EMEs been more flexible. The availability of low priced consumer goods and services from EMEs was worldwide. Yet, it can be observed that the Euro area as a whole did not exhibit large current account deficits throughout the current decade. In fact, it exhibited a surplus except for a minor deficit in 2008. Thus it is difficult to argue that the US large current account deficit was caused by China's exchange rate policy. The existence of excess demand for an extended period in the U.S. was more influenced by its own macroeconomic and monetary policies, and may have continued even with more flexible exchange rate policies in China. In the

event of a more flexible exchange rate policy in China, the sources of imports for the US would have been some countries other than China. Thus, it is most likely that the US current account deficit would have been as large as it was – only the surplus counterpart countries might have been somewhat different. The perceived lack of exchange rate flexibility in the Asian EMEs cannot, therefore, fully explain the large and growing current account deficits in the US. The fact that many continental European countries continue to exhibit surpluses or modest deficits reinforces this point.

Apart from creating large global imbalances, accommodative monetary policy and the existence of very low interest rates for an extended period encouraged the search for yield, and relaxation of lending standards. Even as financial imbalances were building up, macroeconomic stability was maintained. Relatively stable growth and low inflation have been witnessed in the major advanced economies since the early 1990s and the period has been dubbed as the Great Moderation. The stable macroeconomic environment encouraged underpricing of risks. It may be ironic that the

perceived success of central banks and increased credibility of monetary policy, giving rise to enhanced expectations with regard to stability in both inflation and interest rates, could have led to the mispricing of risk and hence enhanced risk taking. Easy monetary policy itself may have generated a search for yields that resulted in a dilution of standards in assessing credit risk leading to erosion of sound practices (Mohan, 2007). Lower yields encouraged excessive leverage as banks and financial institutions attempted to maintain their profitability. Lacunae in financial regulation and supervision allowed this excessive leverage in the financial system. Assets were either taken off banks' balance sheets to off-balance sheet vehicles that were effectively unregulated; or financial innovation synthetically reduced the perceived risks on balance sheets. Financial innovations, regulatory arbitrage, lending malpractices, excessive use of the originate and distribute model, securitization of sub-prime loans and their bundling into AAA tranches on the back of ratings, all combined to result in the observed excessive leverage of financial market entities.

Components of the Crisis:

Most of the crises over the past few decades have had their roots in developing and emerging countries, often resulting from abrupt reversals in capital flows, and from loose domestic monetary and fiscal policies. In contrast, the current ongoing global financial crisis has had its roots in the US. The sustained rise in asset prices, particularly house prices, on the back of excessively accommodative monetary policy and lax lending standards during 2002-2006 coupled with financial innovations resulted in a large rise in mortgage credit to households, particularly low credit quality households. Most of these loans were with low margin money and with initial low teaser payments. Due to the 'originate and distribute' model, most of these mortgages had been securitized. In combination with strong growth in complex credit derivatives and the use of credit ratings, the mortgages, inherently sub-prime, were bundled into a variety of tranches, including AAA tranches, and sold to a range of financial investors. As inflation started creeping up beginning 2004, the US Federal Reserve started to withdraw monetary accommodation. With interest rates beginning to edge up, mortgage payments also

started rising. Tight monetary policy contained aggregate demand and output, depressing housing prices. With low/negligible margin financing, there were greater incentives to default by the sub-prime borrowers. Defaults by such borrowers led to losses by financial institutions and investors alike. Although the loans were supposedly securitized and sold to the off balance sheet special institutional vehicles (SIVs), the losses were ultimately borne by the banks and the financial institutions wiping off a significant fraction of their capital. The theory and expectation behind the practice of securitisation and use of derivatives was the associated dispersal of risk to those who can best bear them. What happened in practice was that risk was parceled out increasingly among banks and financial institutions, and got effectively even more concentrated. It is interesting to note that the various stress tests conducted by the major banks and financial institutions prior to the crisis period had revealed that banks were well-capitalized to deal with any shocks. Such stress tests, as it appears, were based on the very benign data of the period of the Great Moderation and did not properly capture and reflect the reality (Haldane, 2009).

The excessive leverage on the part of banks and the financial institutions (among themselves), the opacity of these transactions, the mounting losses and the dwindling net worth of major banks and financial institutions led to a breakdown of trust among banks. Given the growing financial globalization, banks and financial institutions in other major advanced economies, especially Europe, have also been adversely affected by losses and capital write-offs. Inter-bank money markets nearly froze and this was reflected in very high spreads in money markets. There was aggressive search for safety, which has been mirrored in very low yields on Treasury bills and bonds. These developments were significantly accentuated following the failure of Lehman Brothers in September 2008 and there was a complete loss of confidence.

Impact on India:

Initial Impact of the Sub-prime Crisis

The initial impact of the sub-prime crisis on the Indian economy was rather muted. Indeed, following the cuts in the US Fed Funds rate in August 2007, there was a massive jump in net capital inflows into the country. The Reserve Bank had to

sterilize the liquidity impact of large foreign exchange purchases through a series of increases in the cash reserve ratio and issuances under the Market Stabilization Scheme (MSS). With persistent inflationary pressures emanating both from strong domestic demand and elevated global commodity prices, policy rates were also raised. Monetary policy continued with pre-emptive tightening measures up to August 2008. The direct effect of the sub-prime crisis on Indian banks/financial sector was almost negligible because of limited exposure to complex derivatives and other prudential policies put in place by the Reserve Bank. The relatively lower presence of foreign banks in the Indian banking sector also minimized the direct impact on the domestic economy. The larger presence of foreign banks can increase the vulnerability of the domestic economy to foreign shocks, as happened in Eastern European and Baltic countries. In view of significant liquidity and capital shocks to the parent foreign bank, it can be forced to scale down its operations in the domestic economy, even as the fundamentals of the domestic economy remain robust. Thus, domestic bank credit supply can shrink during crisis episodes. For instance, in response to the stock and real estate market collapse of early 1990s, Japanese banks pulled back from foreign markets - including the United States - in order to reduce liabilities on their balance sheets and thereby meet capital adequacy ratio requirements. Econometric evidence shows a statistically significant relationship between international bank lending to developing countries and changes in global liquidity conditions, as measured by spreads of interbank interest rates over overnight index swap (OIS) rates and U.S. Treasury bill rates. A 10 basis-point increase in the spread between the London Interbank Offered Rate (LIBOR) and the OIS sustained for a quarter, for example, is predicted to lead to a decline of up to 3 percent in international bank lending to developing countries (World Bank, 2008).

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