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India and the Crisis of 2008

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Friends,

I want to thank the Ashoka University Economics Society for inviting me. I heard and read a lot about this unique University. So I seized the earliest excuse to come here. Thanks, one and all, for making my wish come true.

The lecture is part of The Indian Economy at 70 series. For our economy, global crisis of 2008 is the point at which we withstood stress and staked a claim to be one of those who matter for the global economy.

The subject suggested by the organisers to me is dear to my heart and hence another reason to be happy.

To be very very happy, I look forward to the Questions and Answers session that follows. I urge you, do not to confine yourself to the subject in the interactive session, so that I get to know what the bright energetic and educated youth of our country is curious about.

Course of the Global Crisis

The Global Financial Crisis originated in 2007, with what has been called as the sub-prime mortgage crisis in the United States of America. Prior to the crisis, substantial housing activity took place in the US. That activity was funded by mortgages, which were in turn expanded through derivative instruments. Significant construction activity took place, and people bought houses by borrowing heavily. At some stage, this bubble in the housing sector burst. People started defaulting on the mortgage payments due. This, in turn, affected the financial institutions, which had purchased these financial instruments based on the financing of housing activity. The problem quickly spread to Europe since many of the European financial institutions had also purchased some of these financial instruments.

In such a situation, there was loss of confidence among large financial institutions, with not enough monetary transactions taking place among them. They were hoarding their money instead of using it. This led to what may be described as a global liquidity crisis.

The system required money for purposes of transactions to keep the financial, trade and economic systems functioning normally. Central bankers around the world took the initiative to inject massive liquidity into the system. The process of injection of liquidity was undertaken through coordinated action by several leading central banks. However, it was soon realized that some of the financial instruments could simply not be serviced through regular payments because the underlying assets, such as houses in the United States, had lost their market or saleable value. In other words, the problem was not only one of lack of liquidity in the market, but also one of doubt about the solvency of some of the institutions involved.

In September 2008, one of the important global financial institutions, which was in deep trouble, viz., Lehman Brothers was allowed to collapse in the US. This created a panic. There was a threat of depression, perhaps more severe than that in the 1930s. So, the onset of the crisis is generally placed at this "Lehman moment" in mid-September, 2008.

Leading central banks, particularly in the United States, the United Kingdom and Europe, decided to supplement injection of liquidity with the bail—out of institutions as necessary, through several means. These included injection of capital and nationalization of some entities. These developments in the financial sector adversely impacted the business sentiment and economic activity.

In brief, both monetary and fiscal actions of an unconventional nature and unprecedented magnitude became necessary in the advanced economies to avert a possible collapse in the financial system. Relaxations of standards of regulation were taken, as an immediate measure. The monetary measures which are not considered appropriate in normal times were resorted to; and, these were described as "unconventional".

While these developments took place in the advanced economies, there was a drying up of credit for trade between various economies. Further, the disruption in the financial markets had its impact on sentiment and economic activity in the advanced economies, which, in turn, affected the sentiment and export prospects for developing and emerging market economies. This process, of the problems being transmitted from a few advanced economies to developing and emerging market economies and other advanced economies in different parts of the world, has been described as contagion. Hence, many countries that were not the originators of the problems of the housing or financial sectors were also affected, and the concerned governments, therefore, had to consider monetary and fiscal measures, and in some cases, regulatory relaxations.

In order to harmonize the national policy measures to counter the global financial and economic challenges, a group of 20 economies (the G-20 countries, which considered themselves systemically important for the world) met at the level of heads of state and initiated a process of coordinating various measures to avoid depression and restore normalcy. The adverse impact of the crisis on economic activity was sought to be moderated through expansionist fiscal and monetary measures broadly described a stimulus. The International Monetary Fund and the World Bank were also called in to provide assistance to some of the most affected countries. It is generally agreed that these host of unconventional, varied but coordinated measures have averted a possible collapse in the financial system and, perhaps, deep economic depression, though recession could not be avoided.

It is useful note that financial sector of Canada or Australia was not seriously affected, but the real sector was affected due to contagion. China and India were also spared for similar reason. In contrast, U.K. with close links to global finance of USA had to reckon with crisis in financial sector. In many ways, the financial crisis was Anglo-Saxon, but the impact was on global economy due to contagion.

As a result of several policy measures, economic recovery took place in some countries quickly, while in some others it has been somewhat delayed. Further, recovery in some countries was strong, while in others it was weak. The uneven recovery took place in varying shapes in different countries. These are generally classified as: V, L, U, W, √

Correspondingly, exit from the unconventional measures and policies for providing stimulus, both on the monetary and the fiscal sides, varied between different countries, depending on their assessment of the nature of recovery. In some countries, the stimulus had to continue because of their judgement that the policy has yet to deliver results. G-20 attempted some coordinated moves in regard to exit from the stimulus, but this was not very successful. In these circumstances, it was generally agreed that consequent upon the uneven recovery, there has been a divergence in the policy responses to meet the varying conditions in different countries. This has made coordinated efforts for exit from the stimulus at the level of the G-20 countries more difficult in contrast to the efforts to provide stimulus, which were coordinated.

As the global economy progressed towards uneven recovery, there was a general relief that the financial markets were functioning normally. However, there were concerns about continuing unemployment and the incipient and fragile economic activity in the advanced economies. Unemployment was high in the United States, while the fiscal and monetary stimulus has become contentious and less effective than expected. It also transpired that some of the countries in the Euro zone were having serious fiscal problems, which were not anticipated. These are mainly in southern Europe. These governments found it difficult to raise resources to manage their public finance. Coordinated actions among different countries in the Euro zone were initiated to address the problems of these countries in Europe.

There were serious policy constraints on the affected countries, since they did not have the option of adjustment through the exchange rate, in as much as they were part of the Euro currency zone. It also transpired that a large part of the public debt of countries in southern Europe was held by banks in northern Europe. The banks in these countries were already significantly leveraged, i.e., their capital was possibly not sufficient to provide for potential risks in their asset portfolios. Thus, the fiscal problem of some countries transformed itself into a problem for the financial sector in the other European countries. In an unusual move, advanced economies, Greece and Portugal, sought IMF assistance.

In many ways, the crisis continued in the Euro zone for several years with consequences for the global economy. Japan is yet another major economic power, but its economy had been generally stagnant for almost 20 years. Japan was affected by the contagion from global financial crisis; in addition, it was severely affected by a nuclear accident following the earthquake and tsunami in March 2011.

In this situation, the emerging market economies in general, and China in particular, displayed significant resilience in the first phase. Their financial sectors were fairly robust, and their stimulus was effective in moderating the downturn and ensuring rapid recovery to almost pre-crisis levels of growth—one yet to be achieved in most economies. In the second phase, these economies faced pressures due to inflation brought about partly by the excess liquidity injected by the advanced economies to continue the stimulus. Since the crisis, incremental growth in output of the world was mainly on account of China, India, and broadly BRICS.

Causes

Although there is no unanimity on the causes of the financial crisis, it is possible to list five major areas which are considered significant in bringing about the global financial and economic crisis. Some countries, such as the United States, had been generating current account deficits for a prolonged period on a large scale; while others, such as China, had been building current account surpluses and reserves. This reflected fundamental macro-economic imbalances in the functioning of the global economy.

The United States of America, which provides US dollars both to the domestic economy and the global economy, had been adopting a soft monetary policy or a policy of ample supply of US dollars at low interest rates. Globally also, monetary authorities in most parts of the world kept interest rates low. They were focused on price stability, which was maintained during the period, but did not pay sufficient attention to the increasing asset prices (of equities, real estate, etc.) amounting to asset bubbles. This process resulted in excessive risk taking and high leverage in the financial sector. In other words, inappropriate monetary policies, particularly by the country that provides the global reserve currency, fuelled the build-up of vulnerabilities in the financial sector.

The financial sector itself had grown beyond reasonable limits, taking advantage of the easy monetary policy and also the highly deregulated atmosphere. There was a belief in policy circles that a highly deregulated financial sector would foster economic growth and bring about elements of stability through a process of self-corrective mechanisms. However, the financial sector had some built-in incentives to excessive risk taking, which was enabled by soft regulation, particularly in international financial centres. The financial sector, therefore, took on a life of its own, embraced unsustainable risk and brought about the crisis.

Finance became global while regulation remains national. Further, U.S.A. and U.K. took to competitive deregulation to attract financial activity – regulating in race to the bottom, and excesses of finance.

The ample liquidity of the reserve currency and the build-up of foreign exchange reserves by some countries such as China and India, was a reflection of the inadequacies of the international monetary system. There was neither market discipline nor rules of the game that governed the supply and demand of the global reserve currency, viz., the US dollar. There was virtually no lender of last resort in the world for the financial sector, though the IMF as an institution was expected to provide some liquidity to specific countries in times of distress. The IMF had very limited resources as well as capacities to discharge these functions.

There were broader issues of governance both in the public sector, particularly in regard to the functioning of the regulatory regimes, and in the private sector, particularly in the conduct of senior management in the financial sector.

There were multiple causes for the Crisis; but it is interesting that those who made fortunes did not go to jail or pay penalty. Global financial conglomerates paid billions of dollars of penalties with admitting guilt and regulators accepted the position. These seem to indicate that global finance has succeeded in comprehensive regulatory capture.

Cures: An Assessment

There has been an effort, especially through dialogue within the G-20 countries, to correct these observed weaknesses of the past that caused the crisis, so that sustainable recovery is put in place and the possibility of a future crisis is minimized. A quick assessment of the corrections that appear to have taken place in terms of the causes that gave rise to the crisis would be revealing.

First, on the macro-economic imbalances, there is no agreement on a proper definition of such imbalances or the policy measures to correct such imbalances. Meanwhile, there is some evidence that global macro-economic imbalances have been moderated.

Second, the loose monetary policy that originally contributed to the crisis seems to be continuing in the most important countries in the world, especially the US, the UK and Europe, as part of continuing the monetary stimulus. A modest beginning has been made to move towards normalcy in interest rates and withdrawing liquidity in USA. There is a divergence of opinion on the importance of continuing the fiscal stimulus at this stage and on when fiscal austerities should be taken up in the future. Attempts to tighten fiscal policy in some countries did not help matters.

Third, significant discussions have taken place on reforming the regulation of the financial sector, especially in the US, the UK and Europe. Certain legislative changes have been introduced. However, it still seems to be work-in-progress; and the most important changes, as per globally agreed standards, are expected to be completed only in 2019.

Fourth, there is no evidence of any significant changes in the basic framework of the global financial architecture, though the IMF and the World Bank have been strengthened with resources, and marginal changes have taken place in their governance. Recent evidence that the international monetary system has not changed much is provided by the fact that the down-grading of the United States' sovereign (long-term) debt by a ratings agency, Standard and Poor's, has, in fact, resulted in strengthening of the US dollar.

The G-20 and the Financial Stability Board have been active, but there has been no commitment to act on several aspects recommended in the meetings of the G-20.

In brief, it is not clear whether the causes of the crisis have been significantly resolved or still remain unresolved.

There is a new reality challenging the old theories and balances; but there is no clarity on what the new theory should be and how new balances will emerge. The review of balances encompass national and global; real and finance; monetary and fiscal; advanced and developing; and growth versus stability. The role of Central banking is being reviewed. Inequalities have become a major issue. In many ways, the global financial crisis impacted not only global economy but also politics and societal concerns, especially inequality and environmental concerns.

India's Position

India has been less affected by the crisis because of several reasons.

It did not contribute to the global imbalance. Prior to the crisis, India had reasonable balance in terms of a sustainable current account deficit at less than 2 per cent. Domestic savings and investment were broadly in balance.

There have been some macro-vulnerabilities in the fiscal and external sectors, but the financial sector remained strong and resilient.

In the run up to the crisis, a counter-cyclical monetary policy was adopted to moderate the build-up of asset bubbles.

Regulation of the financial sector was also counter-cyclical.

However, India was affected mainly due to the contagion and the deceleration in global economic activity. The crisis had a moderate impact on the country, and India recovered quickly. The recovery was rapid not only because it did not have initial vulnerabilities, but also because three sets of important measures were taken, namely, fiscal stimulus, monetary stimulus and regulatory forbearance.

The government increased its expenditure to make up for loss of aggregate demand from the global economy. Monetary stimulus was undertaken to ensure that there was adequate liquidity. Regulatory forbearance was undertaken in terms of loosening the standards of regulation as well as the criteria adopted for assessing the wealth of the financial institutions, in particular banks.

In retrospect, however, it appears that the fiscal stimulus was, in fact, fiscal deterioration (since the increase was in recurring revenue expenditures), the monetary stimulus was excess and prolonged, while the regulatory forbearance was excessive and prolonged. Cumulatively, this seems to have resulted in pressures on the economy in particular in 2013.

The current problem in banking in India is partly attributed to the excesses in response to the crisis, perhaps, following G-20 advice more than the domestic realities.

There has been full recognition of these excesses of the past and corrective actions have been taken on monetary and regulatory fronts in recent years. On fiscal front, there is much that has to be done.

Overall, however, our economy is looking up. Global economy is also showing signs of beginnings of recovery.

Journey so far, and Way Forward:

I was born in 1941, and lived through the independent India. I wrote about it in my autobiography.

When I look back, it was a fascinating journey that can be divided into phases:

a) 1947-1972 – made India.

b) 1972-1991 – Mismanaging India

c) 1991-2014 – Modernising India

d) 2014 – Emerging Power

In this, 2008 Crisis is a turning point mainly because the world recognised our worth.

The most satisfying moment for me was my work relating to external sector. From 1957-1997, India was held hostage to the scarcity of foreign exchange. Every citizen was treated as a criminal unless otherwise proved. The policy-making was hostage to foreign exchange constraints. India could not hold its head high in the global economy.

We got into a serious balance of payments crisis in 1991.

By the crisis year of 2008, we built ample forex reserves. We have come a long way from the day when Mrs. Gandhi as a daughter of Prime Minister had to give a petition for release of foreign exchange equivalent to Rs.8,000/-. Now you go and collect it from the bank as long as it is for genuine purpose.

There is a broad consensus that India in the years ahead, will record highest or second highest growth among major economies. There is a consensus that it has political system stability.

There is, above all, the confidence of the younger generation that their future will be better than in the past, is the highest in India compared to all other major economies.

We can be proud of being Indian.

We, the older generation, are proud of where you are heading.

We are also ashamed of some of the things that we are leaving behind for you. These are high levels of poverty, environmental issues, the miserable state of basic education and public health; elements of divisiveness, to name a few.

We are hoping that you will succeed where we failed.

Thank you.