INDIA AND IMF

THE 2008 GLOBAL FINANCIAL CRISIS AND POLICY RESPONSES

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By 2009, India had arrived on the international economic scene. The Indian economy had grown at 8.6 percent for 5 years, and it was opined that if the rate of growth kept up, India would be transformed like China with US $ 1 trillion economy doubling 8 ½ years[3]. It was projected that poverty would be reduced at an unimaginable speed and the 11th Five Year Plan had projected an annual growth rate of 9 percent rising to 10 percent by 2011. Indian policy makers had reckoned that India may not be severely affected from the 2008 Global Financial Crisis largely because of public ownership of banks, strict prudential rules laid down by RBI and limits on external commercial borrowings. That said, Indian stock markets witnessed a 60 percent loss in values, foreign portfolio investment slowed down and rupee lost 20 percent value against the dollar reaching Rs. 50/ dollar, with the global financial freeze accelerating the currency depreciation. Government borrowing rose sharply and abruptly in the crisis years of 2008-09 and 2009-10. The Reserve Bank of India managed the borrowing program by maintaining easy liquidity conditions[4]. The growth forecast was revised from 9 percent to 7.1 percent and even that proved optimistic, although India remained the second fastest growing economy in the world after China.

Expectations that the Indian economy is ‘decoupled’ from the West were completely belied. The stock markets’ sharp decline in response to global crisis were the first indications of global developments retaining their hold over Indian markets. Foreign institutional investors were pulling out. The current account deficit widened. Remittances and earnings from software exports that had propped up the current account in the past showed signs of declining. Software exports to the U.S. were under strain.

India’s corporate sector was increasingly integrated with the world. India’s IT companies which derived 85 percent of their revenues from exports to United States and Britain, employing 2 million workers witnessed job losses.

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[3] The Economist October 11, 2008

[4] Duvvuri Subbarao., *India and the Global Financial Crisis – Transcending from Recovery to Growth*., Comments of Dr. D. Subbarao, Governor RBI at the Peterson Institute for International Economics, Washington DC, April 26, 2010., RBI Speeches

An analysis by the IMF of the Indian corporate sector suggested that the global crisis could have a serious impact on the Indian corporate sector and near-term growth. The significant volatility in the exchange rate, equity prices, and interest rates triggered by the global crisis, together with the decline in global economic activity and capital flows were to weigh on India's firms. The IMF estimated that the economic growth impact could be over four percentage points; with GDP growth rate in 2007/08 at 9 percent, the IMF estimates implied a deceleration to around 5 percent[5]. As capital flows to India declined in the immediate aftermath of the crisis, the IMF suggested that India could prepare for the return of capital flows to Emerging Markets by continuing with capital account liberalization and pro-growth reforms. On the sharp decline of the rupee, the IMF said that an exchange rate depreciation is likely to be less inflationary when output was slowing.

In the G-20 meeting[6] in October 2008, Governor RBI, Duvvuri Subbarao had urged advance economies to keep the emerging market central banks in the loop on financial market developments as they viewed them and also on their proposed policy responses. The US Treasury and the Federal Reserve had conducted regular briefings for select emerging market economies including India. The advanced economies had to resort to unconventional monetary policies and quantitative easing and large scale asset purchases to flood the system with liquidity. The lowest policy rate India reached during the crisis was 3.25 percent while several advanced economies had reached near zero percent policy rates.

On February 16, 2009 the Union Finance Minister appraised the Parliament of the Global Financial Crisis. In his budget speech, Finance Minister, Pranab Mukherji[7] said

> "The global financial crisis which began in 2007 took a turn for the worse in September 2008 with the collapse of several international financial institutions, including investment banks, mortgage lenders and insurance companies. There has been a severe choking of credit since then and a global crash in financial markets. The slowdown intensified with the US, Europe and Japan sliding into recession. Current indicators of the global situation are not encouraging. Forecasts indicate that the world economy in 2009 may fare worse than in 2008.
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> A crisis of such magnitude in developed countries is bound to have an impact around the world. Most emerging market economies have slowed down significantly. India too has been affected. For the first time in 9 months of the current year, the growth rate of exports has come down to 17.1 percent. ..Industrial production has fallen by 2 percent…In these difficult times, when most economies are struggling to stay afloat, a healthy 7.1 percent rate of GDP growth still makes India the second fastest growing economy in the world."

[5] India *Selected Issues*., International Monetary Fund, January 23, 2009
[6] Duvvuri Subbarao., *Who Moved My Interest Rate*., 2016 pp 21-45
[7] Interim Budget 2009-10, *Speech of Pranab Mukherji*, Minister of Finance February 16, 2009

The Government decided to relax the Fiscal Responsibility and Budget Management Act targets in order to provide for much needed demand boost to counter the situation created by the global financial meltdown. The Fiscal Responsibility and Budget Management Act (FRBM) requires the government to commit up-front to a fiscal policy strategy over a multiyear period. The FRBM lays down the following: (i) reduction of the current deficit by at least 0.5 per cent of GDP in each financial year beginning with 2004/05; (ii) reduction of the overall deficit by at least 0.3 percent of GDP in each financial year; (iii) limit of 0.5 percent of GDP on the incremental amount of guarantees given by the central government; (iv) initial annual limit on debt accumulation of 9 percent of GDP, to be progressively reduced by at least one percentage point of GDP each year.

A substantial fiscal stimulus was provided through two packages announced by the Government on December 7, 2008 and January 2, 2009 to provide tax relief to boost demand and aim at increasing expenditure on public projects to create employment and public assets. The Government renewed its efforts to increase infrastructure investments by approving several infrastructure projects. The Reserve Bank of India took a number of monetary easing and liquidity enhancing measures including the reduction in the cash reserve ratio, statutory liquidity ratio and key policy rates. The objective was to facilitate funds from the financial system to meet the needs of productive sectors.

The First Stimulus dated December 7, 2008[8]

The government effected an across-the-board 4 per cent cut in Cenvat to bring down the prices of cars, cement, textiles and other products, and earmarked an additional Rs. 20,000 crore for infrastructure, industry and export sectors for the current fiscal. In what may be dubbed as a mini-budget of sorts to lessen the impact of the global slowdown and recession in the West on the Indian economy, the package, while entailing a revenue loss of Rs 8,700 crore in the remaining four months of 2008-09, sought to revive various crucial sectors such as housing, exports, automobile, textiles and small and medium enterprises (SMEs).

In an all-encompassing measure, the Cenvat on all products — barring non-petroleum goods — was reduced from 14, 12 and 8 per cent to 10, eight and 4 per cent for various categories. Full exemption from basic customs duty has been effected on naphtha to provide relief to the power sector. While the export duty on iron ore fines has been withdrawn, the levy on export of iron lumps has been cut from 15 to 5 per cent. Apparently, the package, drawn up at the instance of Prime Minister Manmohan Singh, who also holds the Finance portfolio, seeks to boost power, exports, housing, auto, SMEs and infrastructure sectors through additional funding.

The 10-point package, with significant incentives for the sectors affected by the slowdown, permitted

[8] The Hindu., “*Government unveils stimulus package*”., dated December 8, 2008

India Infrastructure Finance Company Ltd. to raise Rs. 10,000 crore through tax-free bonds by March as part of the exercise to support the Rs. 1,00,000-crore highways development program. An official statement said: “The government has been concerned about the impact of the global financial crisis on the Indian economy and a number of steps have been taken to deal with this problem.” It also noted that monetary measures effected by the Reserve Bank of India were being “supplemented by fiscal measures designed to stimulate the economy. In recognition of the need for a fiscal stimulus the government had consciously allowed the fiscal deficit to expand beyond the originally targeted level.” “The economy will continue to need stimulus in 2009-2010 also and this can be achieved by ensuring a substantial increase in Plan expenditure as part of the budget for next year,” the statement said.

The size of India’s fiscal stimulus package of Rs. 30,000 crores was considered as modest in comparison with those of most other countries. It was termed a feeble response given the lack of fiscal space considering the budget had provided for salary hikes, oil and fertilizer subsidies and fiscal deficit was projected around 10 percent. The RBI had taken the lead in reduction of policy interest rates, the repo and reverse repo rates to increase bank lending. That said, the transmission mechanism from policy rates to interest rates charged by banks was weak to avert a sharp slowdown. This necessitated the second stimulus package dated January 2, 2009.

The Second Stimulus dated January 2, 2009[9]

The government, in tandem with the Reserve Bank of India (RBI), on Friday announced the much-awaited second stimulus package aimed at reversing the economic slowdown through higher public spending, providing additional liquidity for onward lending at lower interest rates, boosting sagging sale of commercial vehicles and making easier credit availability for the export sector, housing and small industries. The package — the second within a month and last for this fiscal — marks a clear shift from reining in inflation to spurring growth in the grim scenario of a crumbling financial system and recession in the West so as to minimise the slowdown impact, even as the government’s total revenue loss in 2008-09 is officially expected to be Rs. 40,000 crore with a fiscal deficit of about 6 per cent of the GDP (gross domestic product), as per Planning Commission estimates. While the RBI slashed its key policy rates yet again to inject an additional Rs. 20,000 crore into the banking system, the government has asked the public sector banks (PSBs) to hike their credit targets for the fiscal so as to ensure optimal disbursal of funds at least cost. Inflationary pressures are easing and additional liquidity is being made available to PSBs at cheaper rates. Since last October, the RBI has pumped over Rs. 3,20,000 crore into the monetary system to usher in a low interest regime, especially when inflation was coming down in the wake of the fall in the prices of fuel, metals and farm commodities.

[9] The Hindu., “*The Second Stimulus Package*” dated January 03, 2008

The interim budget did not enthuse the media, who felt that despite the Rs. 30,000 crores allocation to NREGS, the issues of generating employment of non-rural workers was not addressed.

The Hindu[10] said

> "..India is among countries that have a high exposure to increased risk of poverty due to the global economic downturn. As the sectors that fueled the high annual economic growth rates brace themselves for hard times, job creation in these areas has also weakened. Specific measures to facilitate employment are called for in segments that are badly affected by the economic slowdown, such as Information Technology (IT), IT enabled services, textiles, gems and jewelry, and retail trade. … the entire issue of addressing the urgent issue of urban employment has been left to the successor government that will be formulating the full budget."

On February 19, 2009 the rupee hit 50/ dollar in a jittery market. The RBI's holding of US T bills rose by US $ 6.9 billion to US $ 23.1 billion in December 2008 as India's forex reserves rose from US $ 247.8 billion in November 2008 to US $254 billion in December 2008. Monetary authorities in China, Russia, Hong Kong, Norway, Ireland and Israel also added the lower yielding dollar asset to their foreign exchange reserves. China had added US $ 218 billion in 2008 while India added US $ 8.2 billion.

The Economic Times[11] said

> On Wednesday, the rupee briefly breached the 50-mark against the dollar to end Rs. 49.97, with the market beginning to price in political risk, fiscal slippages and decline in interest of foreign fund houses in emerging market assets. What's pushing up the dollar in the international market is the pervasive interest even among central banks, in US Treasury bills. Despite the US slowdown and abysmal return in US T bills, funds, banks and sovereigns are buying these bonds, which are still perceived as safe haven.
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> In the face of these forces, the domestic currency market largely ignored RBI Governor D.Subbarao's sentiment that lower inflation and current account deficit in coming months could create the possibility of a rate cut. Some state owned banks sold dollars to prevent the rupee from dropping further, but this did not help."

India's 2008 Article IV Consultations with the IMF were concluded on February 6, 2009. The IMF projected India's growth to moderate to 6 ¼ percent in 2008-09 and further to 5 ¼ percent in 2009-10. Headline inflation came down from 13 percent to 4.4 percent in January 2009 and

[10] The Hindu., "*Addressing Urban Job Losses*"., dated February 20, 2009

[11] The Economic Times., *Rupee hits 50 in jittery market.*, dated February 19, 2009

was projected to further drop to 3 percent by March 2009 and to 2 percent on average in 2009-10. Current account deficit was projected at 3 percent of GDP primarily due to oil import bill and deterioration in exports. For 2009-10 the IMF forecast that the current account deficit will narrow to 1 ½ percent of GDP. Capital inflows were expected to decline, with portfolio investment recording US $ 11 billion outflow and external commercial borrowing slowing down considerably. The foreign exchange reserves declined from a historic peak of US $ 315 billion in May 2008 to US $ 252 billion in February 2009. The stock market declined by 50 percent and the rupee declined by 23 percent. The RBI's measures had eased the domestic liquidity pressures and brought down interbank rates significantly. India's spending prior to the onset of crisis had risen significantly with the agricultural debt forgiveness, expansion of the rural employment guarantee scheme and 21 percent civil service wage hike.

The IMF recommended that India faced spillovers from the global crisis. The key short term policy objective was to sustain liquidity and credit flows. The monetary and structural policies had to bear the burden of adjustment given the high public debt – GDP ratio. The IMF felt that rising credit risk and liquidity pressures could put the financial system under strain. It was important that India took note of the potential bank re-capitalization needs and measures to promote early loss recognition, full disclosure of bad assets and filling of information gaps. The IMF supported India's gradual approach to capital account liberalization. It was felt that the sizeable fiscal stimulus should support economic growth in 2008-09. There remained concerns about fiscal sustainability given the high ratio of public debt to GDP. The fiscal space available was to be used for infrastructure and poverty related spending and for bank recapitalization if needed. The IMF reiterated that medium term fiscal consolidation remained a priority and should be anchored in the fiscal rules framework.

The 2009 Article IV consultations[12] of the IMF with India were concluded in January 2010. India's economy was one of the first in the world to recover after the global crisis. Prompt fiscal and monetary policy easing combined with a fiscal stimulus had brought growth to pre-crisis levels. Capital inflows were back on the rise and financial markets regained ground. Growth was projected to rise from 6 ¾ percent in 2009-10 to 8 percent in 2010-11. The IMF commended the Reserve Bank of India for commencing the first phase of exit from monetary accommodation and generally considered that conditions were right for a progressive normalization of monetary stance. The withdrawal of the monetary stimulus was to be done in a gradual manner to soften the impact on long term interest rates and help anchor inflation expectations. India faced challenges in managing capital flows and the IMF recommended sterilized intervention to help reduce exchange rate volatility. The RBI's approach to use prudential measures in case of asset bubbles was also supported by IMF and tightening of capital controls was to be an instrument of last resort.

[12] *India 2009 Article IV consultations*., International Monetary Fund., January 25,2010

The financial system had weathered the global crisis well. The strengthening of capital of public sector banks and financial regulation, the higher provisioning arrangements introduced had all proven successful. There were issues of distressed assets and the insolvency framework. Infrastructure investment remained a priority and public institutions had an important role to establishing the framework for infrastructure financing.

After almost a decade there is good news on economic growth in April 2017. The World Economic Outlook[13] has said that global growth is projected to increase from 3.1 percent in 2016 to 3.5 percent in 2017 and 3.6 percent in 2018. Growth picked up in the United States, has remained solid in the United Kingdom despite Brexit. Japan and Euro Area countries of Germany and Spain are also witnessing strong growth. Economic activity in emerging market economies and developing countries is mixed, with China witnessing strong growth, a modest slowdown in India and a recession in Brazil.

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[13] *Gaining Momentum*, The World Economic Outlook, The International Monetary Fund, April 2017