International Conference

Global Economic Downturn: Lessons and Way Forward

The International Financial Crisis: India and G 20 Initiatives

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The Current Crisis

- By common consensus the global economy passing through perhaps the most difficult and uncertain times **since the Great Depression** of the 1930s. More severe than the global oil shock of the 1970s.
- Unlike the Latin American Debt Crisis, the Japanese Real estate bust, and the East Asian Currency Crisis, the current crisis is both **deep** and **global**.
- The crisis is proof that no economy is decoupled from developments in the US, which is arguably ***THE*** systemically critical economy.
- Prognosis: comparative research indicates that crises originating in the real estate and banking sectors tend to be both **severe** and **protracted**.

Roots of the Crisis

- Rising defaults in the **sub prime segment** of the US housing market
- Ordinarily these defaults **should have been easily absorbed** since the sub prime segment was relatively small
- Sub prime defaults however ignited an **explosive powder keg of Imbalances, Innovations and Ineptitude** to escalate a global crisis of unprecedented proportions.

The Macro-economic Backdrop

- **Imbalances:** Excessive global liquidity deriving from global imbalances inflated asset bubbles, drove interest rates down and encouraged excessive leveraging & risk taking.
- **Ineptitude:** Loose monetary policy in the US disregarded the ‘Taylor Rule’ and focussed almost exclusively on consumer prices while disregarding asset price bubbles through overleveraging in the relatively unregulated ‘shadow banking’ system.
- **Innovation:** Financial deregulation in the United States lowered oversight of declining credit standards, including proliferation of brash innovative originate-and-distribute “securitized”, and especially “structured” financial instruments, such as “collateralized Debt Obligations” (CDOs).

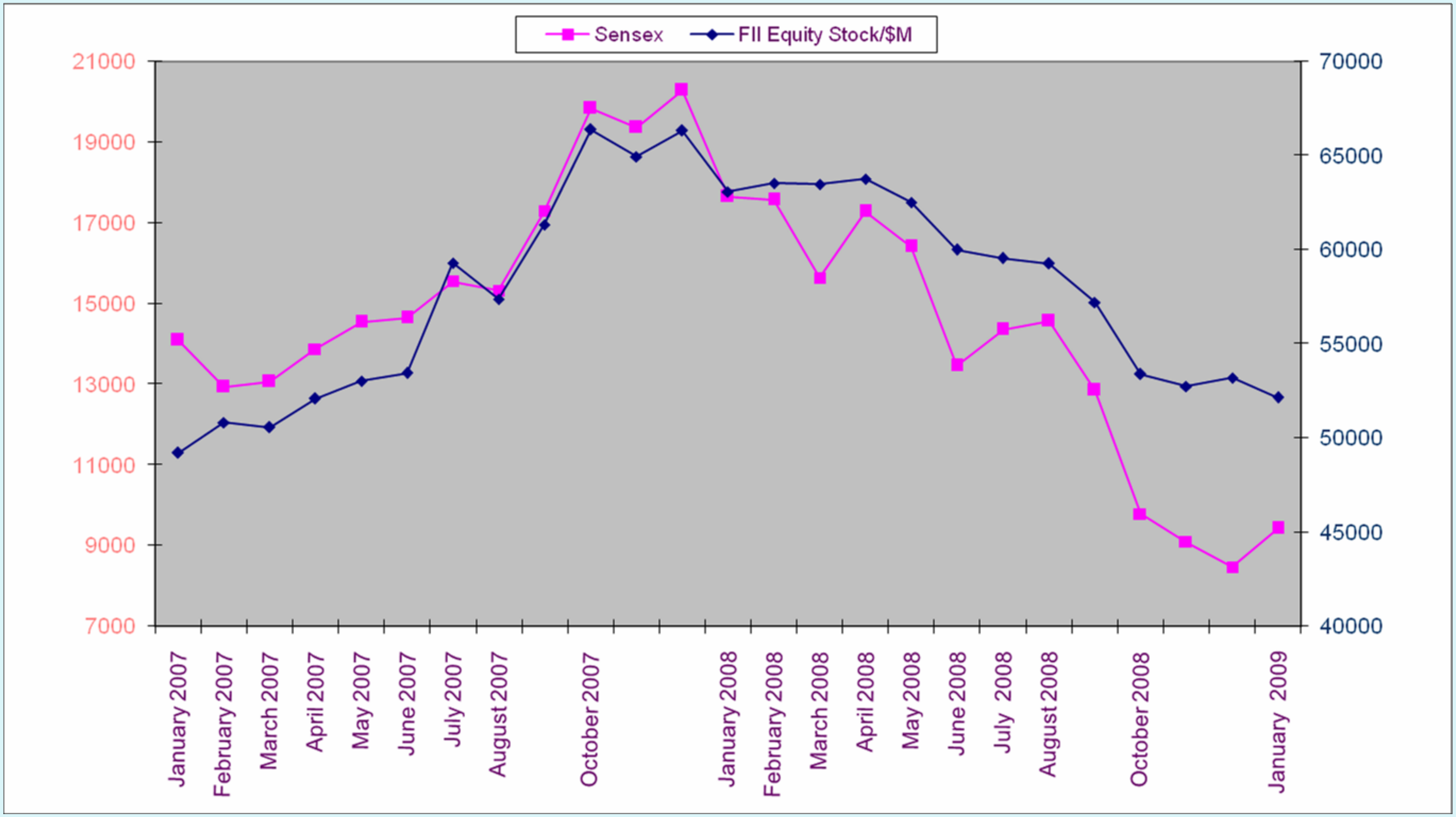
Initial Impact of the Credit Crunch

- In the **early stages it was unclear** as to what the impact of the US sub prime financial crisis would be on the real economy.
- There was a **flight to quality to emerging markets** like China and India: unprecedented bull run in stock markets and currency appreciation: the seductive decoupling argument, with China and India rushing to rescue the global economy.

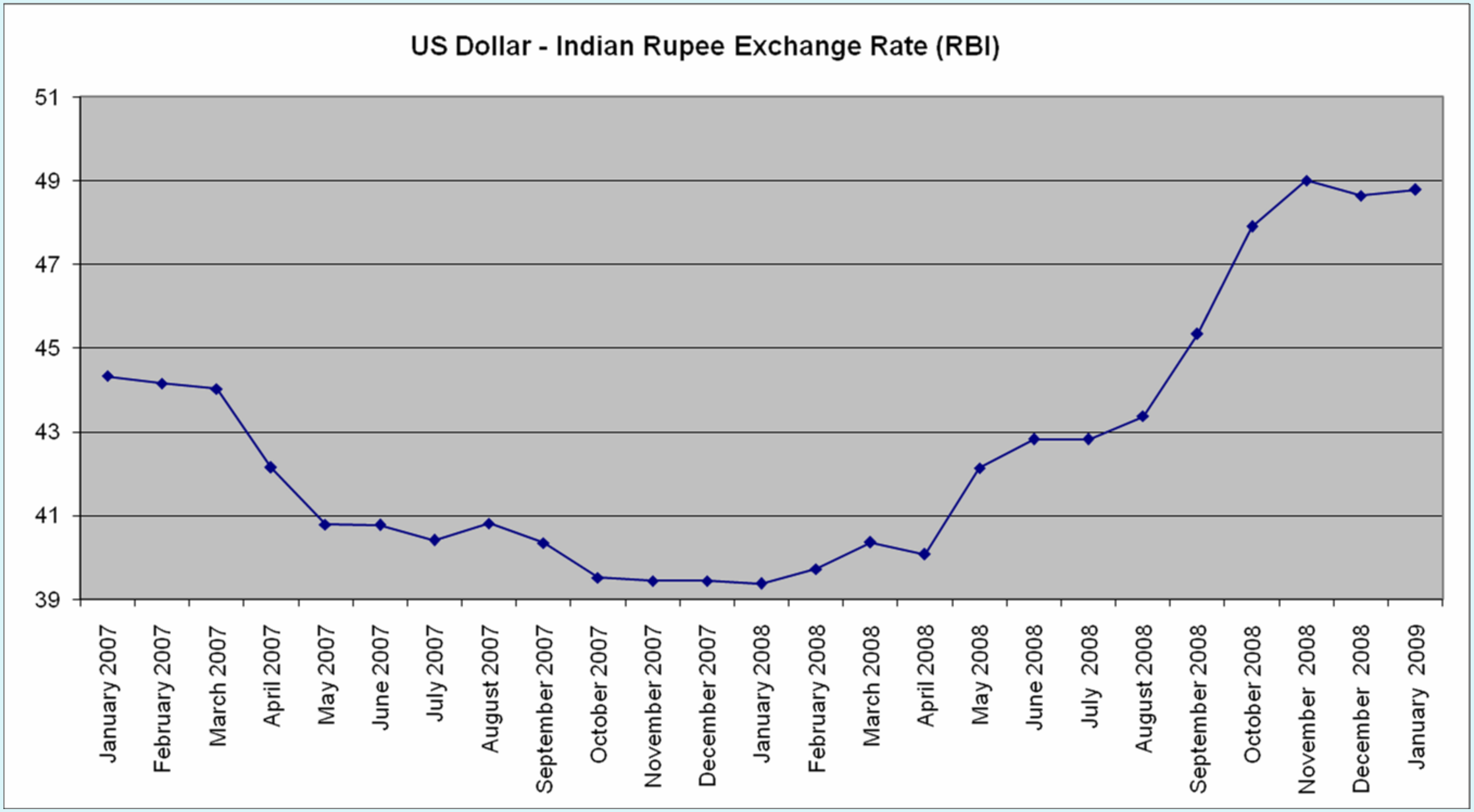
Second stage of Deleveraging

- Deleveraging adversely and sharply impacts both **demand and growth**.
- A realization how **coupled** we all are.
- While financial markets remain robust in several **emerging economies**, including India, trade and investment channels of transmission having **devastating effect**.
- Investment, industrial production, employment, exports are all downbeat.
- Sharp fall in prices stoke fears of **deflation**.

Sensex and Capital Flows



Indian Rupee



Policy Response

- Policy response to stabilize the financial sector and the economy so far largely based on **lessons derived from the Great Depression:** Ben Bernanke, Chairman of US Fed, an authority on the Great Depression.
- Focus on:
  - **Monetary loosening** : US Fed had aggravated the Great Depression by tightening monetary policy as liquidity was drying up.
  - **Fiscal expansion**: parallels with Roosevelt's ***New Deal***
  - **Trade openness**: protectionist pressures unleashed by the Smoot-Hawley Tariffs aggravated the Great Depression.

Monetary Policy

- **Easing liquidity** caused by credit crunch
- Stimulating demand and investment
- Policy Actions:
  - US Fed made successive unprecedented cuts in Fed Funds Rate from from 5.25% in September 2007 to 0-0.25% on December 16, 2008.
  - Bank of England lowered the Base Rate from 5% in October 2008 to 1 % on February 5, 2008, the lowest in its 315 year history.
  - The ECB, more focussed on inflationary expectations, slower off the blocks, lowering its key fixed rate from 4.25% in October 2008 to 2% on January 21, 2009.
  - All three have also directly injected liquidity into money markets.
  - Central Banks across the world have followed suit.
- **Liquidity trap?** Monetary policy losing traction in developed markets because dispersal of toxic assets has heightened counterparty risks.

Fiscal Policy

- To **recapitalize banks** that have suffered extensive losses and asset write-downs.
- Make up for the sharp **fall in private demand**
- Policy Actions: IMF expects stimulus of 1.5% of global GDP
  - US & China: 6% of GDP
  - Japan and Canada: 2% of GDP
  - Germany: 2.4% of GDP
- Some countries have less **fiscal space** and capacity to borrow.
- Sharp differences over the **multiplier impact** of government spending.
- **Potential clash** between monetary and fiscal policies.
- Fiscal impact of **revenue decline** likely exceed that of stimulus.

Trade Policy

- Isolated, **minor protectionist moves** by several countries, but according to WTO protectionist pressures have by and large been resisted so far.
- **Pressures are mounting** because of sharp rise in unemployment and leakage of fiscal stimulus abroad through trade and investment linkages.
- In contradistinction to the Great Depression, **manufacturing chains are now global**, so structurally difficult to close economies.

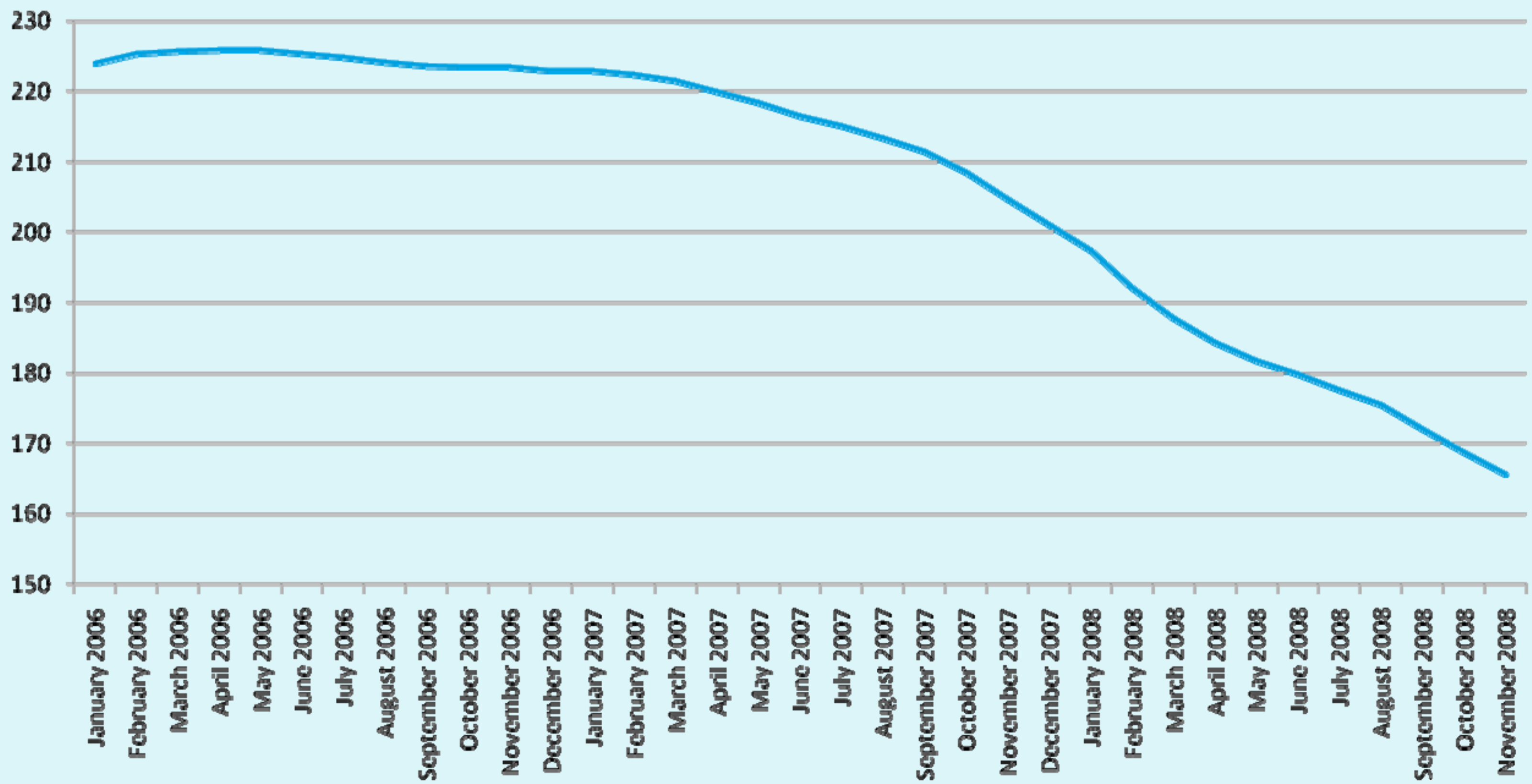
Steps Taken by India

- Monetary
  - benchmark overnight **lending rate** cut by 350 basis points from 9% to 5.5% between July 29, 2008 and January 2, 2009.
  - **Liquidity injection of about 8%** of the GDP through lowering bank cash reserve requirements and special refinance facilities.
- Fiscal
  - net additional expenditure upwards of $ 30 billion (Rs. 150320 crore) through supplementary parliamentary grants, or **about 3% of GDP, apart from tax breaks.**

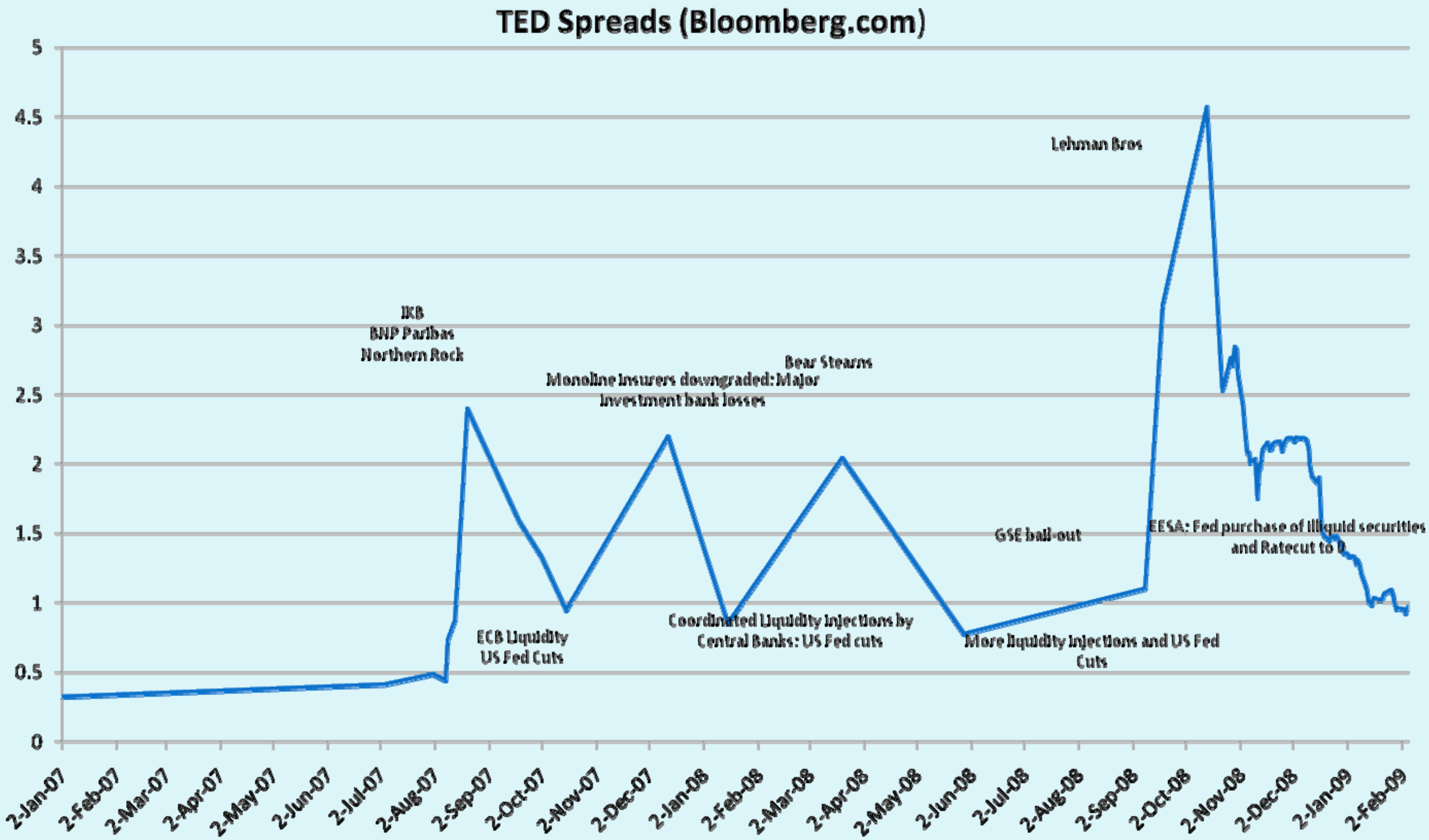
Impact of Policy Actions

- **Housing prices** continue to slide
  - Case Shiller US House Price Index
- **Credit crunch** continues
  - TED spreads
- Estimates of **toxic assets** continue to rise (IMF and Nouriel Roubini)
  - ABX prices in freefall
- **Real economy** not stabilizing
  - January 28 IMF Projections

S&P Case Shiller Seasonally Adjusted (Composite 10) House Price Index

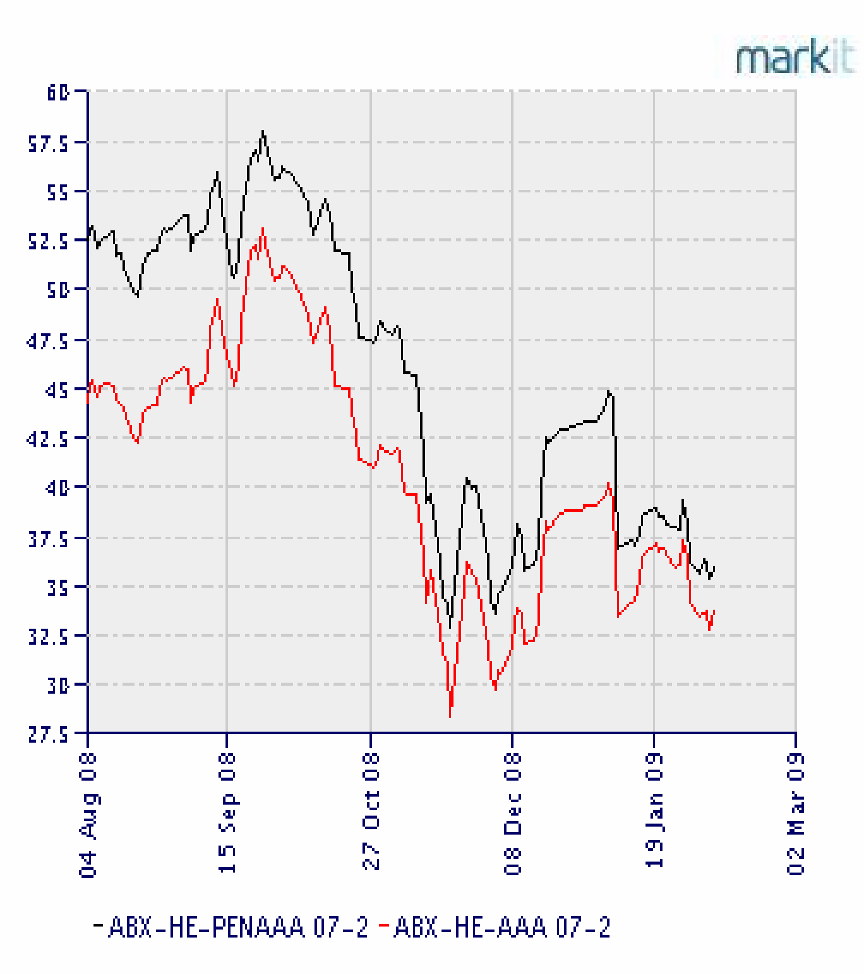


Credit Crunch Canary



Toxic Assets (Markit.com)

ABX Indices: AAA Rated



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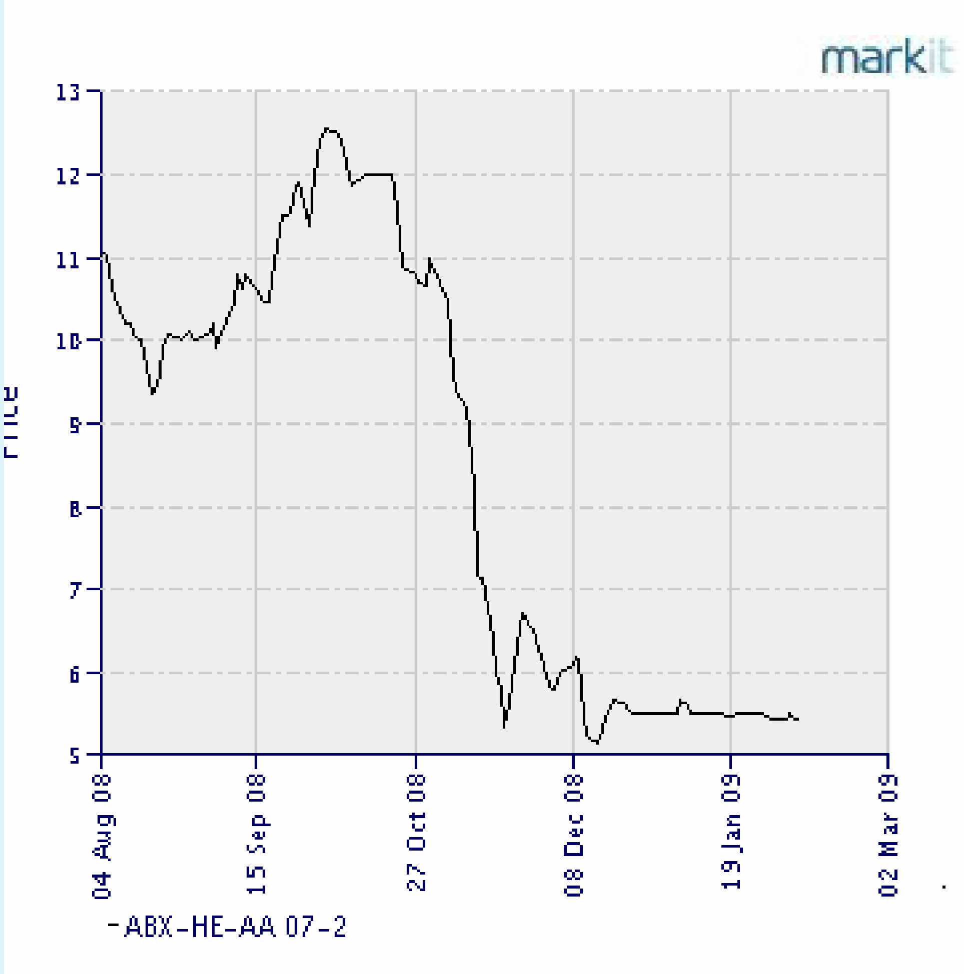

Growth Projections?

- In this **uncertain** environment difficult to make growth projections. IMF has revised its April 2008 projections downwards four times.
- January 28, 2009 projections unusual as these do no pre-suppose “no policy change” and are **contingent on continuing monetary and fiscal interventions**. Even so, global growth projection of 0.5% in 2009 is **lowest since WW II**.
- Global goods and service **trade volume** projected to decline by 2.8% in 2009. Asia affected more sharply.
- Unlike **OECD** countries that have entered recession and **negative growth** territory, China and India would remain the fastest growing economies in the world in 2009.
- If recovery in western economies is protracted, **Asian growth could suffer more** sharply because of its dependence on export markets.

IMF World Economic Outlook: January 28, 2009

	2007	2008	2009
World	**5.2**	**3.4**	**0.5**
Advanced Economies	**2.7**	**1**	**-2**
U.S	2	1.1	-1.6
Euro Area	2.6	1	-2
UK	3	0.7	-2.8
Japan	2.4	-0.3	-2.6
EMEs	**8.3**	**6.3**	**3.3**
China	13	9	6.7
India	9.3	7.3	5.1
Asean 5	6.3	5.4	2.7
Brazil	5.7	5.8	1.8
Mexico	3.2	1.8	-0.3
Western Hemisphere	5.7	4.6	1.1
Russia	8.1	6.2	-0.7
C & E Europe	8.6	6	-0.4
Middle East	6.4	6.1	3.9
Africa	6.2	5.2	3.4

Recent Indian Indicators

- **Growth** 2009:
  - IMF: 5.1; S&P: 4.7; Morgan Stanley: 4.3;
  - EAC to PM: 7-7.5%.
- **Industrial Production**:
  - The Index of Industrial Production grew by just 3.9% during the period April-Nov. 2008, compared to 9.2% in April-Nov.2007.
- **Savings and Investment**:
  - To dip by at least 2-3% of the GDP in 2009-10 according to EAC to PM
- **Trade**:
  - current account deficit more than doubled from $ 11 billion in April to September 2007 to $ 22.3 billion in the corresponding period of 2008.
- **Capital Flows**:
  - surplus on the capital account, used for balancing the deficit on the current account, declined sharply from $ 50.9 billion to $ 19.9

Co-ordinated Action

- Because the **world is so integrated** through trade and capital flows, and the crisis is global in scope, a realisation that globally co-ordinated action by systemically important economies essential.
- **G 20** has emerged as the forum for concerted multilateral action since it includes all systemically important economies, accounting for about 85% of global GDP.
- Agenda set by the **Washington Declaration** of Mid November 2008 issued by G 20 leaders.
- **Current Chair** of G 20 : United Kingdom

G 20 : Background

- Represents **75% of global GDP** (PPP), and 81% including the Euro Area. (2007)
- Africa, Central and Eastern Europe and LDCs **under-represented** .
- Formed at the time of the **East Asian Crisis** a decade ago.
- **Chair rotates** annually: last chair Brazil, current chair UK, next chair South Korea (‘Troika’)
- Till the Washington Leaders’ Summit meeting only at the **Finance Ministers’ level.**

G 20 : Countries

Developed Countries

- USA
- UK
- European Union
- France
- Germany
- Italy
- Australia
- Canada

Developing Countries

- China
- India
- Indonesia
- South Korea
- Russia
- Saudi Arabia
- Turkey
- South Africa
- Argentina
- Brazil
- Mexico

G 20 Process to Address the Crisis

- **Leaders' summit**
  - Washington, November 15, 2008
  - London, April 2, 2009
  - ?
- **Sherpas' process**
  - Back to back with Leaders' Summits
  - Conference calls: January 14 and February 5, 2009
  - Face to face meeting London, February 25-26/March 6-7, 2009
- **Finance Ministers** and (finance and central bank) Deputies Process
  - Sao Paulo, November 13-14, 2008
  - London, January 31-February 1, 2009
  - London, March 13, 2009
- **Working Groups**
  - Conference Calls
  - E-Mail groups
  - One or two face to face meetings

G 20 Working Groups

- The Washington Declaration has laid out the broad agenda, both **short-term** (palliative) and **long-term** (preventive).
- G 20 Troika has formed **4 WGs** to address the actionable points.
- **Macro-economic issues** to be handled directly at the Finance Ministers and Leaders levels (including Deputies and Sherpas)
- Each WG **co-chaired** by Developed and Developing Countries (India co-chairs WG I on financial regulation)
- India has formed **5 mirror groups** that are injecting India’s views into the G 20 working groups.

WG I: Strengthening Transparency and Enhancing Sound Regulation

- **Forward looking** but also linking back to current crisis
- Focus on **Five Broad areas**:
  - Pro-cyclicality and capital buffers
  - Strengthening OTC structures
  - Broadening regulatory boundaries
  - Compensation schemes
  - Transparency in valuation and accounting
- Much of the detailed work being done by **specialized agencies** like FSF, IMF, IASB, IOSCO, etc.

WG II: International Co-operation and Market Integrity

- Immediate expansion of **FSF** on clear metrics
- **Governance issues** relating to other international bodies such as IASB, IOSCO, Supervisory Colleges
- Contingency **planning and crisis management** structures covering systemic institutions, including exit strategies and harmonizing host/investor country interests.
- Improving analytical tools for identifying macro-financial vulnerabilities and closer collaboration between **FSF and IMF on early warning systems**.
- Issues relating to **market integrity**: money-laundering, tax havens and off shore centres.

WG III: Reforming the IMF

- Strengthening IMF **early warning surveillance** in an even handed manner.
- Broad consensus on **expansion of IMF resources in the short run**, including through borrowing, to address the sharp decline in capital flows to EMEs.
- Broad consensus on governance reform, including open selection of MD, and quota expansion, but some **disagreement on timing**.

WG IV: World Bank and Regional Development Bank (RDB) Reform

- Consensus on timely **countercyclical response** to the crisis through flexible, instruments, front loading and dynamic provisioning.
- Broad support for an immediate and substantial **general capital increase of the ADB**.
- On governance, broad agreement on reform of selection process of institution heads, but **less agreement on other reforms.**
- Little support for expanding the crisis management mandate to include **climate change issues.**

Leaders’ London Declaration

- WGs to submit **Reports to Deputies**
- Deputies and Sherpas to interface before the **Finance Ministers Meeting**
- UK Chair: What is **agreed to at FMs level** should not be re-opened at Leaders’ level.
- **Sherpas to negotiate final Declaration** to be issued on April 2, 2009

Potential Pitfalls before the G 20

- **Loss of credibility**:
  - London declaration merely re-iterating the Washington declaration at a time the global economic situation is fast deteriorating.
  - Countries going back on what they have agreed (trade, regulatory reform, governance reform)
- Focus shifting from looking forward to looking back/**blame-games:**
  - Global imbalances or regulatory failure?
  - Overconsumption or excess savings?
  - Exchange rate manipulation?
- Widening of agenda and **loss of focus**:
  - climate, Labour, trade, etc.
- **No institutional framework** to implement/enforce co-ordinated response.
- Rival developed and developing country **caucuses**.

Issues Important for India

- Important to stick as closely as possible to issues agreed to by the Leaders in the declaration and ***not get distracted*** by a whole host of new structural issues that are in any case being handled in special for a like UNFCCC/IGPCC, WTO, ILO etc.
- Focus should be on stabilizing the global economy and the financial system, and on common set of broad regulatory principles informing the financial sector across the globe. ***Dominant role to be played by developed countries since the crisis was of their making.***
- ***More needs to be done to stabilize*** the financial and economic system, including bolder initiatives to take toxic assets out of the system.
- ***Global imbalances*** need to be addressed over the medium term.
- ***Protectionism*** can take various shapes and forms and includes, inter alia, subsidies, non-tariff barriers, agriculture and services. OECD countries need to take the lead in indicating what the entire world should commit itself to.
- Comprehensive governance reform of IFIs, including ***immediate expansion of the FSF.***
- Finding means to ***restore EMEs access to capital flows***, including counter-cyclical role to be played by MDBs.
- ***Even handed surveillance*** of all systemically important economies and financial institutions.
- ***G 20, or a smaller group including BRICs***, to become the predominant global multilateral forum, eclipsing the G 7.
- ***Leadership of LDCs?*** China trying to wear this mantle.

Co-ordination amongst EMEs

- To **make an impact** it is important that India consult and work closely together with likeminded developing countries.
- Developing countries have **concerns of their** own that should be adequately reflected in the G-20 documents.
- Important that these views are **injected into G-20 drafts** sufficiently early.
- India regularly **meeting on the sidelines** of G 20 meetings with China, Russia, Brazil, South Africa, and Mexico.
- Such co-ordination should create the impression of creation of a **rival caucus** that could result in a backlash from G 7 countries: bilateral consultation and country position papers containing common elements.

Common Ground amongst EMEs

- More needs to be **done by developed countries** to stem the downslide since the crisis originated in developed countries.
- G 20 process: a right balance between **conference calls and face-to-face meetings** so that the views of EMEs are adequately reflected in the final draft. This was because several EME representatives were not very articulate in English, the medium through which such conference calls are conducted.
- Any paper to be circulated at both the Finance Ministers meeting on 14-15 March, and the Leaders Summit on April 2, should be **circulated well in advance** so that the views of EMEs could be reflected in the draft.
- The four Working Groups constituted should put across the **views of EMEs**.
- Immediate expansion of the **FSF** as the Washington declaration envisaged an important role for an 'expanded' FSF in the emerging financial architecture.
- While short term counter-cyclical issues were important, such as enhancing resources to make up for **the deficit in private capital flows,** governance issues should not get crowded out in the process. There was a need for a clear road map in this regard.
- Focus on core issues of financial regulation and the economic downturn **without getting distracted** by climate change, trade, health, education, labour, etc, which are being handled in other forums.
- The **future status of the G-20 Leaders process** should be clearly spelt out.
- If the G-20 reaches out to other countries, such outreach **should not be**

Billion Dollar Questions

- Is **unwinding of global imbalances**, and substantial domestic demand expansion in EMEs, a necessary condition for revival of growth?
- Is a **regulatory fix** and consequential revival of confidence in in the financial sector sufficient to stimulate the real economy?
- Is the era of **hyper growth** over, and is this providential from the sustainability

Thank You for the Patient Hearing