

**CURRENT GLOBAL FINANCIAL TURMOIL  
AND CHALLENGES CONFRONTING INDIA**

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**FORUM**  
OF FREE ENTERPRISE

## I : CURRENT GLOBAL FINANCIAL TURMOIL

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*"Free Enterprise was born with man and shall survive as long as man survives".*

- A. D. Shroff  
1899-1965  
Founder-President  
Forum of Free Enterprise

In September 2008 the US financial institutions faced a most traumatic crisis since 1930. This has been a sequel to the sub-prime crisis which raised warning signals way back in mid-2007, that all was not well with the financial system in the USA and to a lesser extent in other important financial centres.

Let us consider the genesis of this crisis. It is important to examine the general psyche in America as it is where it all started. For a decade and more household savings rate in the US has been marginal or nil. Majority of the Americans live on borrowed funds by mortgaging their houses and liberal use of credit cards for consumption. The gross debt of households, companies and the Government has doubled since 1980, to more than 350% of the GDP, higher than it was during the depression. Consumers were encouraged to borrow by low interest rates and rising asset prices. Currently consumer credit alone constitutes 100% of GDP. Household debt has soared to 140% of disposable income. The younger generation are products of the affluent society and believe in living for today, oblivious of the future. They are totally mindless of what Abraham Lincoln had observed 150 years ago:

*You cannot bring about prosperity by discouraging thrift.*

*You cannot keep out of trouble by spending more than you earn.*

*You cannot establish sound security on borrowed money.*

In fact America has for years lived beyond its means due to the dominance of its currency. Even now 62% of global reserves are invested in dollars and three fourths of world trade designated in this currency. High saving Asian households and dollar hoarding central banks produced a global savings glut which pushed real interest rates into negative territory, in turn stoking the housing bubble fuelled by financiers resorting to risky ventures with borrowed money. The flight to safety by investors the world over as a result of the plummeting of the value of their holdings in equities, by 30% to 80%, has resulted in a global rush to buy US treasuries. Consequently the Dollar is getting stronger by the day and has appreciated by over 20% against Sterling, Euro and even more against currencies of many emerging countries. Only the Yen displayed a contrarian trend in recent weeks rising to a 13 year high.

The USA, undoubtedly one of the most affluent societies in the world, has thrived on consumerism. Over the years two broad indicators for judging the state of the economy have been the number of housing starts and the volume of automobiles sold. Almost 12% of the employment, direct and indirect, is provided by the housing sector. The auto industry is also a very large employment generator.

Let us look at the housing scene first, the main cause of the current debacle. Over 50 million Americans own their homes, out of which at least 40% have mortgages on them. The home loans saw an unprecedented surge between 1997 and 2006 and home prices in general more than doubled, and in prime areas more than trebled. This boom was fuelled by ready availability of credit at very low margins, or nil with liberal moratoria and relatively low interest rates.

In 2007 with perceptible slowing of the US economy the housing market was adversely impacted with prices declining gradually to the extent of 40% or more from the peak. Unsold homes today are half of the normal inventory. Housing starts are lowest in 17 years, down one third from 1991. Commercial as well as investment banks saw the housing boom as a promising area to enter. Various innovative, exotic and very complex packages were evolved bundling prime and sub-prime mortgages. These carried attractive interest spreads for the lenders, 2% to 3% above the normal rates. Some of the largest banks and financial institutions in the world got lured into this area like - Citi Group, Merrill Lynch, Bear Stearns, Lehman Brothers and even AIG, the world's premier insurance company.

When home prices started falling last year many home owners found that they owed more on their mortgages than the worth of their homes. More than six million home owners were at least two to three months behind their loans at the end of October. How did these iconic institutions with so much talent and experience behind them get into this mess? Was it their weak internal appraisal systems, regulatory failures to guard against excessive risk taking, poor assessment by rating agencies or excessive greed on the part of managements? Obviously it appears to be a combination of all these factors.

In 2007 the financial services industry contributed almost 40% of the total corporate profits in the USA as against only 10%, in 1980 many of the top brass got seven figure salaries and bonuses. Compensation of CEOs of large American companies grew to an obscene 275 times that of an average employee.

The auto industry has also fallen a victim. Sales have slumped to the lowest level in decades and it has sought and received

financial assistance from the Government to the extent of \$ 25 billion.

With plenty of liquidity around and overzealous lenders, some of the investment banks worked on a leverage of as high as 25 to 30 as against an average of 10, preferably 12, considered prudent by leading banks. As collaterals started sinking and mortgagees began failing on meeting their repayments, lenders were stuck with unsaleable assets. They in turn were faced with repayment of loans borrowed by them, mostly short term. Several financial institutions and the financial markets as a whole were rudely shaken. Credit became increasingly tight and in many cases non-available. Banks looked up to Federal Reserve for a bailout.

Even the mighty home mortgage giants in the world with solid Government backing, Fannie Mae (their slogan "as the American dream grows so do we") and Freddie Mac, faced near collapse with an exposure of almost \$5 trillion. They had to be virtually nationalized by the US Government by extending them lines of credit and replacing the top management. The AIG Group had to be bailed out by the Federal Reserve by providing a two year loan of \$85 billion against warrants totaling 79.9% of equity, at a high interest rate. A further loan of \$38 billion has been made available against fixed income securities. AIG has started selling divisions to repay the debt.

There has been ripple effect in the UK. Northern Rock and Bradford & Bingley, two leading banks, have been nationalized. UK Government is providing £50 billion of additional funds for bolstering capital of banks and standing guarantees of upto £250 billion for new debts provided by banks. The contagion is spreading to other countries in Europe. The

Union Bank of Switzerland, which was once considered to be one of the most conservative global banks, had to write off over \$45 billion last year due to huge losses and has earned the sobriquet "used to be safe". It has received further Swiss Government funding as also Credit Suisse. The Belgium-Dutch large financial group Fortis is being acquired by BNP. Some other continental banks are over-extended and considering sale of part of their businesses. In Ireland, where banks are oversized, Government has offered guarantees to banks almost equal to twice its GDP. The total commitment by Governments in the Euro area now exceeds \$ 2600 billion.

President Bush a few weeks ago lamented: "American economy is facing unprecedented challenges and we are responding with this unprecedented action". The Treasury Secretary, Mr. Henry Poulson, unveiled a huge aid package of \$700 billion with a view to salvage and mitigate any adverse impact on other sectors of the economy. This offer is over and above the \$1000 billion of taxpayers' money, the Federal Reserve has already made available to various banks and financial institutions.

These steps are aimed at injecting badly needed liquidity in the financial system and avert a recession, signs of which are already very evident. The US unemployment has risen consistently since January 2008 touching 6% and which may shoot up to 9% next year.

Recapitalizing many of the financial institutions is imperative to deleverage them. Despite the feverish activity the programme will take several weeks before it makes any impact.

Availability of credit has become very difficult and spreads have increased by 200 to 400 basis points. The financial institutions in the developed countries have become very risk

averse and unduly cautious in extending credits affecting output and several more banks are bound to be afflicted. A marked slowdown in the US and other developed economies is inevitable and the impact is already felt globally. Corporate profits have started falling in many countries.

Is the financial world out of the woods as a result of these massive bailouts in USA and Europe? Certainly not. There is still total lack of confidence. The Managing Director of IMF has rightly pointed out that the steps taken so far are only short term palliatives and offer no long term solution which lies in addressing the root causes. There has been a systematic failure and concerted action needs to be taken by central banks of leading developed as well as emerging countries (like India and China) to restore stability to avert a major global recession.

What is reassuring is that concerted action is being taken at the highest levels by Governments of most major developed countries and some emerging countries. However, to restore confidence, so badly dented, many more bold and innovative measures will have to be initiated and more importantly the bailout packages implemented speedily and effectively.

There is a strong move to resurrect the now moribund IMF to play a key coordinating loan in strategizing coordinated action as also to lend to countries in distress. It has bailed out recently Iceland, Hungary and Ukraine. Speed is of the essence. To restore stability and confidence in the global financial system the IMF will have to reinvent itself and adopt a much more flexible approach than in the past. What has been done so far is falling far short of evolving a new financial architecture which is the need of the hour.

## II : CHALLENGES CONFRONTING INDIA

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Rapidly falling stock market indices, sudden and sharp depreciating rupee, swiftly contracting forex reserves, rising pressures on the liquidity in the financial markets, mounting fiscal strains, and drifting consumer and investment confidence unveils the prevailing other side of the India Growth Story that could not have been envisioned even by the critics and skeptics in the early months of 2008. What has been happening so far is unprecedented. Undoubtedly, all this and more is the outcome of the current global financial turmoil - the dimensions, magnitude and intensity of which have yet to be fathomed fully! Surely, the policy makers as well as business and industry have been stunned by the sequence of events, unleashed over the last fifteen months and especially in the last few weeks, in the global financial and economic environment.

While it started with the sub-prime mortgage crisis in the USA, its aftermath in terms of acute impairment of asset valuations of banks and financial institutions, liquidity crunch and credit crisis, especially the incredible pace at which high and mighty US and European banks and financial institutions have either gone down under or currently being held on with massive bailout packages, is mind-blowing. Already, the on-going crisis has imposed enormous financial burden on the Federal Reserve Board/the US Government, current estimate of which has crossed a grand figure of over one trillion dollars, including intensely debated and finally approved bailout plan of \$700 bn. to rescue the financial system.

Like-wise, it has become imperative for Europe and several other countries to undertake either exclusive or collective measures to rescue their respective banks and other financial institutions. The composite value of all such bail out packages is currently estimated at over two trillion dollars. All these rescue plans, however, have so far failed to calm either the Wall Street or European financial markets. Obviously, it is going to be a long-drawn process before the dust of such unprecedented economic storm settles down, and better visibility on the future outlook for the global financial system and economy starts emerging. Most of the experts and all those intimately connected with the financial markets have kept the time horizon of next 18 to 24 months for the global economy to be restored to its happy and healthy days.

Incidentally, it has been a very tough and compulsive choice for all those die-hard believers and advocates of capitalist economy in the US and Europe to deploy a strongly market interventionist strategy of bail out packages, involving, among other things, take-over/nationalization of banks or financial institutions. Many critiques and skeptics of such policy initiatives have sought to argue, and perhaps rightly so, that (a) the state intervention is undermining the essence of the capitalist economy; and (b) tax payers' good money is being diverted (or wasted) on those who deserved to be punished by the market for their acts of unpardonable indiscretion and indulgence. Several experts are also wary whether the US/European bailout packages would be adequate to deal with the magnitude of current financial crisis. Indeed, the international management guru Mr. Kenichi Ohmae has gone on record to say that there may be an urgency to create "international facility" for as much as \$5 trillion. "The liquidity has to be so big that people won't get panicky", according to him. Several others also feel the imperatives of more

coordinated and comprehensive policy response of the international community, especially the IMF, the World Bank and G 20 member countries, if the spectre of deep recession bordering on Great Depression is to be dealt with promptly and firmly.

Needless to say, the genesis of the US financial crisis and its fallout on global financial markets will continue to occupy significant space in discussions, debates and analysis of many experts for long, long time to come. Many interesting findings and lessons will be drawn for the future direction and structure of the new financial landscape. The role of the complex web of financial products and services, including enigmatic derivatives market, which expanded many-fold in the recent years through very aggressive participation of many banks and financial institutions, will obviously be redefined and reoriented.

But in the meantime, many countries, their businesses and industries and thousands of millions of people will suffer agonizing pains and pangs of the collapse of asset values, loss of jobs, and loss of incomes manifesting in the overall deceleration (or even acute recession!) in their respective economies and consequently, in the global economic, trade and investment growth. In substance fully exploded global financial crisis is now unleashing enormous cascading and ripple effects across the world aggravating both the financial and the real economic performance of almost all the countries. What are the challenges confronting India arising out of this unprecedented crisis situation?

Confluence of Other Adverse Events:

Before turning to the India specific issues, it is also imperative to briefly reflect on several other major international events

that preceded the present financial crisis in the USA and the Europe. As a matter of fact, there has been a perilous convergence of several other adverse forces vitiating the current global economic outlook:

- First, the extreme volatility in the international crude oil prices, which after reaching the peak of \$147 per barrel in early July 2008, have started retreating sharply thereafter. However, a clear direction of international crude oil prices has yet to emerge - the trend in the last few weeks has been quiet wayward and prices have swung in the range of \$128 per barrel on September 22 (showing a record jump of \$21 per barrel in a single day) to less than \$63 per barrel by the end October 2008. The rapidly falling trend in the crude oil prices is clear evidence of emerging contraction in demand rather than improvement in supply of crude oil. It also reflects the impact of recent sharp appreciation in the US dollar.
- Second, alongside the earlier boom in the international crude oil prices (from early 2006 till July 2008), the global commodity prices also experienced the unprecedented boom spreading across many commodity segments - food, edible oils, fertilizers, metals, etc. The prices of many of these goods after rising two or three fold in a short span of two to three years have now started easing sharply. Even so, the prices of most of these commodities are still higher by 20 to 30% compared to the level over a year ago. Such commodity prices boom, which unleashed a spectre of global inflation in 2007-08, has also severely hurt many countries, but more so the developing countries like India. The on-going sharp correction in commodity prices - witness, the Economist's dollar all-items index (excluding oil and precious metals) plunging

by 37% since the beginning of July 2008 - does augur well for the global economy, but at the same time, it also discounts the future uncertain and depressing economic outlook.

Last, the combination of global financial crisis, uncertainties in the behaviour of exchange rates of most major currencies, violent fluctuations in crude oil prices and the earlier widespread (albeit tapering) boom in non-oil commodity prices, have caused adverse impact on the global economic and trade growth prospects in the current year. Not surprisingly, the IMF has already forecast a drop in the world economic growth from 4.9% in 2007 to 3.7% in 2008. Like-wise, WTO projects global exports, which had declined from 8.5% in 2006 to 5.5% in 2007, to decelerate further to 4.5% in 2008.

It is necessary to emphasize at this stage that all the above projections were generally based on various assumptions made in early July or August 2008. Evidently, much water has flown since then, and consequently, there would inevitably be further downward revisions in the expected growth of global economy and global exports not only during 2008, but also in the subsequent year. Indeed, several international institutions (IMF, World Bank and ADB) and experts have expressed their fears about likely accentuation of the adverse impact of the current financial turmoil into 2009 and beyond. The crisis of confidence and sense of despondency is, thus, pervading all through the global economy.

### **Impact on the Indian Economy:**

How can India Growth Story, which dominated our perception and thinking process for the past few years, remain intact in such an environment of heightened uncertainty and fears of

impending "flat growth" or acute recession in many major economies? India can not be immune or decoupled given its rapidly globalizing manifestations of crucial economic parameters. Witness the progressive integration of India with the global economy:

- First, foreign trade has emerged as a key growth driver. The share of foreign trade now accounts for over 45% of GDP as compared to just about 25% in 1990-91. In particular, exports of goods at \$159 bn in 2007-08 and "net" invisible (including services exports and remittances) at over \$73 bn together represent over one-fifth of India's GDP. The annual growth rate of merchandise exports during the last four years was well over 22% and India now accounts for over 1% of world exports as compared to just about 0.4% in 1990-91.
- Second, India is emerging not only as a hub for outsourcing computer software and a whole gamut of BPO services, but also for manufacturing exports. Automobiles, auto ancillaries, capital goods, pharmaceuticals and several other new areas of export competitiveness have been increasingly attracting the attention of the global players.
- Third, gross capital inflows have been scaling new heights every year. Such inflows in 2007-08 were \$115 bn., comprising mostly FDI (\$32 bn), portfolio investments (\$29 bn), commercial loans (\$42 bn.) and banking capital (\$12 bn). Thanks entirely to such vibrancy of capital inflows, India had substantially strengthened its forex reserves to the level of \$310 bn. by the end of March 2008. Since then, however, there has been a sharp decline in the forex reserves to about \$258 bn by the

close of October, 2008, largely due to huge withdrawal of investments by the FIIs, widening of the trade gap, and inevitable revaluation of the reserves due to the sharp fluctuations in the Indian rupee in the current year so far. Even while there still exists a great deal of comfort in our current level of forex reserves, the fact remains that capital inflows would witness a sharp deceleration (or even contraction) in the current year, making a further major dent in the prevailing strength of forex reserves.

Last, alongside, India's outbound investments (i.e. Indian companies investing and acquiring companies abroad) have also expanded. In 2007-08, such investments were about \$17 bn - showing over seven-fold expansion in a span of just three years. In short, India has also shown its entrepreneurial capability for venturing into the promising foreign markets.

In substance, while India has gained a great deal from the impetus of such strong globalization efforts spanning over the last decade or more, its downside risks have now become an integral part of her growth story. There can be no escape from this reality. But surely, India can steer her way through with least amount of damage, provided our policy makers can put all their acts together and respond to the challenges with bold and courageous action, often involving unconventional or unorthodox initiatives. Before reflecting on this aspect, it is relevant to briefly outline the current state of the India growth story.

#### **The Current State of the Economy:**

Given this milieu, needless to emphasize, India will be confronted with noticeable downside risks, both direct and indirect, on her recent high growth story. The impact of the



current financial crisis will be felt mainly through (a) slowing down of global trade; (b) deceleration of capital inflows; (c) drop in investment ratio; and (d) uncertain behaviour of exchange rate markets. Already, based on various parameters of economic performance, it is evident that the Indian growth story has already weakened in the first half of the current financial year. Witness the key indicators:

- (a) Real GDP growth in Q1 (April-June) of 2008-09 was 7.9% as compared to 9.2% in the corresponding period of 2007-08;
- (b) Industrial production growth in the first four months (April-August) of 2008-09 was 5.7% compared to 9.7% in the corresponding period of the previous year;
- (c) Infrastructure industries (comprising crude oil, electricity, petroleum refinery products, coal, finished steel and cement) growth during the same four months of the current financial year dropped to 3.7% from 6.6% in the corresponding period of the previous year;
- (d) Inflation rate escalated sharply in the current financial year, and despite some correction in last few weeks, it still stands at an uncomfortable level of over 10.6% on y-o-y basis as of mid-October 2008 compared to 3.5% around the corresponding period of the previous year;
- (e) Fiscal stress is increasingly becoming visible from the fact that just in first four months of 2008-09 (April-August), the fiscal deficit has already crossed 87% of the annual target of Rs.133,000 crores. While tax revenues growth is slowing down, the Government's expenditure is expected to rise steeply under the impact of increased subsidies on food, oil and fertilizers; higher growth in

administrative expenditure with liberal modifications in the Pay Commission's Award to government employees; and so on. Witness, the recent massive supplementary demand for grants of the Central Government for over Rs.105,600 crores, of which over 85% is on account of non-plan expenditure.

- (f) Stock markets have been violently wayward showing high pace of drift and despondency - the SENSEX currently hovering around 10300 mark (3rd November) mark has already recorded a sharp fall of as much as about 50% in comparison with the peak level of 21,200 on January 10, 2008. Over the period, the loss of market capitalization has been precipitous from Rs.73 trillion to just about Rs.30 trillion.
- (g) Corporate profits and profitability, which experienced magnificent growth, thereby contributing to a surge in corporate investments in the previous four years, have started coming under severe pressures in the current year so far.
- (h) Forex reserves, which had reached a record level of \$316 bn at the end May 2008 have receded progressively to \$258 bn. by the close of October 2008. With the mounting trade and current account deficit on the one hand, and falling capital inflows on the other forex reserves would be coming under further pressure.

Thus, even before the current global financial crisis, the Indian economy was in the midst of a slow down. The economic environment has now become even more vulnerable. There are tough and challenging tasks in achieving high growth - even 7 to 7.5% real GDP growth in

the current and the next financial year - with relative macro stability (containing inflation well below the double digit level and managing exchange rate of the rupee on an even keel), seems an extremely, extremely tough proposition.

#### Mechanism of the Likely Adverse Impact:

What is going to be the trigger mechanism of direct and indirect impact of the global financial crisis on the Indian economy at the macro level?

- Foreign trade – especially, the expected slow down in global export markets. In the last four years, the average annual growth of exports in value terms was well above 22% and was significantly higher than growth of GDP at current market prices. This was sustained mainly because of the high growth phase of global exports. Given the current weightage of exports of goods and services in the Indian economy, 5% points slow down in their growth, would mean (roughly speaking) a reduction of about 1% points in real GDP growth. Message: the Government (Ministry of Commerce) must promptly and aggressively redesign and pursue the export promotion policy even in the midst of global economic slowdown. Otherwise, the exporters will not be able to make gains from rapidly depreciating rupee.
- Foreign capital inflows – especially, the contraction in non-FDI capital inflows. During the last four years, total capital inflows amounted to over \$200 bn, which contributed to the creation of liquidity in the financial markets and strengthening of the value of the rupee. No longer, such a happy situation is available. Message: every effort will have to be made not only to conserve the **forex** reserves, but to augment the

same by improving the ease of doing business in India. Also, the anticipated large current account deficit of over 3% of GDP in 2008-09 is unsustainable. Hence, the Government (as well as RBI) will have to formulate a strategy for the next couple of years to incentivise those saving **and/or** augmenting **forex** earnings.

- ♦ Exchange rate behaviour – uncertainties in supply-demand position of dollar and the extent of divergence in domestic and international interest rates would cause two-way fluctuations. Message: the RBI will have to calibrate the movement of the exchange rate so as to prevent its excessive depreciation and at the same time revisit the issue of safe level of **forex** reserves to be maintained for steering the economy through current global financial crisis.
- ♦ Saving and investment – to begin with saving to GDP ratio would be adversely affected by the impact of (a) slow down in the real GDP growth; (b) the stresses and strains on fiscal health reducing the public sector saving; (c) pressures on corporate performance and profitability affecting private corporate sector saving; and (d) erosion in the income and wealth growth of the households affecting their contribution to saving. If there is an overall 4% points drop in the domestic saving to GDP ratio (and consequently in the investment ratio), there would be 1% point reduction in real GDP growth given the incremental capital output ratio of 4:1 in the current Indian context. Message: this crucial building block of high domestic saving and investment required for high economic **growth** of recent years needs to be refortified. For this purpose, in the next couple of

**years, the Government may have to hold back the implementation of the FRBM targets of revenue and fiscal deficit, but at the same time anchor the change of fiscal stance with good fiscal governance, so that the "fiscal flexibility" is effectively and productively deployed.**

While the adverse impact of global economic crisis has already become visible in most of the above parameters, its spread and intensity would become more pronounced in the remaining part of the current year and beyond (i.e. in 2009-10). Admittedly, India has an advantage of two key factors: first, four fifths of the growth momentum of our economy is domestic demand driven, as exports (of goods and services together) even now constitute only about 20% of GDP; second, over ninety percent of investments are financed from the domestic savings - capital inflows (absorbed through current account deficit) even now account for the balance of just about 10 percent. These factors offer significant **cushion to mitigate severity of downside risks to India growth story.**

#### **Emerging Weaknesses of Underlying Growth Levers:**

From the macro perspective, what is also important to recognize is the fact that the high growth phase of 2004-05 to 2007-08, has been predominantly driven by the domestic demand (consumption + investment). While the share of consumption expenditure - private as well as of the government is declining, the share of Gross Domestic Capital Formation (GDCF) to GDP is progressively expanding. Evidently, investment demand (GDCF) has been making a much greater contribution to the incremental real GDP growth in the economy in the last four/five years. However, thanks to the current global financial crisis, there are genuine

concerns whether this can be sustained in 2008-09 and 2009-10.

The growth of private final consumption expenditure, which in real terms was rising at about 7.5 to 8% in the last four years, will probably decelerate to 6 to 6.5% per year in the next two years under the impact of anticipated reduced growth of per capita income and "crisis of consumer confidence". This is inevitable with the ominous prospects of (a) likely loss of jobs or stagnation in the creation of new jobs both in manufacturing and services sectors; (b) the erosion of "real wealth" effect of deflation in values of financial (stock market related) and real assets (housing related); and (c) increased incidence of servicing the existing borrowings in case of large number of households in the middle and upper middle class.

Like-wise, investment demand would be adversely impacted by reduced growth of domestic saving and loss of "investor confidence" (or market sentiments). Both the components of investment demand would be severely impaired by widely expected decline in the corporate profitability. Besides, sense of nervousness would be pervasive – witness, the failure of several IPOs and rights issues, even of top class companies with a proven financial records, in the recent months. The outlook for public investment is equally (if not more) uncertain given the fiscal constraints on the one hand and pressures on profitability of PSUs on the other.

**Fortunately, the underlying liquidity levers of the economy - the "potential" banking resources are comfortable.** The liquidity crisis, which is so very acute in the global financial system - especially in USA & Europe, can be taken care of in India through substantial effective reduction in both Cash Reserve Ratio (CRR) and Statutory

Liquidity Ratio (SLR). The overwhelming considerations in initiating such reductions are two fold, namely, (a) inflation, which is currently hovering around 10.6% and (b) specifically in the case of SLR, it will be driven by the fiscal needs of the Government. But both these options - of reducing CRR and SLR - are available for the policy makers to stem the sharp downturn arising out of liquidity constraints.

Stimulatively Already, the RBI, in a span of just about three weeks in October 2008, has reduced CRR by 3.5% points to 6.5%. At the same time the SLR has also been lowered by 1% to 24% of net deposits. These measures together will facilitate a release of about Rs.180,000 crores into the banking system, thereby enabling the banks to resume their normal credit disbursement. Further, to mitigate the redemption pressures on the mutual funds, the RBI has injected Rs40,000 crores by opening special window of borrowings for banks. Also, the Repo rate has been cut progressively from 9% to 7.5%, thereby signaling the prospects of gradual softening of interest rates in the economy, if the inflation outlook could be better managed in the coming months.

The other major policy initiatives of the RBI/Govt. include: (a) increase of 50 basis points in the interest that banks offer on Non-Resident Indian deposits; (b) doubling of the limit on FII investment in corporate bonds; (c) decision of SEBI to reverse the restrictions imposed on participatory notes or Offshore Derivative Instruments (ODI) that it had imposed in October 2007; and (d) easing norms for external commercial borrowings for companies engaged in the core sector - limit of such borrowings on rupee expenditure raised from \$100 mn. to \$500 mn; and also interest rate cap on

external funds with maturity beyond 7 years raised from 6 months London Inter-bank Offer Rate (LIBOR) plus 3.5% to 4.59%.

More recently, while unveiling the mid-year monetary policy, the RBI Governor, Dr. Subbarao, stated that the key objectives of the monetary policy are "to ensure a monetary and interest rate environment that optimally balances the objectives of financial stability, price stability and well-anchored inflation expectations, and growth". Further, it was also pointed out that "in the context of the uncertain and unsettled global situation and its indirect impact on the domestic economy in general and the financial markets in particular" the RBI will "closely and continuously monitor the situation and respond swiftly and effectively to developments, employing both conventional and unconventional measures."

Surely, there is a further scope to reduce CRR by another at least 2% points with a potential of making available to banks liquid resources of another Rs.80,000 crores. Besides, every one percentage point reduction in the SLR would help in augmenting liquidity in the market of about Rs.40,000 crores. These estimates of "releasable" extra liquidity are based on current size of deposits. But growth of deposits, even if it slows down, would still remain fairly comfortable (say, around 16 to 18% on y-o-y basis). Thus, from the Indian perspective the issue of liquidity per se from the domestic financial system (banks) is not a matter of concern.

However, there will be critical countervailing constraints on liquidity supply by virtue of external constraints (factors), namely, due to anticipated sharp contraction of capital inflows, large trade deficits and consequential drawing down of forex

reserves. The RBI while managing the exchange rate of the rupee (vis-a-vis US \$) may be required to sell dollars and absorb rupee liquidity from the market. Also, demand for liquidity will be higher because of the anticipated fiscal stress (Govt.'s market borrowings would sizably exceed the budget estimates).

Taking an overview, while liquidity (credit availability) per se may not constitute a major constraint, cost of funds (interest rates) will remain high till such time as double digit inflation is conclusively reined in. This, however, does not rule out the prospect of symbolic (or compulsive) interest rates cuts, say, up to another 100 basis points over the next six months. This may not reduce the spread between RBI induced new interest rate structure and the actual lending rates charged by the banks to their borrowers. What is also crucial is willingness of the banks to lend, especially to non-prime borrowers and equally importantly the willingness of customers to borrow given the uncertainties of the market environment for their products and services.

### Concluding Observations: **A Way Forward**

The current global financial crisis has unveiled unprecedented external challenges for India in navigating its high growth story in the next two years. As the dimensions and intensity of the crisis become even more comprehensible in the coming months, both the Government and the RBI will have to become more proactive with respect to its policy stance. With global economy hurtling towards recession (one expects there would be no reverberations of Great Depression of 1929), the Indian growth story cannot remain unscathed. Indeed, we should be greatly relieved if the economy grows even at the rate of 6.5 to 7% per year in the next two years.

We believe that effective and smoother liquidity management and credit availability - or similar monetary policy measures, including interest rate reduction will not be enough. The policy makers may have to even evaluate other policy options - what is ambiguously being described as "unorthodox" or "unconventional". For raising the aggregate demand (private consumption expenditure and public and private investment), a calibrated interventionist fiscal policy stance is now inevitable.

Illustratively, public spending on infrastructure areas like roads, ports, airports, power, etc. will have to be expedited. Similarly demonstrable projects like Delhi Mumbai Industrial Corridor and Railways' golden quadrilateral must invite prompt clearances, financial allocations and placement of orders. The urgency of strategizing and expanding the mechanism of Public Private Partnership and Viability Gap Funding was never so great than as at present. Over last couple of years, so much was expected from the policy of Special Economic Zones. Now is the most opportune time to put them into effective implementation mode with the participation of all the stakeholders, including the required contribution of the respective State Governments.

Further, exports must assume the extreme focus what with the prospects of expected sharp growth contraction of the global trade. The gains of depreciating rupee cannot accrue to the exporters unless required infrastructure and rules and procedures relating to exports are simplified further. India will have to do its best to compensate the likely shortfall in the domestic demand through increased export efforts.

What have been outlined above are essentially the measures underlining the imperatives of fiscal expansion (or stimulus)

by keeping in abeyance FRBM targets of fiscal and revenue deficits. To advocate the cause of fiscal expansion under the conditions of high inflation, rising current account deficit and depreciating rupee will in all probability be looked upon as fiscal obduracy and irresponsibility. But, as pointed out earlier, such option must be anchored with the essence of fiscal governance and not by fiscal profligacy. The calibrated Keynesian strategy may have to be resurrected! Let us not allow the essence of India Growth Story to be written off on the altar of global financial turmoil as well by our own limitations of fiscal discipline, which no doubt, makes great sense under normal conditions!

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*The text of Mr. Minoor R. Shroff's article is based upon the talks delivered in Visakhapatnam on 19th and 20th September at the Andhra University and Gitam University respectively, and also at a joint meeting of the Forum of Free Enterprise and Indian Merchants' Chamber, on 21st October in Mumbai.*

*The text of Mr. Sunil Bhandare's article is based upon the talks delivered in Visakhapatnam of 19th and 20th September 2008 at the Andhra University and Gitam University respectively.*

*The texts have been since updated till the time of going to the press.*

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*The views expressed in the booklet are not necessarily those of the Forum of Free Enterprise*

*"People must come to accept private enterprise not as a necessary evil, but as an affirmative good",*

**- Eugene Black**

# FORUM

## of Free Enterprise

The Forum of Free Enterprise is a non-political and non-partisan organisation started in 1956, to educate public opinion in India on free enterprise and its close relationship with the democratic way of life. The Forum seeks to stimulate public thinking on vital economic problems of the day through booklets, meetings, and other means as befit a democratic society. .

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