

8th India – Korea Dialogue

*India, Korea and the Global Financial
Crisis: Cooperation and Responses*

***Responses to and Implications of the Global
Financial Crisis***

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The Global Financial Crisis

The Macro-economic Backdrop

- **Imbalances:** Excessive global liquidity deriving from global imbalances inflated asset bubbles, drove interest rates down and encouraged excessive leveraging & risk taking.
- **Innovation:** Proliferation of innovative complex, non-transparent and illiquid originate-and-distribute “securitized” and “structured” financial instruments, such as “collateralized Deb/Bond Obligations” (CDOs/CBOs) making it almost impossible to pinpoint location of instruments at risk.
- **Policy failures:**
 - Loose *monetary policy* in the US focussed almost exclusively on consumer prices while disregarding asset price bubbles.
 - *Financial deregulation* and lowered oversight in the United States led to declining credit standards, proliferation of opaque financial instruments and accumulation of hyper-leverage and systemic risks outside the regulated banking system
- **Contagion:** Rapid global integration transmitted the crisis to every corner of the globe through trade and investment linkages.

Nature of the Current Crisis

- Most difficult and uncertain times **since the Great Depression** of the 1930s.
- Crisis both **deep** and **global**
 - Unlike the Latin American Debt Crisis, the Japanese Real estate bust, and the East Asian Currency Crisis
 - More severe than the global oil shock of the 1970s.
- Proof of the systemic criticality of the **US economy** and financial system: 1929 and 2008.
- Prognosis:
 - **Stabilization of US** pre-condition for revival of global economy
 - comparative research indicates that crises originating in the real estate and banking sectors, and those global in scope, tend to be both **severe** and **protracted**.

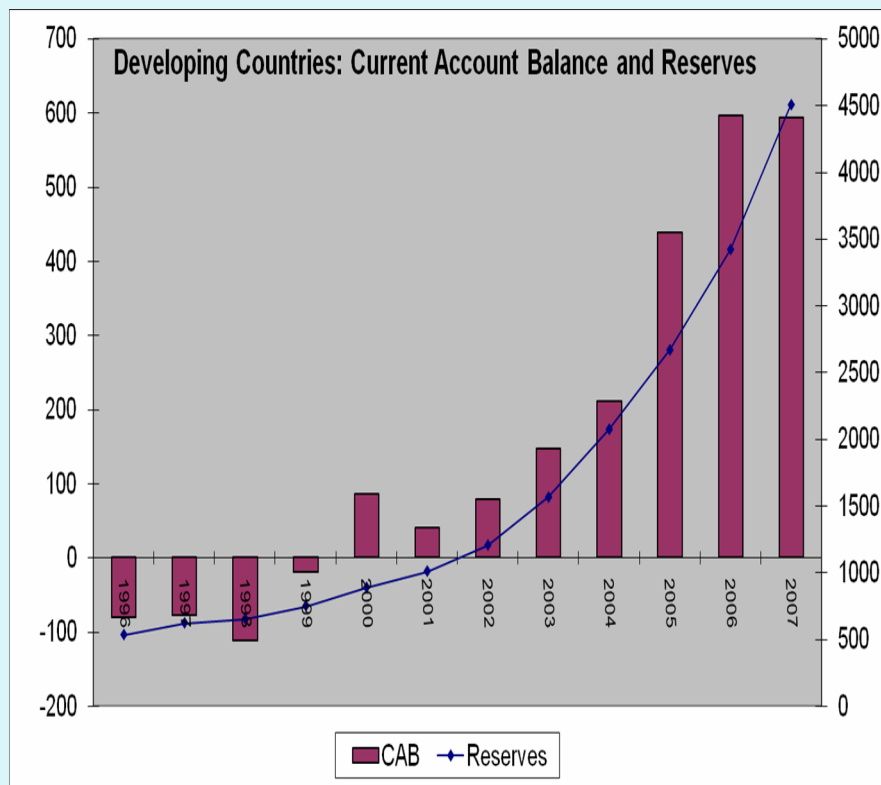
Two Imponderables

- **Yet *another* financial crisis** or will it fundamentally change macro-economic policy and management ?
- Why could economists, surveillance agencies and practitioners **not foresee** the storm despite accumulation of several macro-economic anomalies?
 - **Big disconnect** between consumer and asset prices
 - **Consumer prices** not responding as expected to growing liquidity and even rising input prices
 - Weakening link between **growth and employment**
 - **Interest rates and currency** not responding to trade and budget deficits
 - Greenspan: Fed losing ability to **control of long-term interest rates** because of huge capital movements
 - Build up of **systemically critical risk** outside the regulated banking system (Fed organized bail-out of LTCM)
 - A **global crisis** originating in a sector traditionally considered **non-tradable**
 - Developing countries becoming **net exporters of capital**

Role of Global Imbalances

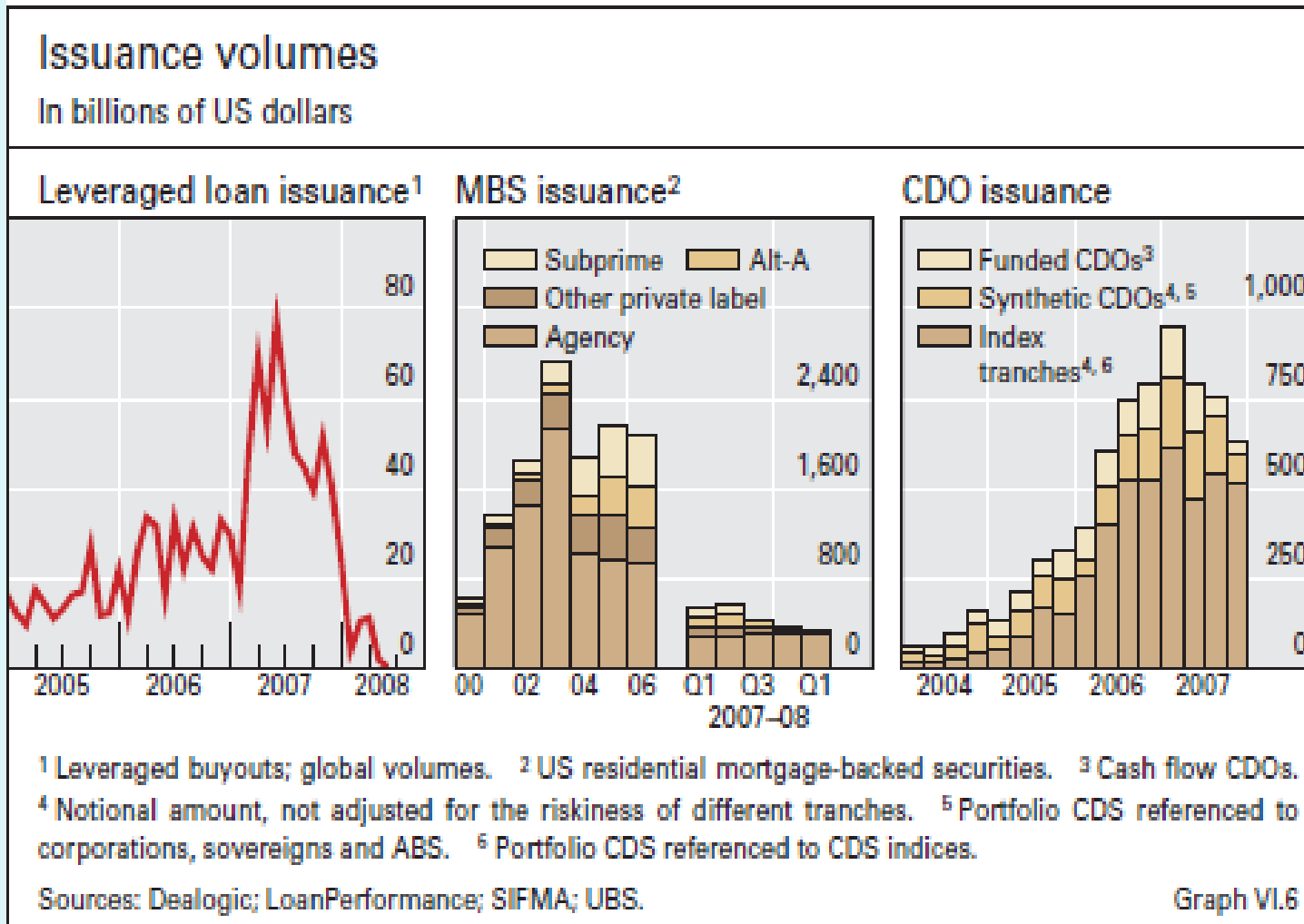
- **Cumulative Current Account Surplus** of developing countries between 2000-07 was \$ 2797 billion
- During this period developing countries added \$ 3759 billion to **reserves**
- Indicates that most of these **surpluses flowed** back to developed countries to finance consumption derived from **asset booms, financial innovation and leveraged demand** that enabled developing countries to sustain export-led growth.
- This recycling through reserve accretion added to **liquidity** in both **developed** (through purchase of hard currency denominated securities) and **developing** countries (to the extent of unsterilized monetization)
- **Decline of capital flows and reserve accretion** now impacting developing countries mostly on account of **decline in leveraged demand** in developed countries and **higher cost of capital**.

Imbalances and US Monetary Policy



US Urban CPI rose by just 10% between June 2000 and March 2004, while the US Case Shiller Housing index rose by 60%.

Proliferation of Opaque Instruments



Impact of First Phase of Credit Crunch

- Sharp decline in price of **financial assets** pushing up yields.
- Unclear what the impact of the US sub prime financial crisis would be on the **real economy**.
- Because of little exposure to toxic assets, continued high growth and the decoupling theory, there was a **flight to quality to emerging markets** like China and India:
 - unprecedented bull run in stock markets
 - currency appreciation
- Speculative bubbles in **commodities**.
- **Dollar** depreciation

Impact of Second stage of Credit Crunch

- **Decoupling argument** loses credibility
- Deleveraging adversely and sharply impacts **demand and growth across the globe** through trade and investment channels.
- Growth, capital flows, Investment, industrial production, trade and exports all sharply **downbeat across the globe.**
- **Flight of capital to quality: Dollar appreciation.**
- **Commodity boom pricked.**
- Sharp fall in all prices, both asset and consumer, stoke fears of **deflation.**

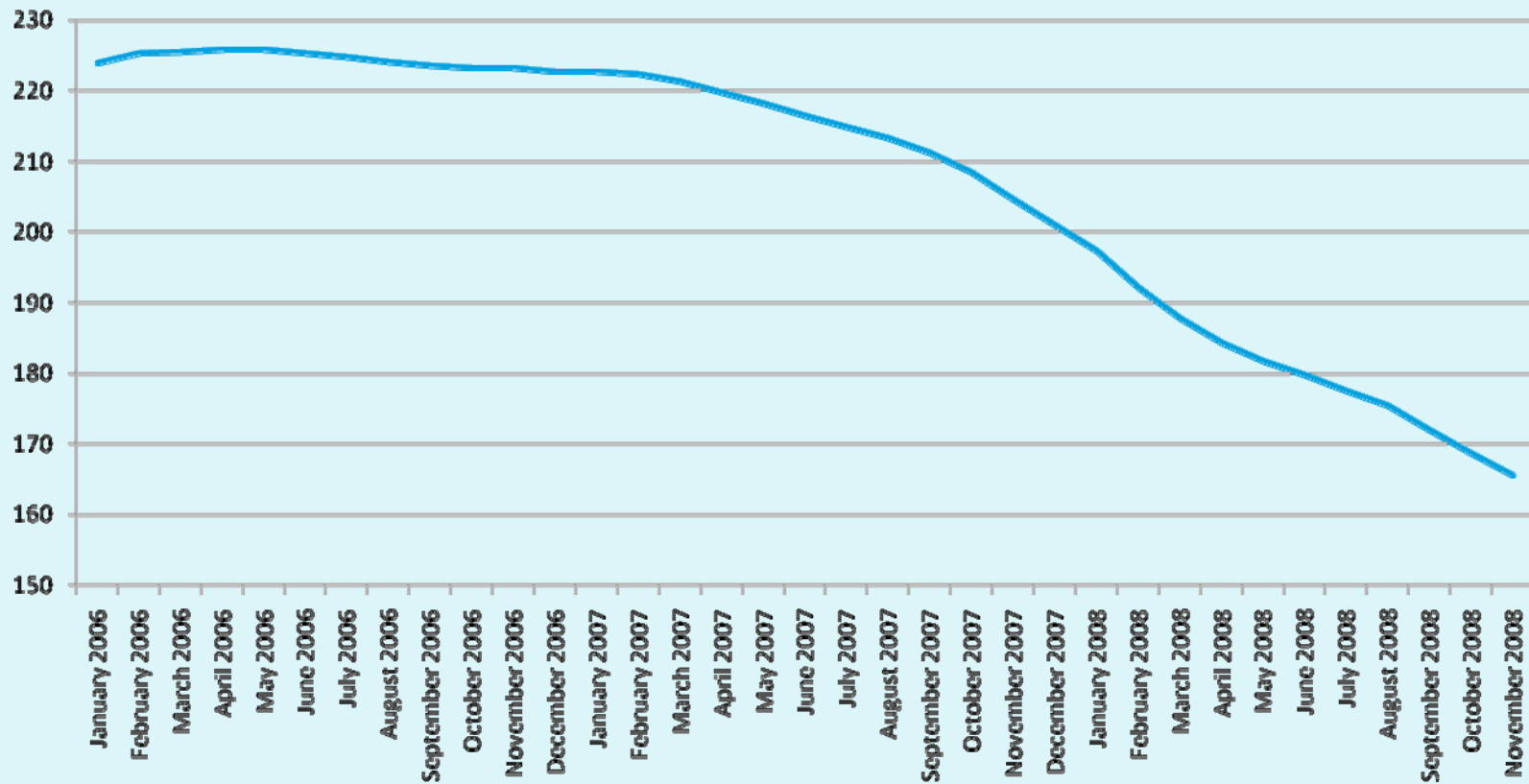
Is the worst behind us?

- Green shoots of recovery or dead cat bounce?
- Irving Fisher and the Great Depression.
- Mostly based on **stock rebound, fiscal expansion and backstopping. Sustainable recovery** hinges on revival of private demand. Jury still out.
- **WEO April 2009**, IMF Projections.
 - First decline of global GDP since WWII in 2009.
 - Sharp fall in growth, trade and industrial production in 4Q 2008 and 1Q 2009.
 - **China and India** only major countries projected to continue growing significantly in 2009.
- Comparative research indicates that crises originating in the real estate and banking sectors, and those global in scope, tend to be both **severe** and **protracted**.

Is the Worst Behind US?

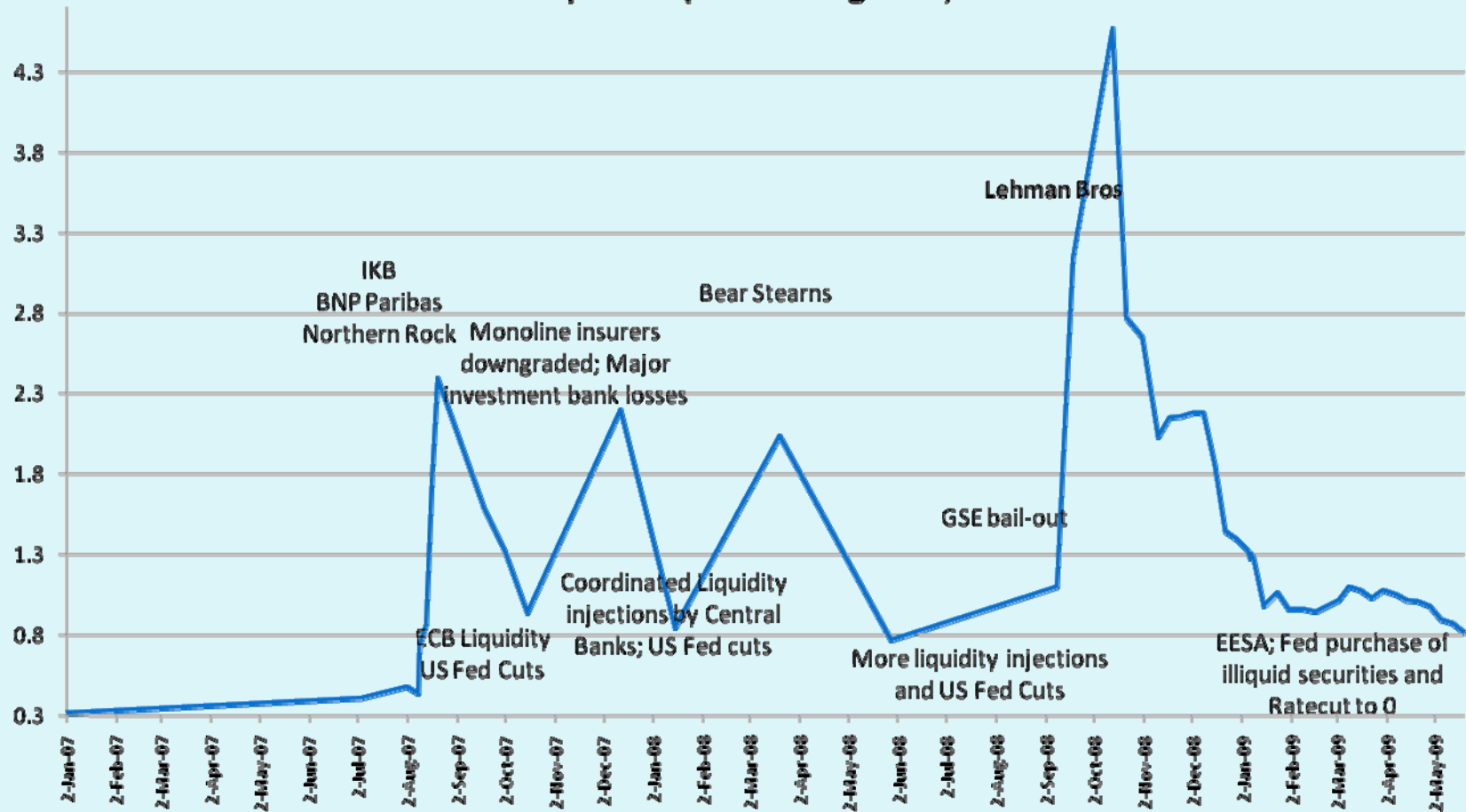
- **Housing prices** continue to slide
 - Case Shiller US House Price Index
 - Largescale upward revisions of ARMs coming up in 2009-10
- **Credit crunch** continues despite stock rebound
 - **TED** spreads
 - **ABX and CMBX** prices in freefall
 - **Defaults spreading** beyond sub prime and even housing sector.
- Estimates of **toxic assets** continue to rise
 - IMF: \$ 4 trn and Nouriel Roubini: \$ 4.6 trn
 - Far in excess of rescue packages

S&P Case Shiller Seasonally Adjusted (Composite 10) House Price Index



Credit Crunch Canary

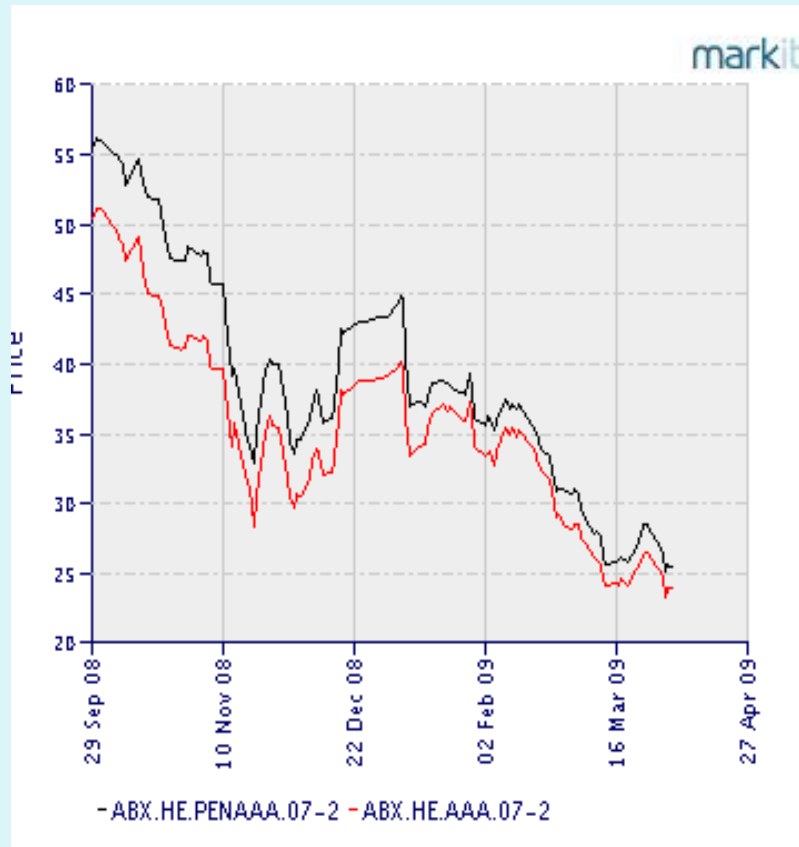
TED Spreads (Bloomberg.com)



Toxic Assets (Markit.com)

ABX Indices: AAA Rated

ABX Indices: AA Rated



Toxic Assets (Markit.com)

CMBX Indices: AAA Rated

CMBX Indices: AA Rated



The Global Response

Global Policy Response

- Policy response to stabilize the financial sector and the economy so far largely based on **lessons derived from the Great Depression**: Ben Bernanke, Chairman of US Fed, an authority on the Great Depression.
- Policy reform agenda set by **G 20 rather than G 7/8** or IMF
- Chief ingredients:
 - **Monetary loosening** : US Fed had aggravated the Great Depression by tightening monetary policy as liquidity was drying up.
 - **Fiscal expansion**: parallels with Roosevelt's *New Deal*
 - Ring fencing **toxic assets** and **recapitalizing** banks
 - **Trade openness**: protectionist pressures unleashed by the Smoot-Hawley Tariffs aggravated the Great Depression.

What more can policy makers Do?

- More of the same?
 - Policy rates already zero bound
 - QE being done as required
 - Size of fiscal expansion debatable ('automatic' vs 'discretionary': sharp differences within G 20 between US, UK vs Europeans)
 - However, at every stage plans to take out toxic assets have been less than ambitious
- More innovative “recession” tax policy?
 - give tax credit for consumption rather than savings?
 - Put additional income in the hands of those with the least propensity to save, i.e the poorest?
 - Tax exemption for investment?
- Hope?
 - Wait for measures taken to work

Co-ordinated Global Action

- **Global integration** through trade and capital flows made the crisis global in scope
- Realisation that global problems need **global solutions**
- The **institutional structure** to handle rapid globalization is weak.
- **G 20, a forum of** systemically important economies, accounting for about 75-80 % of global GDP, emerging as the forum for concerted multilateral action.
- **Global agenda** set by the **Washington Declaration** of November 15, 2008 and **London Communiqué** of April 2, 2009 issued by G 20 leaders.

G 20 : Background

- Represents **75% of global GDP** (PPP), and 81% including the Euro Area. (2007)
- Africa, Central and Eastern Europe and LDCs **under-represented** .
- Formed at the time of the **East Asian Crisis** a decade ago.
- **Chair rotates** annually: 'Troika' of last chair Brazil (2008), current chair UK (2009), next chair South Korea (2010)
- Till the Washington Leaders' Summit meeting only at the **Finance Ministers' level**.
- Next Summit meeting on September 24-25, 2009 in the US. However, permanent **status of Summit meetings unclear**.

G 20 : Countries

Developed Countries

- USA
- UK
- European Union
- France
- Germany
- Italy
- Australia
- Canada

Developing Countries

- China
- India
- Indonesia
- South Korea
- Russia
- Saudi Arabia
- Turkey
- South Africa
- Argentina
- Brazil
- Mexico

G 20 Process to Address the Crisis

- **Leaders' summit**
 - Washington DC, November 15, 2008
 - London, April 2, 2009
 - ***USA (venue tbc), 24-25 September 2009***
 - ?
- **Sherpas' process**
 - Back to back with Leaders' Summits
 - Conference calls: January 14 and February 5, 2009
 - Face to face meeting London, February March 5-6, 2009
 - ***July 30-31, 2009 and September 10-11, 2009***
- **Finance Ministers and (finance and central bank) Deputies Process**
 - Sao Paulo, November 13-14, 2008
 - London, January 31-February 1, 2009
 - London, March 13-15, 2009
 - ***Basle, 27 June ,2009***
 - ***London, September 3-5, 2009.***
 - ***St. Andrews, UK, November 7-8, 2009***
- **Working Groups**
 - Conference Calls, E-Mail groups, One or two face to face meetings
 - Reports finalized and published at <http://www.g20.org/366.aspx>
 - ? Role in follow up/monitoring recommendation outcomes?

G 20 Working Groups

- The Washington Declaration laid out the broad agenda, both **short-term** (palliative) and **long-term** (preventive).
- G 20 Troika formed **4 WGs** to address the actionable points.
- **Macro-economic issues** handled directly at the Finance Ministers and Leaders levels
- WGs **co-chaired** by Developed and Developing Countries (India co-chaired WG I on financial regulation)
- India formed **5 mirror groups** that injected India's views into the G 20 working groups.
- WG Reports published at <http://www.g20.org/366.aspx>
- Future Role?

WG I: Strengthening Transparency and Enhancing Sound Regulation

- **Forward looking** but also linking back to current crisis
- Focus on **Five Broad areas**:
 - Pro-cyclicality and capital buffers
 - Strengthening OTC structures
 - Broadening regulatory boundaries
 - Compensation schemes
 - Transparency in valuation and accounting
- Detailed work being done by **specialized agencies** like FSF, IMF, IASB, BCBS, IOSCO, etc.

WG II: International Co-operation and Market Integrity

- Immediate expansion of **FSF** on clear metrics
- **Governance issues** relating to other international bodies such as IASB, IOSCO, Supervisory Colleges
- Contingency **planning and crisis management** structures covering systemic institutions, including exit strategies and harmonizing host/investor country interests.
- Improving analytical tools for identifying macro-financial vulnerabilities and closer collaboration between **FSF and IMF on early warning systems.**
- Issues relating to **market integrity**: money-laundering, tax havens and off shore centres.

WG III: Reforming the IMF

- Strengthening IMF **early warning surveillance** in an even handed manner.
- Broad consensus on **expansion of IMF resources in the short run**, to address the sharp decline in capital flows to EMEs.
- Broad consensus on governance reform, including open selection of MD, and quota expansion.

WG IV: World Bank and Regional Development Bank (RDB) Reform

- Consensus on timely **countercyclical response** to the crisis through flexible, instruments, front loading and dynamic provisioning.
- Broad support for an immediate and substantial **general capital increase of the ADB**, and to review capital expansion of other MDBs.
- On governance, broad agreement on major reform, including selection process of institution heads.
- Little support for expanding the crisis management mandate to include **climate change issues**.

Macro-economic Issues

- Handled directly at the **Sherpas/Leaders'** level
- Centred on
 - Co-ordinated fiscal and monetary **stimulus**
 - Restoring **Trade Finance**
 - Raising additional **resources for IFIs**
 - Countering growing **protectionist tendencies**
 - **Climate** change
 - **Labour** and Employment issues

G 20 Leaders' London Declaration

- Additional **\$ 1.1 trn resources** to restore growth and credit
 - \$ 500 bn new borrowing by IMF
 - \$ 250 bn new SDR allocation
 - \$ 100 bn additional lending by MDBs
 - \$ 250 bn trade finance facilities
- Agreement on **extending oversight and regulatory boundaries** of financial institutions.
- Crackdown on **tax havens**
- Renewed pledge to eschew and roll back all forms of **protectionism**
- Co-ordinated and sustainable fiscal and monetary stimulus
- Time line for reform of governance structure of **BWIs**.
- FSF and other international financial code setting institutions to be made more **inclusive**.

Pitfalls before the G 20

- **Loss of credibility:**
 - London declaration a more detailed and specific version of the original Washington version. Would need to deliver before the third summit in Washington DC.
 - Countries going back on what they have agreed (trade, regulatory reform, governance reform)
 - Poor developing countries and Eastern-central Europe underrepresented in G 20
- **Broadening of agenda and possible loss of focus:**
 - climate, Labour, trade, etc.
- **No institutional framework to implement/enforce coordinated response.**
- **Undercurrents and Caucuses within G 20:**
 - Developed versus developing countries.(Differences on IFI reform)
 - BRIC EMES versus African and smaller developing countries (Poorer countries underrepresented)
 - US versus China (Imbalances and currency issues off the G 20 agenda!)
 - Anglo-Saxon versus Europeans (Differences on extent of regulation, stimulus & IFI reform)

Issues Before EMEs

Co-ordination amongst EMEs

- To **make an impact** it is important that EMEs consult and work closely together.
- Developing country **concerns** should be adequately reflected in G-20 documents. Important that these views are **injected into G-20 drafts** sufficiently early.
- India regularly **meeting on the sidelines** of G 20 meetings with China, Russia, Brazil, South Africa, and Mexico.
- Such co-ordination should not create the impression of creation of a **rival caucus** that could result in a backlash from G 7 countries: bilateral consultation and country position papers containing common elements.

Common Ground amongst EMEs

- More needs to be **done by developed countries** to stem the downside since the crisis originated in developed countries.
- Focus on core issues of financial regulation, economic downturn and capital flows to EMEs **without getting distracted** by climate change, trade, health, education, labour, etc, which are being handled in other forums.
- The **future status of the G-20 Leaders process** should be clearly spelt out.
- **Fiscal and monetary steps** taken by developed countries to combat the crisis should not adversely affect BRIC
 - **Protectionist** tendencies
 - **Crowding out** of capital markets
- Short term counter-cyclical focus should not crowd out **long term governance issues**:
 - comprehensive reform of BWIs to reflect changing economic weights
 - more inclusive international code setting bodies
 - even-handed surveillance of systemically important economies & centres

Major Gains by Developing Countries?

- **Emergence of the G 20** as the primary multilateral forum for economic and financial negotiation
 - Process still ad hoc and not institutionalized
- Inclusion in **international code setting bodies** like FSF, BCBS, etc.
 - Danger of becoming rubber stamps if they do not quickly develop capacity to contribute constructively to development of sophisticated financial markets and instruments
- Consensus on **major IFI reform**
 - Major reform still to take place
 - Resource raising delinked from reform process
 - G 20 EMEs still to put their money where their mouth is
- Consensus on raising **additional resources** to counter impact of decline in private flows
 - Allocation of additional resources still an open issue

Issues for EMEs to ponder

- If they wish to be bigger players at the international high table they need to
 - develop a ***mutually acceptable formula*** for comprehensive restructuring of BWIs
 - ***put some money*** where their mouth is and contribute to global resource mobilization
 - Persuade their ***domestic stakeholders*** about parting with scarce resources needed for infrastructure and income support at home.
 - carry smaller and ***poor developing countries*** along.
Resentment brewing against G 20 in more representative forums like G 24 and World Bank (On issues like sale of IMF gold, single borrower limits in the World Bank)

Ten Trillion Dollar Questions

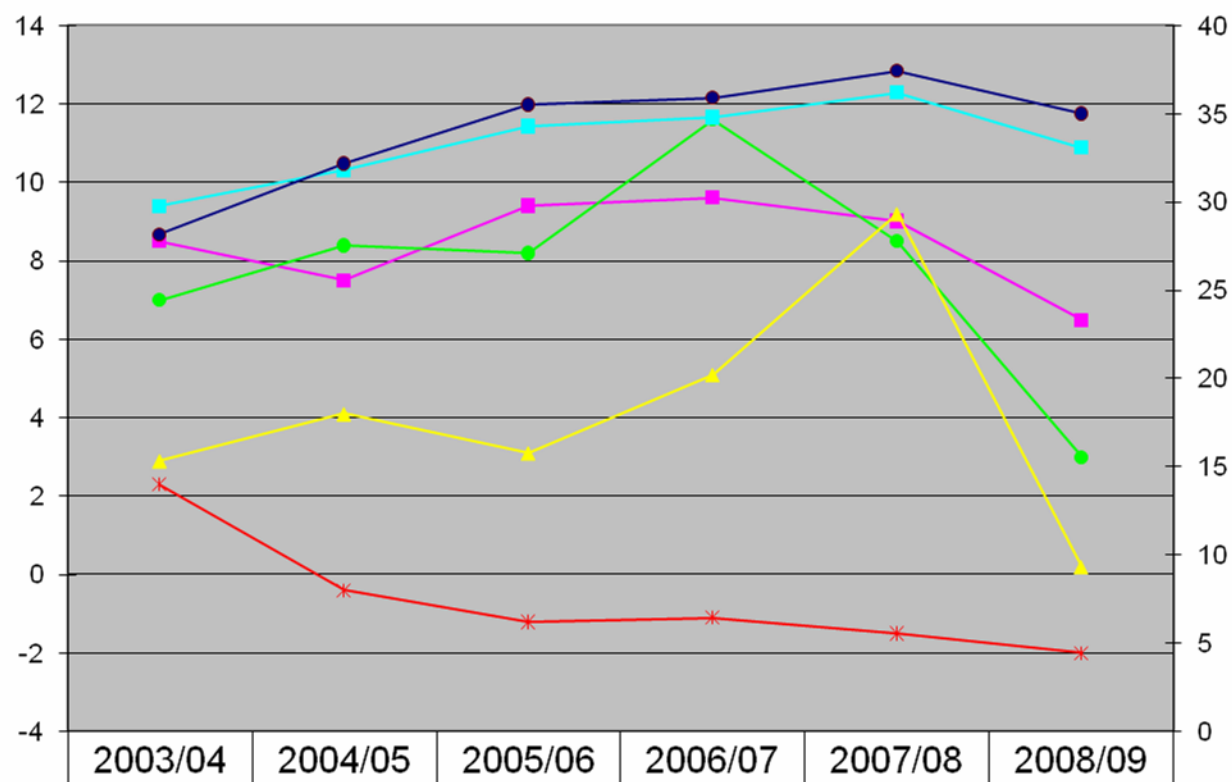
- **Shape of recovery** of the global economy: V U W L?
- Is deflation the **greater threat** or inflation?
- Is **unwinding of global imbalances**, and substantial domestic demand expansion in EMEs, a necessary condition for revival of sustainable growth?
- Is the era of **leveraged hyper growth** over, and is this providential from the sustainability viewpoint?
- Is tighter financial **regulation** here to stay?
- Major changes in **monetary policy** rules?
- Future of the **Dollar** as international reserve currency?
- **Convergence** of Anglo-Saxon and European capitalism?
- Acceleration or deceleration of **globalization**?
- Will **G 20** supplant G 7 and BWIs change radically?

INDIA AND THE GLOBAL CRISIS

India on eve of Credit crunch

- **Growing strongly** at above 8% for 5 years
- **Animated debate** on whether growth was above trend or trend growth had moved up.
 - **Savings and investment** (esp. private) rising smartly
 - **Prices** more or less within tolerance level of 6%
 - **Monetary tightening** dampened growth rate slightly
 - Corporates **circumvented monetary policy** through Capital markets and ECB
- **Service sector** engine of growth
- **Infrastructure** main bottleneck
- **Fiscal correction** over last few years
- **Financial sector** in relatively good shape
 - Implementation of **Basel norms**
 - Regulation based on the premise that financial transactions should be anchored in the **real sector**.
 - **Leverage** levels not excessive
 - **Insignificant exposure** to opaque, illiquid asset backed securities.
 - Conservatively managed with **calibrated** opening up

India Macroeconomic Fundamentals



| | | | | | | |
|---------------------------|------|------|------|------|------|------|
| —■— GDP (Left Axis) | 8.5 | 7.5 | 9.4 | 9.6 | 9 | 6.5 |
| —●— IIP (Left Axis) | 7 | 8.4 | 8.2 | 11.6 | 8.5 | 3 |
| —*— CurAB/GDP (Left Axis) | 2.3 | -0.4 | -1.2 | -1.1 | -1.5 | -2 |
| —▲— CapAB/GDP (Left Axis) | 2.9 | 4.1 | 3.1 | 5.1 | 9.2 | 0.2 |
| —■— savings/GDP | 29.8 | 31.8 | 34.3 | 34.8 | 36.2 | 33.1 |
| —●— investment/GDP | 28.2 | 32.2 | 35.5 | 35.9 | 37.4 | 35.0 |

Impact of First Phase of the Credit Crunch (August 2007)

Sharp rise in net **K flows**

- **Stock market boom**
- Rupee **appreciation**
- Sharp rise in **reserves**

- **Inflationary**

- **Commodity boom**
- Imperatives of **Exchange rate** management

- Central Bank grapples with the **impossible trinity**

- Stabilize GDP?
- Stabilize exchange rate?

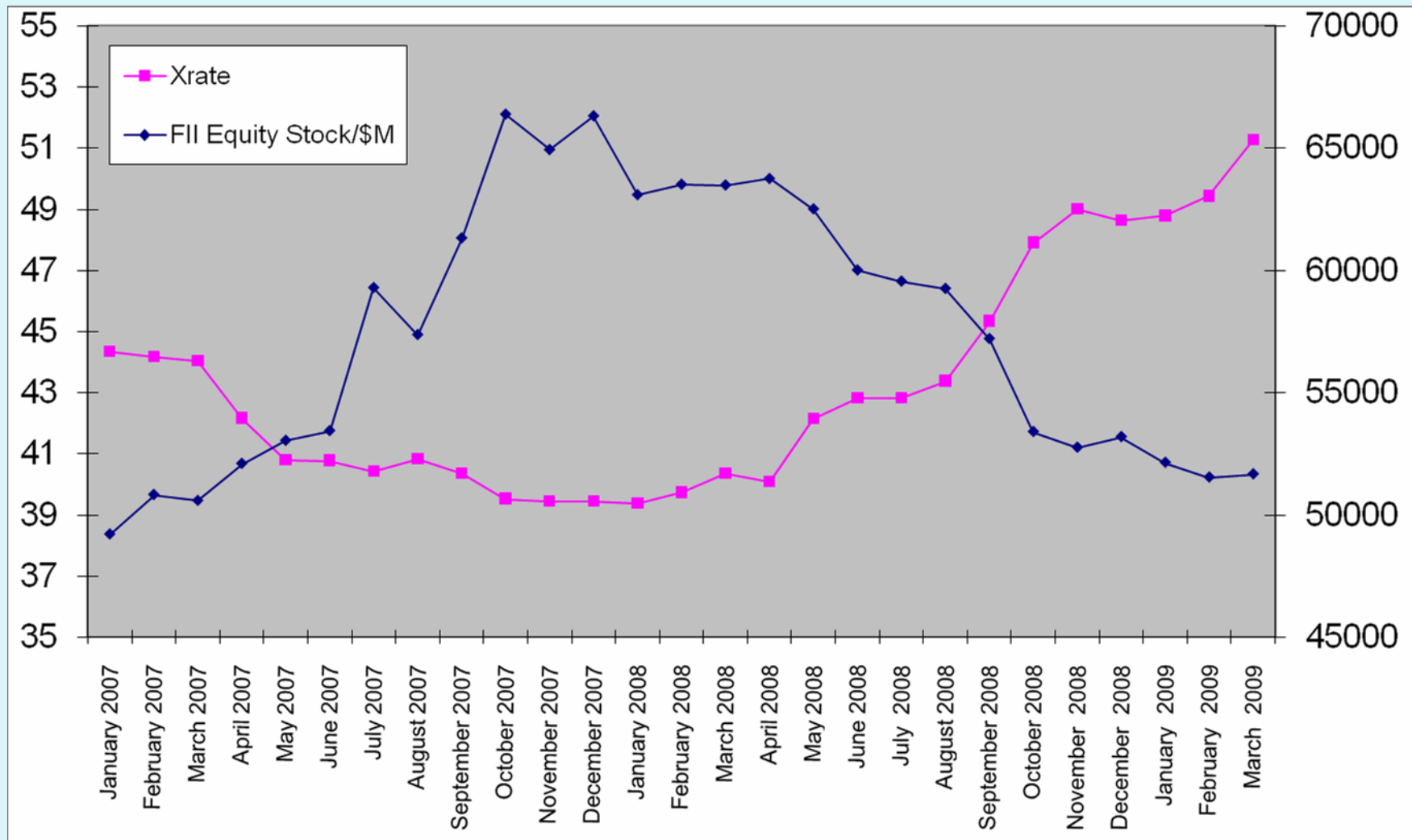
Impact of Second Phase of the Credit Crunch (September 2008)

- Sharp decline in net **K flows**
 - **Stock market** crash
 - Rupee **depreciation**
 - **Capital account** slips into deficit for the first time in several years.
- **Inflation** zero bound
 - **Commodity** bubble pricked
 - Liquidity tight
 - Big increase in **fiscal deficit**
 - Sharp decline in **capital market** financing
 - Only slight decline in **bank credit growth**
- **Economic downslide** led by industrial growth and exports
 - Overall growth still **amongst two fastest globally**
 - **Rural economy** in relatively better shape

Sensex and FE Equity Stock

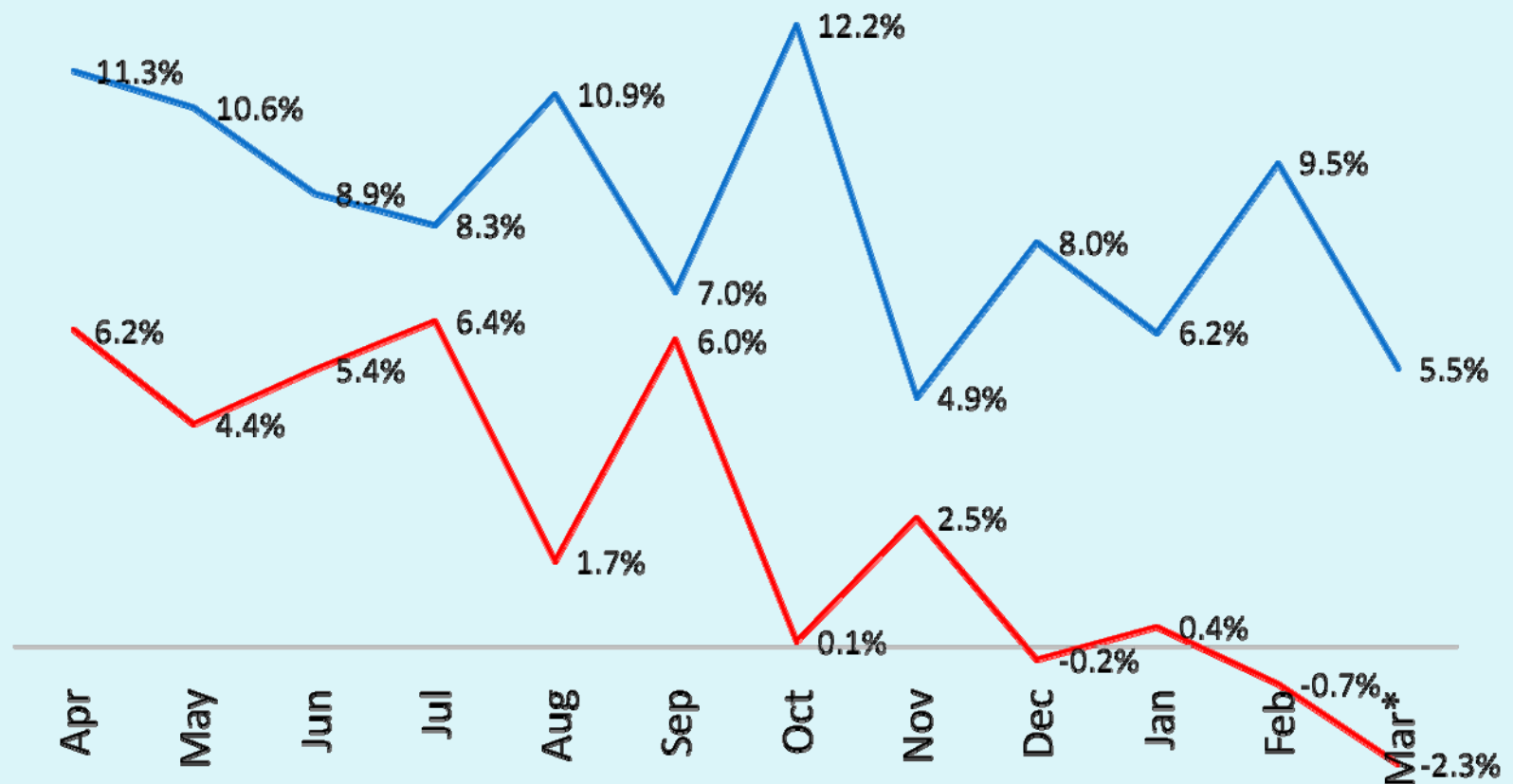


Indian Rupee and FE Equity Stock



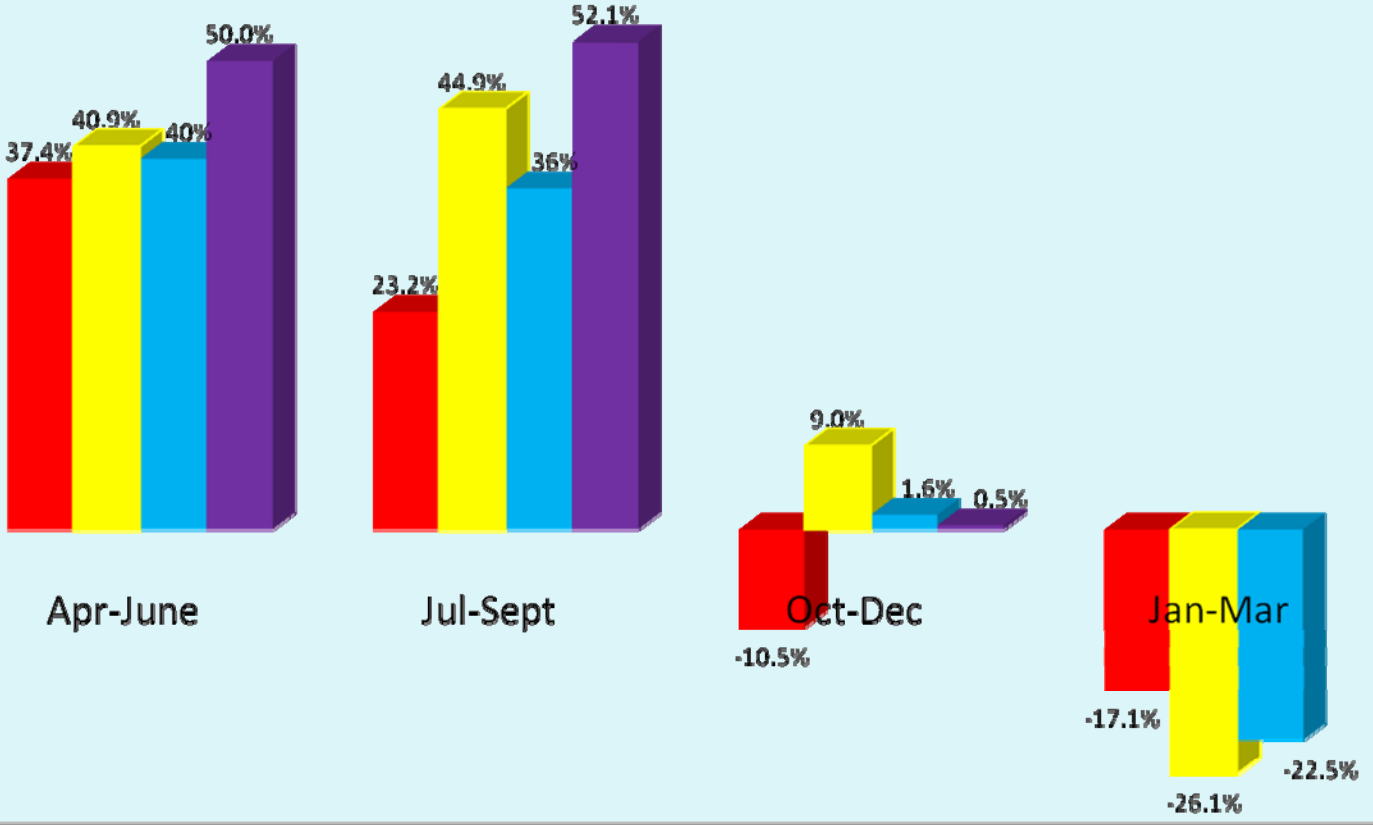
Index of Industrial Production

— 2007-08 — 2008-09



Trade 2008/9 over 2007/8

■ Exports ■ Imports ■ M_Trade ■ Net_Inv



Balance of Payments

■ Apr-June ■ Jul-Sept ■ Oct-Dec

\$ Billion

2007-08

2008-09

Curr_Acc

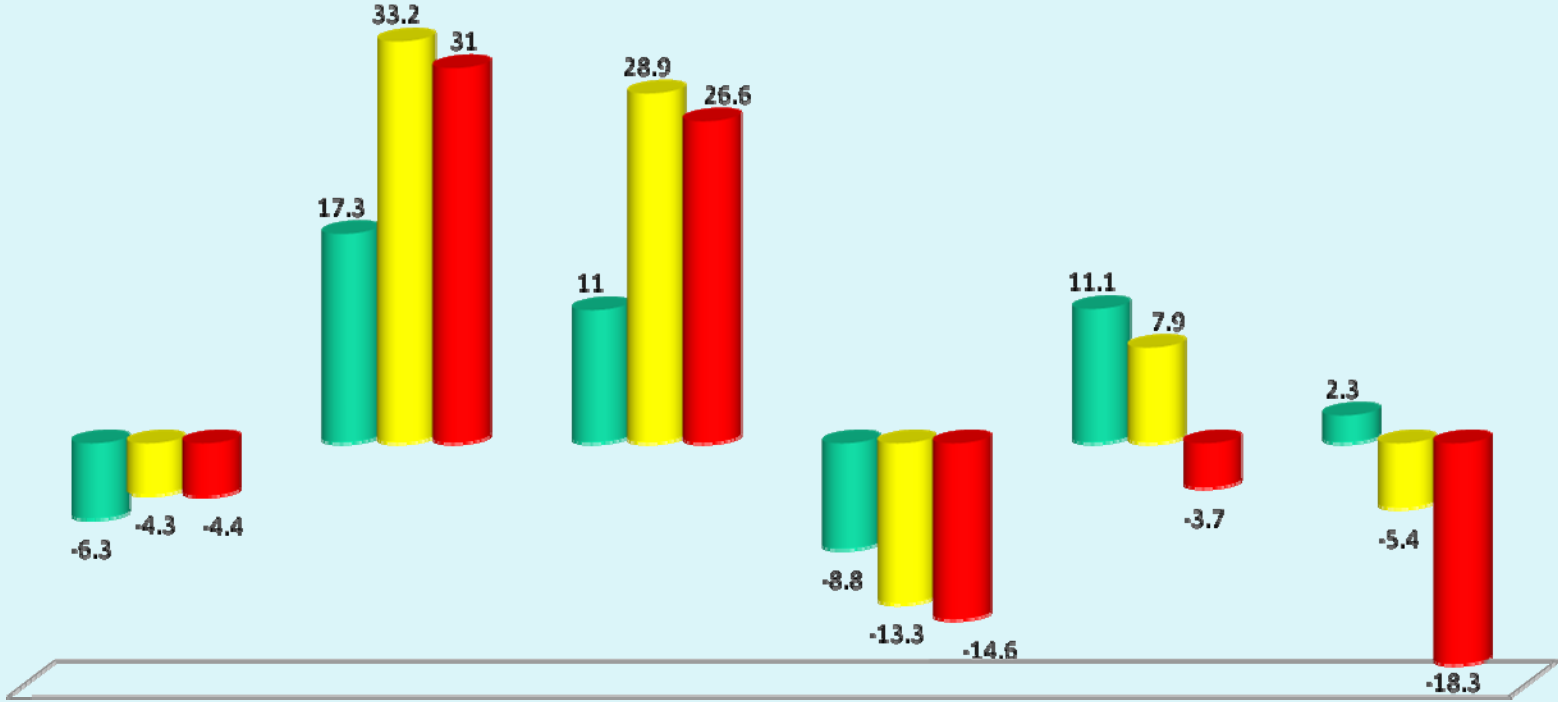
Cap_Acc

BOP

Curr_Acc

Cap_Acc

BOP



Monetary Policy

- Monetary Loosening
 - benchmark overnight **lending rate** (Repo) cut by 350 basis points from 9% to 5% between July 29, 2008 and March 5, 2009.
 - Mandatory **reserve requirements** reduced
 - **Liquidity injection** of about 9% of the GDP through lowering bank cash reserve requirements and special refinance facilities.
 - Unlike western countries monetary policy still has **traction**
 - **Transmission** mechanism weak because of illiquid corporate bond market and key administered interest rates. (*Structural not crisis related feature*)

Fiscal Policy

- Fiscal expansion

- net **additional expenditure** in 2008-09 upwards of \$ 35 billion (Rs. 160000 crore), or a little above 3 % of GDP PLUS enabling State Government stimulus of 0.5% of GDP.
- Not all of this is crisis linked, and **begun in first phase** of the credit crunch, but expansionary anyway
- **instruments** include enhanced outlays on social protection and employment generation schemes, infrastructure, trade finance and promotion, farm loan waiver, public sector pay rise, reductions in indirect taxes.
- IMF March 2009 **projections** show India's overall fiscal balance to decline from -5.2% of GDP in 2007, to -8.4% in 2008, -10% in 2009 and – 8.6% in 2010
- **liberalized norms** to improve access to resources and liquidity, both domestically and externally, through equity and debt.

Growth Upsides

- **Financial sector** robust and not highly leveraged
- **Less dependence on export** sector compared to several other EMEs.
- Robust **farm sector** and growth in rural incomes on account of shift in terms of trade and NREGS
- Domestic enterprises have become more internationally **competitive** because of trade policy reforms
- **Commercial banks** have healthy balance sheets
- **External payments** situation comfortable because of huge reserves
- Softening of **commodity prices**.
- **Monetary space** available

Growth Downsides

- Negative **external environment**:
 - reduction in demand and increasing protectionism
 - Both capital and current account negative
- Business **confidence levels** low and risk aversion
- Bank credit has been unable to **make up for decline** in equity investment, NBFC credit and foreign capital inflows.
- Limited **fiscal space**: IMF March 2009 projections show India's overall fiscal balance to decline from -5.2% of GDP in 2007, to -8.4% in 2008, -10% in 2009 and – 8.6% in 2010
 - PC: worth taking additional risk to boost growth
 - RBI: Danger of crowding out private investment
- Decline in **private investment**?
- **Manufacturing** sector sluggish.
- Weak **monetary policy transmission** because of absence of corporate bond market and continuation of key administered interest rates.
- **Monsoon** uncertainties.

Bottom-line

- Expected that India would **continue to grow** during the crisis although at much below trend levels.
- Main **threat is external**. The most critical issue is stabilization and return to normalcy of global financial markets.
- Since the CAD is modest, only modest levels of capital inflows required for sustainable growth. **Domestic savings adequate** to sustain recent trend growth.
- **Limited policy space** for protracted interventions
 - High fiscal deficit and debt overhang
 - Structural weaknesses in monetary policy transmission

Thank You