ICRIER AND PRI

Workshop on
Policy Response to Global Financial Crisis and India-Japan Cooperation

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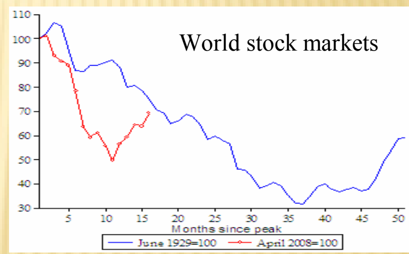
***Views expressed are personal and not those of the Indian government**

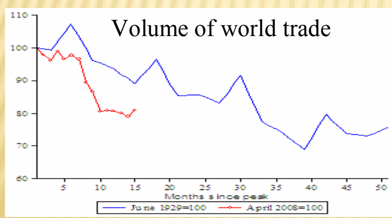
FOUR QUESTIONS

- How bad was – or is – it?
- Whodunit?
- Are we out of the woods?
- Just another financial crisis or will it change macro-economic management?

A TALE OF TWO DEPRESSIONS

EICHENGREEN AND O'ROURKE *(SEPTEMBER 2009)*





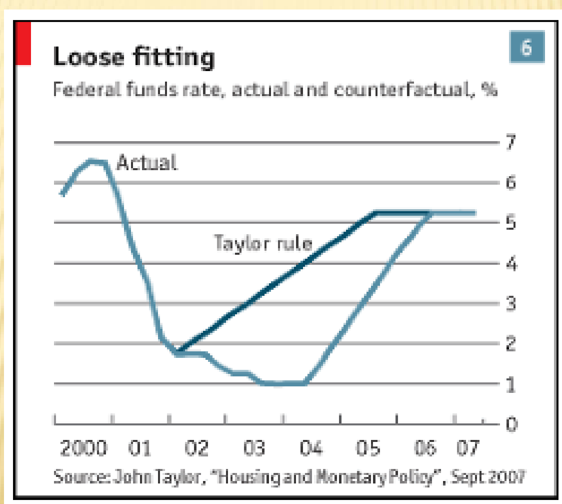
WHODUNNIT?

- Most analysts divided into two camps
  - Global Imbalances
    - Sharp rise in Chinese surplus and US deficit
    - Savings glut drove down interest rates creating a fertile ground for risky practices
  - Policy failures
    - Lax financial regulation leading to hyper leverage
    - Monetary policy too loose

GLOBAL IMBALANCES 2000 - 2007

- **Current account surplus**
  - of developing Asia and Middle Eastern countries rose from $ 110 to $ 660 billion
  - of Japan rose from $ 120 to $ 211 billion.
  - of Germany from $ - 33 to $ 250 billion
- US **current account deficit** meanwhile rose from $ 417 billion to US $ 731 billion.
- **Foreign currency reserves** of developing and emerging economies rose from $ 0.8 to 4.3 trillion.
- **Private Capital** flows to and from developing countries rose from $ 0.55 to $ 3.4 trillion.

US FED: LOOSE MONETARY POLICY



EXPLOSION IN LEVERAGE (MGI)

Country	Leverage increase between 1990/00 & 2000/08
United Kingdom	157%
United States	70%
Spain	150%
France	83%
Italy	64%
South Korea	93%

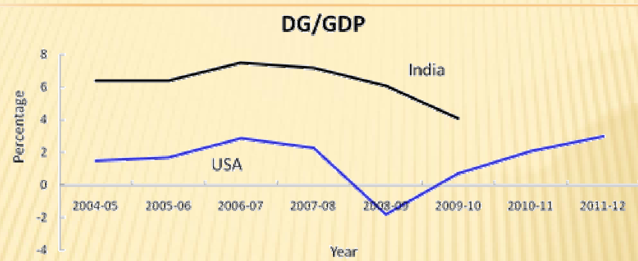
POLICY RESPONSE TO THE CRISIS

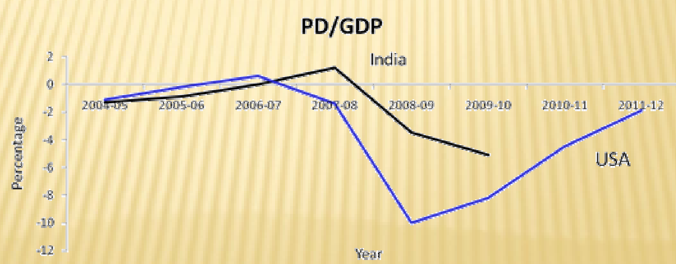
- Lower zero bound interest rates
- Unconventional monetary policy
  - Quantitative Easing
  - Credit Easing
- Aggressive fiscal policies as monetary policy transmission failed
- Divide between fiscal and monetary policies blurred
- Coordination through G 20
- Averted a Second Great Depression?

EXIT FROM EXTRAORDINARY MEASURES

- Timing?
  - ‘New Normal’: output growth rate/gap/inflation
- Sequencing?
  - Fiscal first? EMEs first?
- Unsustainable Debt build up in developed countries
  - Demography linked fiscal pressures
  - No room for fighting second dip
  - Funding deficits
  - Interest rate factor
  - Threat to the Eurozone?

Debt Sustainability

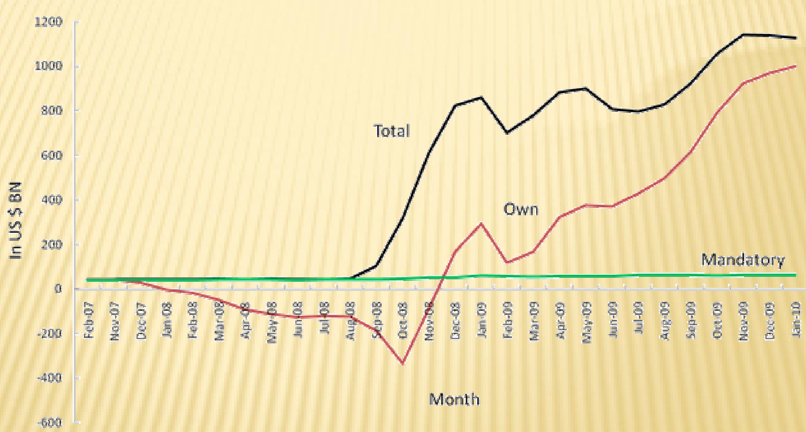




ARE WE OUT OF THE WOODS?

- Positives
  - Near Quarter **growth**
  - **Industrial** growth
  - **Trade** recovering
  - **TED** spreads normalized
  - **Housing** prices recovering
  - **Unemployment** not rising
- Negatives
  - **Output gap** still huge
  - **Life support** in place
  - **Deleveraging** continues
  - **Securitized** markets dead
  - US loan **delinquency** rates
  - Threat of '**double dip**'
  - **BW II** and **US Savings**

DEPOSITORY INSTITUTIONS' FUNDS PARKED WITH US FED



Source: US Federal Reserve

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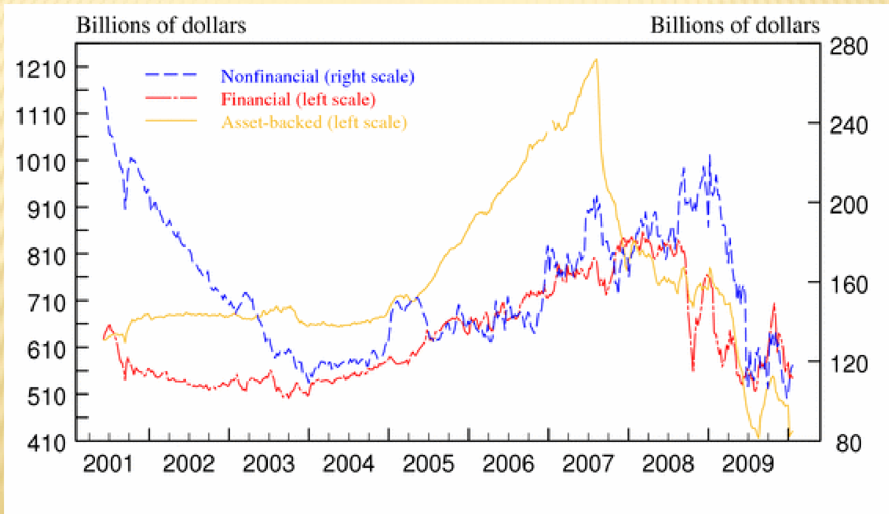
US COMMERCIAL PAPER (US FED)

OUTSTANDINGS WEEKLY (SEASONALLY ADJUSTED)



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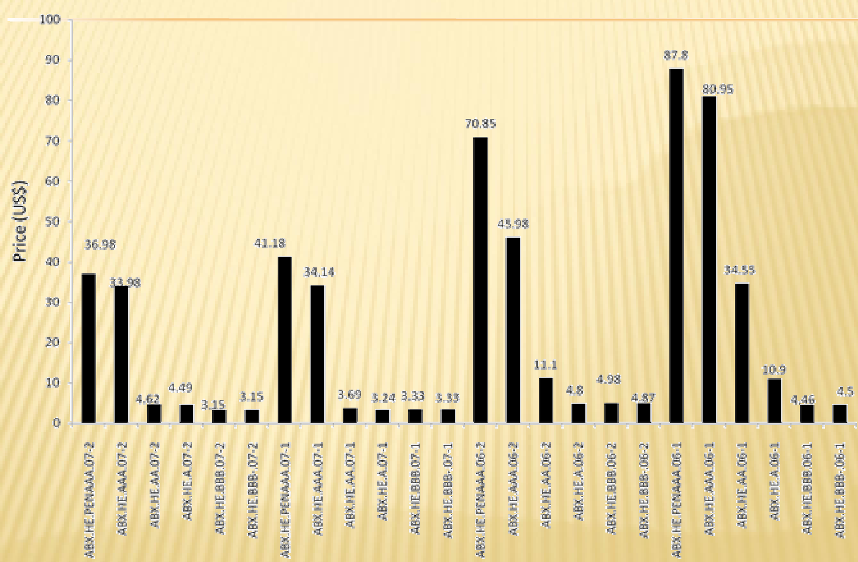
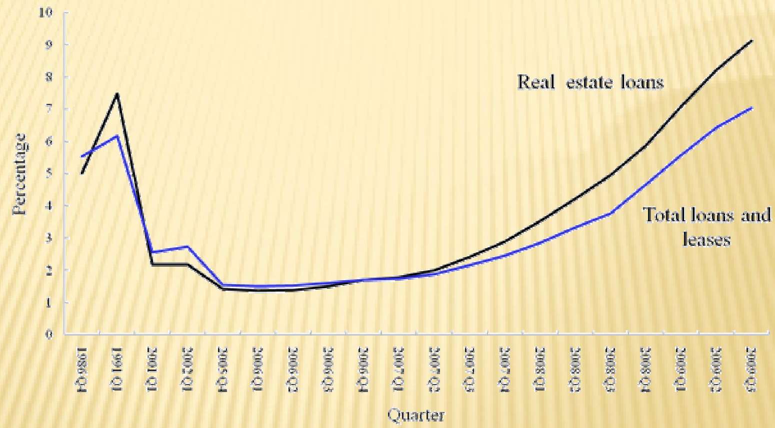
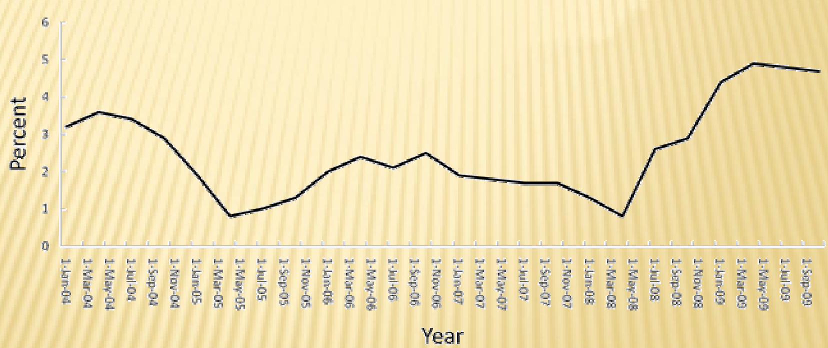
Markit.com ABX Prices on 25-Jan-10



US FED: Loan Delinquency Rates (% of total outstanding)



TRENDS IN US PERSONAL SAVINGS RATE



Source: US BEA

MODERN MACROECONOMIC POLICIES

- Based on lessons from the Great Depression
  - Lord Keynes : Fiscal policy
  - Friedman/Helicopter Ben: Monetary policy
- Tempered by Stagflationary Seventies
  - Keynes, Milton Friedman and Paul Volcker
- Monetary Policy the first line of defense
  - Taylor Rule
  - Pure Inflation targeting
- Bretton Woods II and the Impossible Trinity
- Policy tools blunted by globalization?

THE IMPOSSIBLE TRINITY

Bretton Woods

Stable but adjustable Xrate
Limited Capital Mobility
Limited monetary Indep.

Post Bretton Woods

Floating Xrate
Capital Mobility
Monetary Indep.

- *Stable Exchange Rate*
- *Monetary Independence*
- *Open Capital Account*

Bretton Woods II

Fixed Xrate
Capital Mobility(neutralized by intervention & sterilization)
Monetary Indep

MACROECONOMIC ANOMALIES

- Policy Tools getting blunt
  - Greenspan's conundrum and capital flows
  - Fiscal stimulus leakages through trade
- Inflation
  - CPI stability and asset price inflation
  - Increasing impact of non-domestic factors
- The Dollar puzzle
  - Xrate not responding to US deficits: BW II and reserve currency
- Decoupling of Growth and Employment
  - Outsourcing and growth of invisibles trade
- Tradable and Non-tradable divide collapsing
  - Proximate source of crisis in non-tradable sector
- LTCM rescue
  - Systemic risk and leverage outside regulated system

MACRO POLICIES GOING FORWARD

- Institutionalization of G 20
  - Coordinated monetary, fiscal and trade policies
  - Raising crisis-linked Resources
  - Financial regulation
  - Structural issues? Imbalances
- Reemergence of Fiscal Policy
  - Macro policy of last resort
  - Different this time round: Exit, inflation and politics
- Additional monetary policy targets and tools
  - Recalibrating measures of inflation
  - Leverage and financial stability

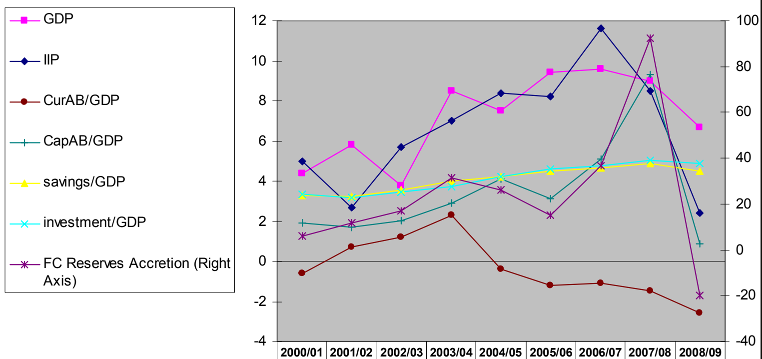
REGIONAL MONETARY CO-ORDINATION?

- Rationale
  - Plentiful reserves
  - 'Chiang Mai' Initiative swaps in place
  - Big economies and small regional economies
  - 'Stigma' attached to IMF windows
- Counter-arguments
  - Cost and efficiency: IMF Resources trebled
  - IMF's new'Flexible Credit Lines'to address Stigma
  - Still to see how Chiang Mai would work: huge bilateral exposures
  - Reserves result of BW II or insurance?
  - Trend towards greater global integration or regional decoupling?

INDIA ON EVE OF CREDIT CRUNCH

- **Growing strongly** at above 8% for 5 years
- **Animated debate:** growth above trend or trend growth up.
  - **Savings and investment** (esp. private) rising smartly
  - **Prices** more or less within tolerance level of 6%
  - **Monetary tightening** dampened growth?
  - Corporates **circumvented monetary policy**
- **Fiscal space created** over last few years
- **Financial sector** in relatively good shape
  - Implementation of **Basel norms**
  - Regulation on premise that financial transactions anchored in **real sector**.
  - **Leverage** levels not excessive
  - **Insignificant exposure** to opaque, illiquid asset backed securities.
  - Conservatively managed with **calibrated** opening up
  - **Asset prices targetted** by central bank

INDIA: MACROECONOMIC FUNDAMENTALS



	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09
GDP	4.4	5.8	3.8	8.5	7.5	9.4	9.6	9	6.7
IIP	5	2.7	5.7	7	8.4	8.2	11.6	8.5	2.4
CurAB/GDP	-0.6	0.7	1.2	2.3	-0.4	-1.2	-1.1	-1.5	-2.6
CapAB/GDP	1.9	1.7	2.0	2.9	4.1	3.1	5.1	9.3	0.9
savings/GDP	23.7	23.5	26.3	29.8	31.7	34.2	35.7	37.7	34.5
investment/GDP	24.3	22.8	25.2	27.6	32.1	35.5	36.9	39.1	37.5
FC Reserves Accretion (Right Axis)	5.9	11.8	17.0	31.4	26.2	15.1	36.6	92.2	-20.1

INITIAL (POST AUG 2007) IMPACT OF CRISIS

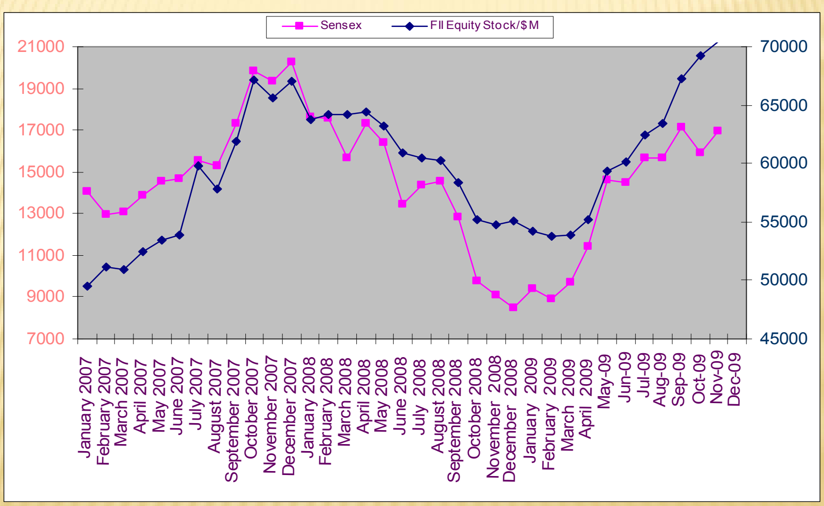
Sharp rise in net **K flows**
- **Stock market** boom
- Rupee **appreciation**
- Sharp rise in **reserves**

- **Inflationary**
  - **Commodity** boom
  - Imperatives of **Exchange rate** management
- Central Bank grapples with the **impossible trinity**
  - Stabilize GDP?
  - Stabilize exchange rate?

SECOND ROUND (LEHMAN CRISIS) IMPACT

- 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
    - **Squaring positions** overseas
    - Big increase in **fiscal deficit**
    - Sharp decline in **capital market** financing
    - slight deincrease in **bank credit growth**
- **Transmission from real to financial sector**
  - **Economic downslide** led by industrial growth and exports
  - **Rural economy** in relatively better shape-terms of trade effect
- **Economic growth still amongst two fastest globally**

INDIA: CAPITAL FLOWS AND ASSET PRICES



INDIAN POLICY RESPONSE

- Monetary Loosening
  - benchmark overnight **lending rate** (Repo) cut by 425 basis points from 9% to 4.75% between July 29, 2008 and March 5, 2009.
  - **Liquidity injection** of about 9% of GDP through lower bank cash reserve requirements (**CRR/SLR**) and special refinance facilities.
  - Transmission mechanism structurally weak because of illiquid corporate bond market and key administered interest rates, hence greater use of monetary aggregate tools. Unlike western countries monetary policy **retained traction.**
  - **Exit? Capital flows – Inflation trade off**Monetary Loosening
- Aggressive Fiscal Policy
  - Sharp increase in fiscal deficit in 2008-09 and 2009-10.
  - Not all crisis related but **well timed and targeted** (consumption)
  - **Traditionally no firewall** between monetary and fiscal policies (OMO)
  - Exit?

Thank You!