

Speech on 6-02-2009 at Gwalior **Global Financial Crisis**

The roots of the current global crisis lie in the interplay of several developments that have fundamentally transformed the financial capitalism that existed in the western world, particularly the USA. Traditionally banks were careful to lend only to trusted clients, and carried the debt on their books. They bore the risk. Now there is securitisation. Lenders pool the loans and resell them as asset-backed securities. These securities are then repackaged, leveraged, tranced and resold many times over. A second related development is the emergence of highly sophisticated derivative products. Especially important among these today are the credit default swaps (CDSs). Taken together, asset-backed securities and derivatives widely spread the risk, but they also breed complacency towards risk. The selling and reselling of risk also lays the foundation for quick contagion. Defaults on original loans at the base rapidly contaminate the entire superstructure of assets and derivatives that rest on this base.

While India is not likely to face a financial meltdown of the kind that was experienced in the US, the global financial crisis will certainly have an impact. When the financial crisis erupted in a comprehensive manner on Wall Street, there was some premature triumphalism among Indian policymakers and media persons. It was argued that India would be relatively immune to this crisis, because of the “strong fundamentals” of our economy and the supposedly well-regulated banking system. But even though we are slightly better protected from financial meltdown, largely because of the still predominant role of the nationalised

banks and other controls on domestic finance, there is certainly little room for complacency.

Impact of the downturn on India

The most immediate effect of that crisis on India has been an outflow of foreign institutional investment from the equity market. Foreign institutional investors, who need to retrench assets in order to cover losses in their home countries and are seeking havens of safety in an uncertain environment, have become major sellers in Indian markets.

In 2007-08, net FII inflows into India amounted to \$20.3 billion. As compared to this, they pulled out \$11.1 billion during the first nine-and-a-half months of calendar year 2008, of which \$8.3 billion occurred over the first six-and-a-half months of financial year 2008-09 (April 1 to October 16). This has had two effects: in the stock market and in the currency market.

The pullout triggered a collapse in stock prices. As a result, the Sensex fell from its closing peak of 20,873 on January 8, 2008, to less than 10,000 by October 17, 2008. Secondly this withdrawal by the FIIs led to a sharp depreciation of the rupee. Between January 1 and October 16, 2008, the RBI reference rate for the rupee fell by nearly 25 per cent. While this depreciation may be good for India's exports that are adversely affected by the slowdown in global markets, it is not so good for those who have accumulated foreign exchange payment commitments

A second route through which the global financial crisis could affect India is through the exposure of Indian banks or banks operating in India to the impaired assets resulting from the sub-prime crisis.

So far the RBI has claimed that the exposure of Indian banks to assets impaired by the financial crisis is small. According to reports, the RBI had estimated that as a result of exposure to collateralised debt obligations and credit default swaps, the combined mark-to-market losses of Indian banks at the end of July was around \$450 million.

A third indirect fallout of the global crisis and its ripples in India is in the form of the losses sustained by non-banking financial institutions (especially mutual funds) and corporates, as a result of their exposure to domestic stock and currency markets. Such losses are expected to be large, as signalled by the decision of the RBI to allow banks to provide loans to mutual funds against certificates of deposit (CDs) or buyback their own CDs before maturity

A fourth effect is that, in this uncertain environment, banks and financial institutions concerned about their balance sheets, have been cutting back on credit, especially the huge volume of housing, automobile and retail credit provided to individuals. According to RBI figures, the rate of growth of auto loans fell from close to 30 per cent over the year ending June 30, 2008, to as low as 1.2 per cent. Loans to finance consumer durables purchases fell from around Rs 6,000 crore in the year to June 2007, to a little over Rs 4,000 crore up to June this year. Direct housing loans, which had increased by 25 per cent during 2006-07, decelerated to 11 per cent growth in 2007-08 and 12 per cent over the year ending June 2008

Finally, the recession generated by the financial crisis in the advanced economies as a group and the US in particular, will adversely affect India's exports, especially its exports of software and IT-enabled services, more than 60 per cent of which are directed to the US.

Thus there's no mistaking that the global financial crisis has found its way to India's shores at a time when the country is in no shape to weather it. The stock market is choppy, there's been a credit squeeze, interest rates are up, and banks continue to rein in loans as inflation hovers at 12%. Growth has slowed from the heady 9% of a year ago to 7.9% for the three months ended in June, and it's forecast to grow only at 7.5% for the fiscal year ending this March. Meanwhile, an already weak currency ended Oct. 8 at 48 rupees to the dollar, its lowest level in 5½ years. The rupee has taken a 21% dive since January last. The central bank's rate cut, which the bank statement calls "ad hoc and temporary," is likely to infuse \$4 billion in domestic liquidity and shore up the rupee by selling dollars

Steps taken/to be taken to meet the crisis

It is difficult to fully comprehend the depth of the global crisis in a country like India that will record growth of around 7 per cent for fiscal 2008 at a time when most developed countries are shrinking. Some sectors like exports, real estate, textiles, IT and transport equipment have been affected severely. But overall, the impact has been limited, thanks in no small measure to the prompt and sustained measures taken by the RBI and the government. The markets have stabilised. The decline of the rupee has been arrested. The stock market has started recovering, the Satyam shock notwithstanding, and the flow of credit is reviving gradually.

The important question is what more should the government do now to contain the expected decline in growth in fiscal 2009. Critics point out that most of the steps so far have been monetary measures to ease the supply of credit, few fiscal measures to revive the aggregate demand. Beyond a point, that is like pushing on a loose string if the binding growth constraint is now on the demand side. Actually, a very substantial fiscal stimulus has been provided through the supplementary demand for grants in September and a second supplementary demand in December

This should be followed by a large deficit in the budget for fiscal 2009, ignoring the FRBM for now. Also, a part of the deficit should be monetised, temporarily shelving the agreement that the RBI will not finance central government debt, in order to minimise the crowding out of private borrowers. The government is currently focusing on additional spending on infrastructure. This is welcome. However, it should also target additional spending on education, health and agriculture. There is compelling evidence that such spending is not only more effective than infrastructure spending in reviving current demand, but also more effective in enhancing future growth potential.

While India is not likely to emerge unscathed from the financial crisis sweeping the globe, its impacts are not expected to be very severe thanks to the structure of its economy, exports and financial markets. India is a part of the global economy and so it cannot be de-coupled from the rest of the world... but India is likely to insulate it from the worst of the effects that would be felt in other countries,”

Domestic demand in India are very strong, the massive investments, which overtook consumption as the key driver of economic growth in 2003-04, have increased by 20 per cent from last year's level

It is true that one important result of the global meltdown will be that our GDP growth rate will be lower than before.

Even the most pessimistic analysts reckon that the Indian economy will keep growing by at least 6% every year even in the worst of times. Even between 1991, when economic reforms were launched, and 2003, the GDP growth rate hovered around 5.5% per year. It has been only in the last five years that we have seen growth rates in excess of 8%. And that will now inevitably fall to around 6% since the global economy is facing a crisis of unprecedented proportions.

A 6% growth rate means that the per capita income of India will grow at more than 4% – for most of its history as an independent nation, India's per capita income has grown usually at about 1%. With per capita income growing at more than 4% a year, tens of millions of Indians can jump out of poverty in the next decade. That is exactly what happened in the last 15 or so years when the percentage of Indians living below the poverty line fell from about 40% to about 25%.

We much remember that, this is a India has perhaps the highest population which has a growing purchasing power and has a long way to go before a Japan/USA type of a consumer saturation sets in. big chance for the

entrepreneurial Indian to innovate new businesses, and, for existing businesses to wake up from their slumber and make their companies more competitive. Every global report is categorically stating that the Indian economy is amongst the only few economies that will show a high positive growth in the near future.