Global Crisis: Challenges and Perspectives

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GENESIS OF GLOBAL FINANCIAL CRISIS

- Monetary Policy in the US and other Western Countries were eased aggressively after dot com bubble.
- The monetary excess during 2002-06 leading to Housing Boom.
- Assets prices recorded strong gains. Demand constantly exceeded domestic output.
- This mirrored in large growing Current Account deficit over the period.

- China/East Asian Countries exporting to USA at low cost leading to growing surplus.
- The Forex Reserves deployed back in US Treasuries.
- This flood of dollar resulted in sharp rise in US spending.
- Large Global imbalance due to very low interest rate and accommodative monetary policy.
- Projected global growth in April 2008 at 3.8% down to contract by 1.3%.
- Major advance economies were in recession.
- Global trade volume to contract by 11%

Table 2: Global Economic Outlook for 2009 (per cent)

Month of Forecast

Indicator	Apr-08		Jul-08		Oct-08		Nov-08		Jan-09		Apr-0	
	2008	2009	2008	2009	2008	2009	2008	2009	2008	2009	2008	200
1. Global Growth	3.7	3.8	4.1	3.9	3.9	3	3.4	0.5	3.4	0.5	3.2	-1.
(a) Advanced Economies	1.3	1.3	1.7	1.4	1.5	0.5	1	-2	1	-2	0.9	-3.
(b) EMEs	6.7	6.6	6.9	6.7	6.9	6.1	6.3	3.3	6.3	3.3	6.1	1.
2. World Trade Volume	3.7	3.8	4.1	3.9	3.9	3	4.1	-2.8	4.1	-2.8	3.3	-1

COMPONENT OF CRISIS

- Crisis roots in USA.
- Sustain rise in Asset prices, lax lending standards in 2002-06.
- Low credit quality.
- Originate Distribute model. Strong growth in complex credit derivatives.
- Predominately Sub-Prime mortgages sold to financial investors.
- Inflation in USA started to rise in 2004 – so rise in interest rate.
- Housing prices depressed. With low/negligible margin; prime-borrower encouraged to default.

- US regulatory failure, multiplicity of regulators, well over 100 at the federal and state level.
- Role of rating agencies.
- Default by such borrowing led to losses by financial institution.
- Wiping of significant portion of capital of Banks.
- Mounted losses and dwindling net worth led to breakdown of trust among banks.
- Inter-bank money market nearly frozen.
- Failure of Lehman Brothers in September 2008.
- Complete loss of confidence.
- Deep and lingering crisis in global financial market.

Differences Between Financial Crisis in US/Europe and India (1)

What has not happened here

- No subprime
- No toxic derivatives
- No bank losses threatening capital
- No bank credit crunch
- No mistrust between banks

Differences Between Financial Crisis in US/Europe and India (2)

Our Problems

- Reduction in capital flows
  - Pressure on BoP
  - Stock markets
  - Monetary and liquidity impact

Temporary impact on MFs/NBFCs (Sept-Oct)

Reduction in flow from non-banks

Perceptions of credit crunch

Differences Between Financial Crisis in US/Europe and India (3)

Our Problems

– Fiscal stress

- Oil, Fertiliser, Food subsidies
- Pay Commission, Debt waiver, NRE
- Stimulus packages
- GFD/GDP ratio: 5.5-6.0%

Large increase in market borrowings

			Rs. crore
	2008-09 BE	**2008-09 RE**	**2009-10 BE**
Gross	1,76,453	3,42,769	3,98,552
Net	1,13,000	3,29,649	3,08,647

Differences Between Financial Crisis in US/Europe and India (4)

India's Approach to Managing Financial Stability (1)

- Current account: Full, but gradual opening up
- Capital account and financial sector: More calibrated approach towards opening up.
  - Equity flows encouraged;
  - debt flows subject to ceilings and some end-use restrictions.
  - Capital outflows: progressively liberalized.

Differences Between Financial Crisis in US/Europe and India (5)

India's Approach to Managing Financial Stability (2)

- Financial sector, especially banks, subject to prudential regulation
  - both liquidity and capital.
  - prudential limits on banks' inter-bank liabilities in relation to their net worth;
  - asset-liability management guidelines take cognizance of both on and off balance sheet items
  - Basel II framework: guidelines issued.
  - Dynamic provisioning
  - NBFCs: regulation and supervision tightened - to reduce regulatory arbitrage.

Recessions defined

- A recession is generally defined as two consecutive quarters of negative economic growth as measured by GDP.
- Ian Macfarlane, a former Reserve Bank governor, once suggested that if GDP is negative at the end of any given year, Australia is in a recession.
- Some also suggest that an unemployment rate of 6% or more indicates a recession.

Depressions defined

- A depression is generally defined as four consecutive quarters of negative economic growth as measured by GDP.
- Some also suggest that an unemployment rate of 10% or more indicates a depression.

Types of recessions

Four types of recessions:

- V-shape: short and shallow, lasting about 8-9 months;
- U-shape: longer and deeper, lasting 12-18 months;
- W-shape: ‘double dip’ type, in which government stimulus works in the short term but quickly fades, and a contraction resumes;
- L-shape: protracted economic stagnation.

Types of recessions

- The US entered a recession in the first quarter of 2008.
- The economy rebounded - a W-shaped ‘double-dip’ recession - in the second quarter, boosted by the $100 billion in tax rebates.
- But the effects of this stimulus had faded by the middle of the third quarter.

Source: “The Perfect Storm of a Global Recession”, Nouriel Roubini, August 2008

Lessons from the Crisis

- Avoid high volatility in monetary policy
- Appropriate response of monetary policy to asset prices
- Manage capital flow volatility
- Look for signs of over leveraging
- Active dynamic financial regulation
  - Capital buffers, dynamic provisioning
  - Look for regulatory arbitrage incentives/ possibilities

Scenarios for the Future

Four possible scenarios:

- The business cycle;
- Geo-political change;
- The green economy;
- Transformational economics.

The business cycle

- The Global Financial Crisis signifies the beginning of a major economic downturn, but things improve in a few years;
- When things do improve, it's business as usual, but with some basic reforms;
- No need for systemic change.

The business cycle

- “The Australian stock market offered investors the best buying opportunity in a generation in 2009, after the bourse suffered its biggest annual decline ever in 2008… The returns on shares are now significantly higher than the alternatives.”

  Source: “Bargains Await Investors in 2009”, 24 December 2008, The Age

Geo-political change

- The US economy is severely weakened.
- Economic and political power move to Asia (Chindia) and Europe.
- Regional economic blocks arise in Europe, the Middle East, Asia and the Americas.
- While economic and political power shift, minimal systemic change occurs.

Geo-political change

Nouriel Roubini:

- “America’s biggest financiers are China, Russia and the Gulf states. These are rivals, not allies… Once you run current account deficits, you depend on the kindness of strangers. This might be the beginning of the end of the American empire.”

Source: “Dr. Doom”, Stephen Mihm,

15 August 2008, NY Times Sunday Magazine

The green economy

- Sustainable development, energy efficiency, low-carbon industries, carbon trading, triple bottom line accounting, renewable energy, etc., are gradually adopted.
- Climate change and global warming increasingly shape economic policy.
- Environmental concerns lead to some systemic change.

The green economy

- “Investment in a ‘green economy’ is now being discussed at high levels as the pathway out of financial crisis to a new round of job growth, prosperity and a low-carbon society.”

  Source: “Time to Unleash the Power of a Green Economy”, 17 December 2008,

  ECOS Magazine

Transformational economics

- Multi-dimensional transformation.
- The emergence of a new collective psychology.
- Systemic change.

Serious new challenges

- The asymmetric nature of the recovery creates serious challenges, both for advanced and for developing and emerging market economies.

- In advanced countries, the main challenge is fiscal consolidation. A year ago, the risk was that private demand would collapse, leading to another Great Depression scenario. The priority was thus to implement fiscal stimulus programs, and avoid this catastrophic scenario.

Serious new challenges

- Demand did not collapse, and has indeed started to grow again, if only weakly.

- One year later however, the risk has shifted location. The loss in fiscal revenues associated with the loss in output is threatening to lead, if not contained, to a debt explosion. In most countries, fiscal consolidation must increasingly be the priority.

Serious new challenges

- Emerging and developing countries face a different set of challenges. One of them is large capital inflows. Higher growth prospects and higher interest rates are attracting large capital inflows.

- Such inflows, especially when driven by growth prospects, are fundamentally good news, but experience suggests that they can also lead to booms and busts.

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Serious new challenges

- The main policy issue facing recipient countries is how to best accommodate these flows, how much to let the currency appreciate, how to use macroeconomic policy, how to use macro-prudential tools, reserves, and capital controls, to best avoid excesses and maintain stable growth

THANK YOU