# *The International Financial Crisis and Its Impact on India*

*by*

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*August 6, 2009*

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The world is passing through a difficult time. More so, the developed world. The industrially advanced countries are now officially in recession, having had two consecutive quarters of negative growth. It is not known at this stage how long will this recession last and how deep will it be. This will be perhaps the deepest recession in the post-second world war period.

The impact of the financial crisis is felt by the developing economies as well. Growth is slowing down in all these countries. India's growth rate in 2008-09 was 6.7 per cent as compared to 9 per cent in the previous year. Prospects for 2009-10 do not appear to be better. While in 2008-09 the first half escaped the impact of global recession, in the current year the impact will be felt throughout the year. Globalisation spreads both prosperity and distress. The contagion works both ways.

**Evolution of the Crisis**

The international financial crisis originated in the sub-prime mortgage crisis which surfaced nearly two years ago in the U.S. With interest rates rising and home prices falling, there was a sharp jump in defaults and foreclosures. However, this would have remained as a purely mortgage market crisis but for the fact that these sub-prime mortgages were securitized and packaged into products that were rated as investment grade. Once doubts about these assets arose they turned illiquid; it also became very hard to price them. As a result, it started affecting a host of institutions which had invested in these products. These institutions were not confined to U.S. alone. Financial institutions in Europe and to a much lesser extent in East Asia had such assets on their books. With the failure of a few leading institutions and most notably Lehman Brothers, the entire financial system was enveloped into an acute crisis. There was mutual distrust among the financial institutions which led to freezing up of several markets including the overnight inter-bank market. Many think today that letting the Lehman Brothers to fail was a great mistake. The crisis in the financial system has now moved to affect the real sector in a significant way.

**Regulatory Failure**

What stands out glaringly in the current episode is the regulatory failure. The regulatory failure was twofold. First, some parts of the financial system were either loosely regulated or were not regulated at all, a factor which led to "regulatory arbitrage" with funds moving more towards the unregulated segments.

The second failure lies in the imperfect understanding of the implications of various derivative products. In one sense, derivative products are a natural corollary of financial development. They meet a felt need. However, if the derivative products become too complex to discern where the risk lies, they become a major source of concern. Rating agencies in the present episode were irresponsible in creating a booming market in suspect derivative products. Quite clearly, there was a mismatch between financial innovation and the ability of the regulators to monitor them. It is ironic that such a regulatory failure should have occurred at a time when intense discussions were being held in Basle and elsewhere to put in place a sound regulatory framework.

**Immediate Tasks**

The immediate tasks before the authorities in the developed world are two-fold. One is to fix the financial system and the other is to maintain the aggregate demand at a high enough level to stimulate the real sector. Since it is the tail of the financial system that is wagging the dog of the economy, the first priority is to take care of the financial system and it this is being done in a number of ways. Liquidity is being provided to key institutions which are locked into assets that cannot be easily realized. In the U.S., the Federal Reserve has lowered the policy rate to near zero. It has also injected liquidity in an abundant measure. Consequently, the balance sheet of the Federal Reserve has expanded from $900 billion to $2.2 trillion. The recovery package of $700 billion approved by the US Congress is being utilized to inject more capital into banks and other institutions. Initially there was some doubt whether the package will be used to buy distressed assets. The recent Geithner proposal envisages such purchases also. Some think that buying the assets is important because this will lead to revival of markets such as housing. To stimulate the economy, a massive revival package is being thought of in the U.S. This is a straight forward application of the Keynesian prescription. The U.S. Congress at the initiative of President Obama has passed a stimulus package of nearly $800 billion.

## Medium Term Concerns

Even as these immediate tasks are addressed, there are medium term concerns. Many of the weaknesses of the financial system developed in an environment of very low interest rates. Pushing interest rates below a level that is not sustainable can also have its consequences. The U.S. has been incurring heavy current account deficits year after year for a decade or so. While analysts have been pointing out to the danger of such a situation, the authorities have been brushing aside these concerns by saying that the U.S. was the desired destination for the investors. But the danger of such a situation is that once there is loss of confidence, it can have serious consequences. The U.S. must address this issue. Closely related to this is the issue of leverage. Almost every segment of the U.S. society including households is a net borrower. Many of the institutions that have fallen into trouble in the current episode are those which were highly leveraged. The net savings rate of the household sector stands negative. It is true that in a globalised system a country’s investment rate is not solely determined by its savings rate. Nevertheless, the extent of leverage is an issue which regulators and policy makers must pay attention, if financial stability is to be achieved.

**Impact on India**

The Indian financial system is not directly exposed to the ‘toxic’ or ‘distressed’ assets of the developed world. This is not surprising since Indian banks have very few branches abroad. However, the indirect impact on the economy because of the recession abroad is very much there. The ‘decoupling’ theory does not hold good.

The indirect impact is felt both through trade and capital flows. The fall in international commodity prices and more particularly crude oil is reducing sharply the import bill from previous estimates. The recession abroad is having an adverse effect on our exports of goods and services. There is a sharp deceleration in the rate of growth of exports in 2008-09. The decline in growth rate in exports will affect strongly some sectors where exports constitute a significant proportion of the total production. Some examples are textiles, automobile components and gem and jewellery.

In contrast, to the strong inflow of over $100 billion in 2007-08, 2008-09 saw a net increase of only $10 billion in capital flows. The flow of portfolio capital turned negative. Indian firms have also experienced difficulties in raising money abroad. All this have an impact the exchange rate.

**Monetary and Fiscal Actions**

The Indian financial system has not been affected in the same way the financial system abroad has been affected for reasons already explained. However, there is the impact of the drying up of liquidity because of the fall in reserves. The inability of Indian firms to raise funds abroad, including trade credit, puts pressure on the domestic banking system for more credit. It is, in this context, one must view the actions of the Reserve Bank in expanding liquidity. Reduction of the CRR and repo and reverse repo rates are steps in the right direction. It is necessary for the RBI to watch the liquidity situation and take such actions as are necessary from time to time. It is being pointed out that the actions of the RBI have not percolated to the ground level. People point to the slow growth in credit. Is this a case of "taking the horse to the pond but cannot compel it to drink?". The role of the Reserve Bank of India is to create an environment in which additional credit can be made available.

Our fiscal actions to stimulate the economy have taken two forms. One is to cut excise duty and the second is to enlarge government expenditure. Both should lead to stimulating aggregate demand. It depends finally on whether the additional expenditures planned are actually incurred. Also we need to look at the composition of expenditure and effectiveness of expenditures. “Digging holes and filling them up” is not a right prescription. Expenditures should be biased towards investment so that capacities can be created which can facilitate growth later. That public spending should remain at a high level in a situation like the present one is not a matter for dispute. The budget estimates of total expenditure for 2009-10 are 37 per cent higher than the budget estimates of 2008-09. With this increase in expenditure, the fiscal deficit in 2008-09 is estimated at 6.2 per cent of GDP, 3.2 percentage points above the FRBM target. The budget estimate of the Central fiscal deficit for 2009-10 is 6.8 per cent. While it is correct to argue that the fiscal deficit target should be an average over the cycle, we need to remember that even in boom years we have not been able to hold the deficit at the target level. Keeping the target as a cyclical average is a good guidance in the medium term. We should revert to the FRBM targets, as the economy begins to recover.

As far as India is concerned, we will see definite signs of recovery in the second half of 2009-10. Fiscal 2010-11 will see a distinct improvement in growth.

The shock waves produced by the financial crisis will have their own effect on the structure of capitalism. Acceptable capitalism would require more regulation. Future discussions must centre around the nature and scope of such regulation. Run-a-way financial innovations that are dysfunctional do more harm than good. There are the lessons that we can draw from the current financial crisis.