

**Brookings  
Cornell University  
Asian Development Bank Institute  
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**Financial Sector Regulation and  
Reforms in Asian Emerging Markets**

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

## Some Questions

- Just another financial crisis?
- Worst since the Great Depression of the 1930s?
- Will it change macro-economic management?
- Queen Elizabeth's question !

## The Goldilocks Economy

<b>Growth and Globalization</b>		
<b>Year</b>	<b>Global Growth</b>	<b>EGS/GDP*</b>
Av. 1991-00	3.1	21.5%
2001	2.3	23.9%
2002	2.9	24.1%
2003	3.6	25.0%
2004	4.9	27.0%
2005	4.5	28.4%
2006	5.1	30.2%
2007	5.2	31.2%
2008	3.0	32.4%
2009	-0.8	26.6%

**IMF, World Economic Outlook, Oct.2009**  
\* Export of Goods & Services as a ratio of Global GDP

## Macroeconomic Anomalies

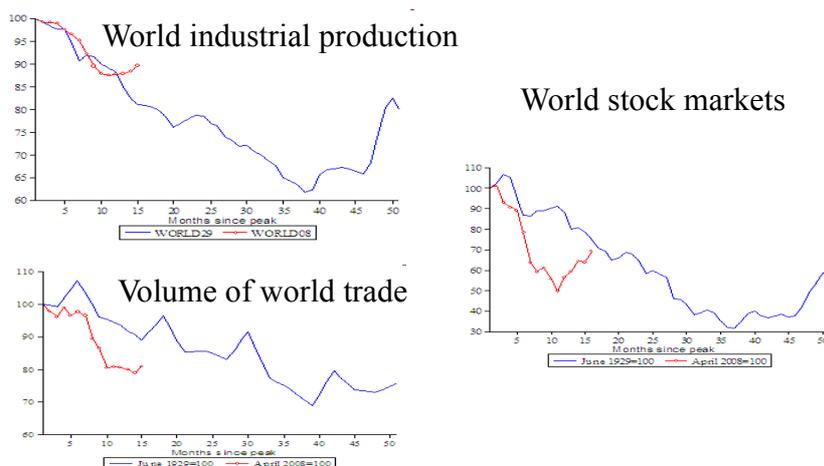
- Policy Tools getting blunt
  - Greenspan's conundrum and capital flows
  - Fiscal stimulus leakages through trade
- Inflation
  - CPI stability and asset price inflation
  - Increasing impact of non-domestic factors
- The Dollar puzzle
  - Not responding to growing US deficits
- LTCM rescue
  - Systemic risk and leverage outside regulated system
- Tradable and Non-tradable divide collapsing
  - Proximate source of crisis in non-tradable sector

## Comparing Recessions

Comparing Recessions				
<i>% change</i>	<b>1975</b>	<b>1982</b>	<b>1991</b>	<b>2009</b>
Output per capita (PPP)	-0.13	-0.89	-0.18	<b>-2.5</b>
Consumption per capita	0.41	-0.18	0.62	<b>-1.11</b>
Investment per capita	-2.04	-4.72	-0.15	<b>-8.74</b>
Industrial production	-1.6	-4.33	-0.09	<b>-6.23</b>
Trade	-1.87	-0.69	4.01	<b>-11.75</b>
Capital Flows/GDP	0.56	-0.76	-2.07	<b>-6.18</b>

## A Tale of Two Depressions

Eichengreen and O'Rourke (*September 2009*)



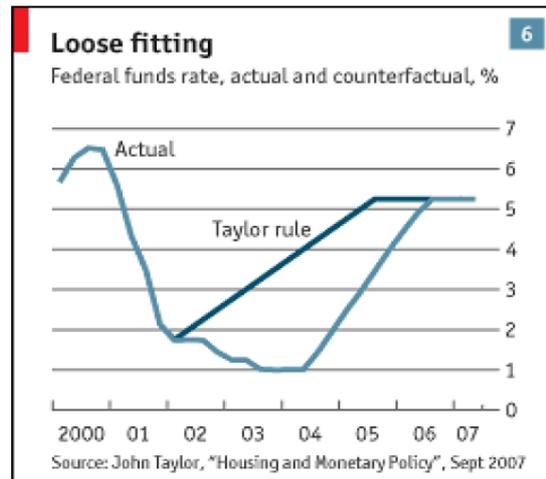
## Whodunnit?

- 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
    - Financial regulation lax
    - Monetary policy too loose

## Current Account Imbalances

- **Current account surplus** between 2000 & 2007
  - 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** inflows and outflows to and from developing countries rose from \$ 0.55 to \$ 3.4 trillion.

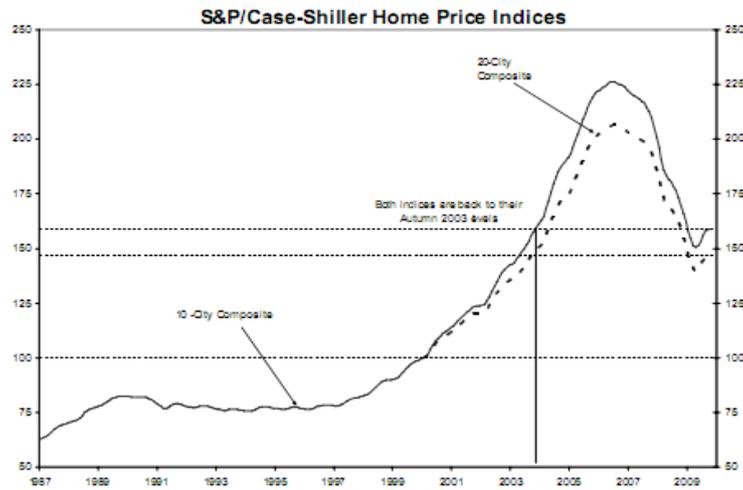
## US FED: Loose Monetary Policy



## Are we out of the Woods?

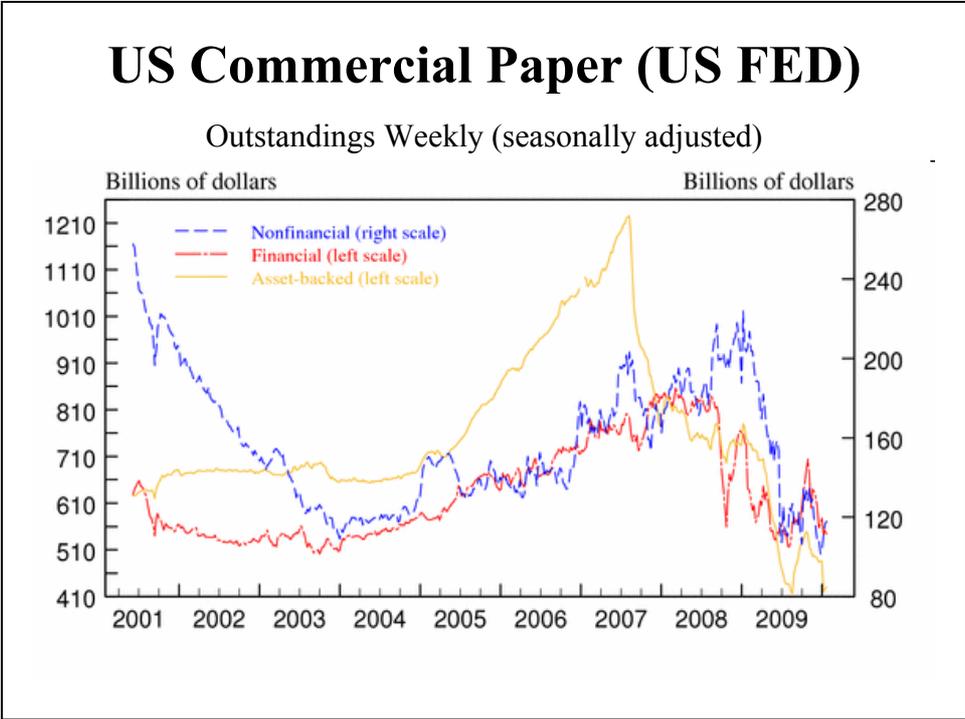
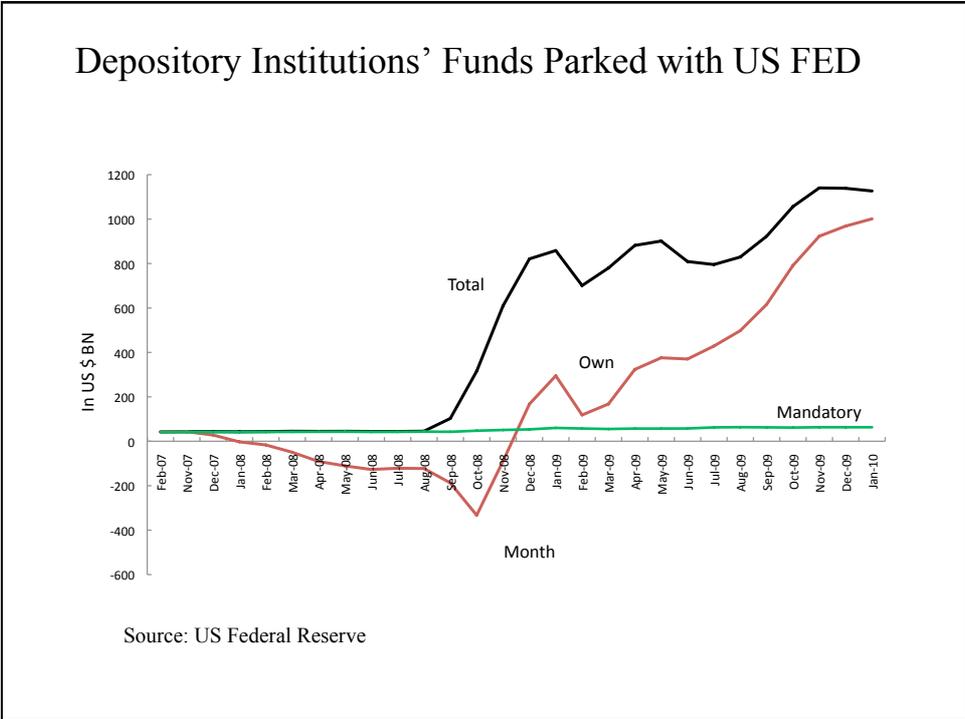
- Positives
  - Near Quarter **growth**
  - **Industrial** growth
  - **Trade** recovering
  - **TED** spreads normalized
  - **Housing** prices recovering
  - **Unemployment** not rising
- Negatives
  - **Output gap** still huge
  - **Life support** in place
  - **Deleveraging** continues
  - **Securitized**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

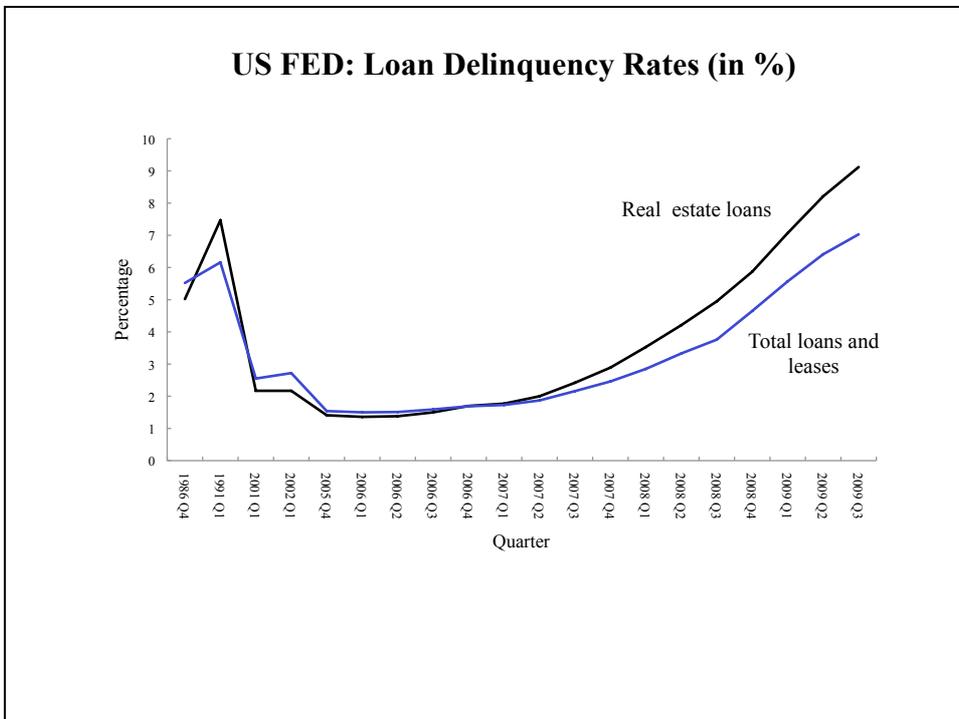
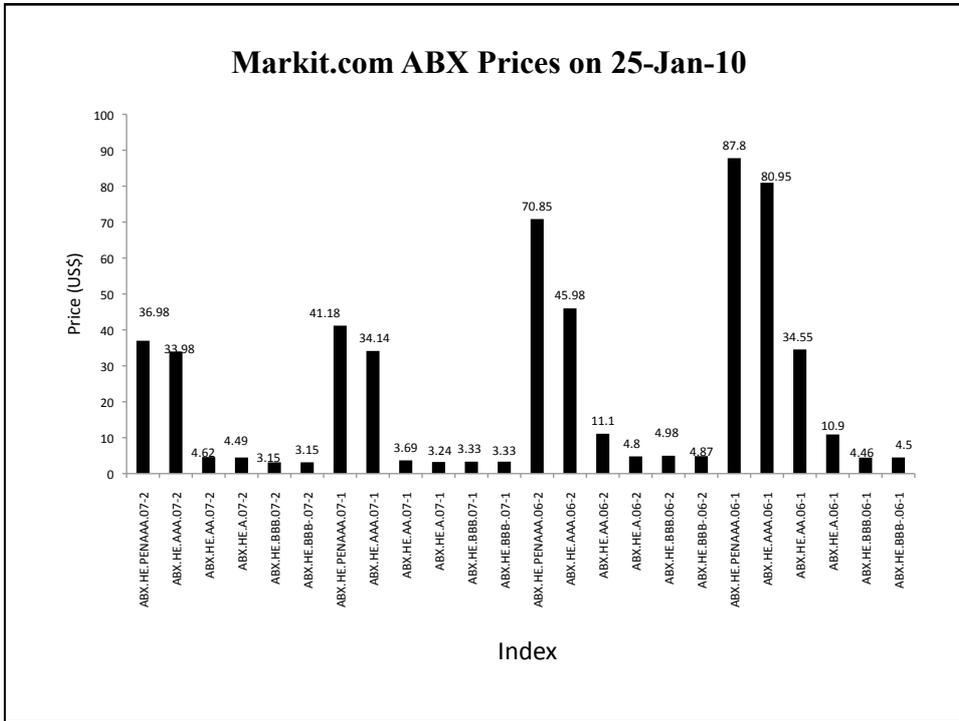
## US Housing Prices (Case-Shiller)



## TED Spreads (Bloomberg.com)



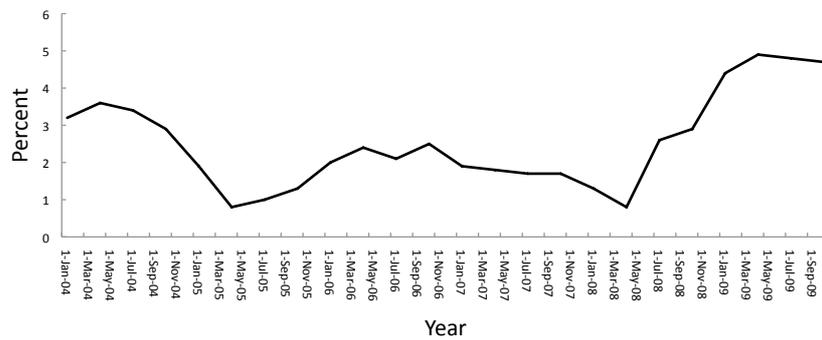




## Million Dollar Questions

- Return to business as Usual?
- Unwinding of global Imbalances?
- Return to Trend Growth?
- Over stimulation and inflation

## Trends in US Personal Savings Rate



Source: US BEA

## Modern Macroeconomic Policies

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

## 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?

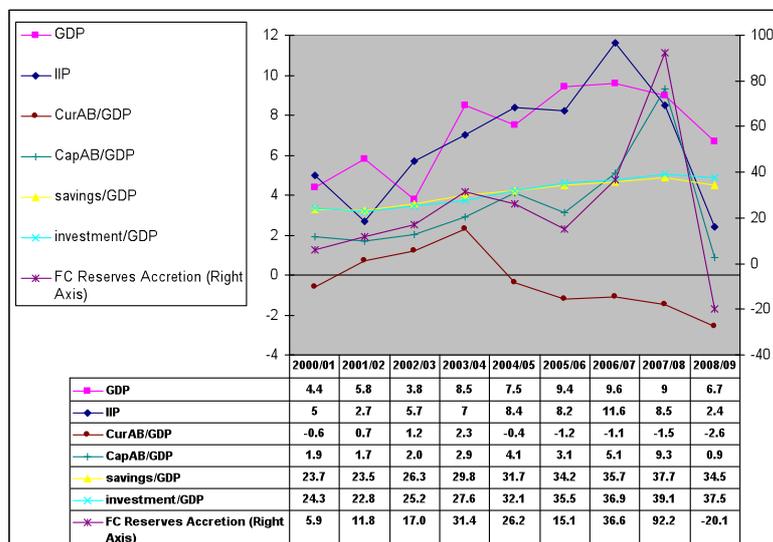
## Exit from Extraordinary Measures

- 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

## 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



## Initial Impact of Credit Crunch (Post Aug 2007)

### Sharp rise in net **K** flows

- **Stock market** boom
- Rupee **appreciation**
- Sharp rise in **reserves**

### • **Inflationary**

- **Commodity** boom
- Imperatives of **Exchange rate** management

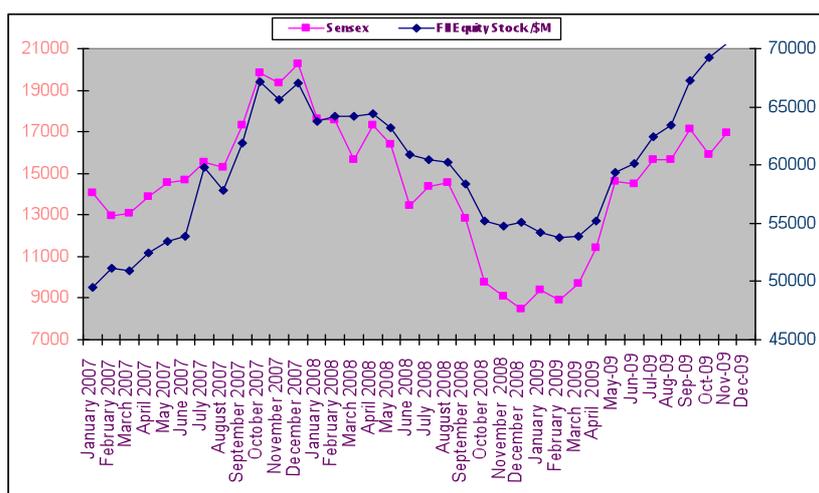
### • Central Bank grapples with the **impossible trinity**

- Stabilize GDP?
- Stabilize exchange rate?

## Second Round Impact of Credit Crunch (Lehman crisis)

- 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 decrease in **bank credit growth**
- **Transmission from financial to real 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



## Monetary Policy

- 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.
  - Mandatory **reserve requirements** reduced
  - **Liquidity injection** of about 9% of the GDP through lowering bank cash reserve requirements and special refinance facilities.
  - Unlike western countries monetary policy retained **traction**
  - **Transmission** mechanism weak because of illiquid corporate bond market and key administered interest rates. (*Structural not crisis related feature*)

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## Fiscal Policy

- Fiscal expansion
  - net **additional expenditure** in 2008-09 upwards of \$ 35 billion (Rs. 160000 crore), above 3 % of GDP.
  - Not all of this is crisis linked, and **begun in first phase** of the credit crunch – therefore timely
  - **Mostly consumption oriented:** enhanced outlays on social protection and employment generation schemes, farm loan waiver, support prices for farmers, public sector pay rise, reductions in indirect taxes – therefore targeted
  - Some expenditures self-limiting – but **how temporary** the fiscal stimulus is still to be seen
  - **No firewall** between monetary and fiscal policies
  - Fiscal Space
    - Structural
    - Crisis linked

## Macroeconomic Policy Outcome

Quarterly Contribution to National Income										
(Y-o-Y Quarterly Growth Rates)										
	2007-08				2008-09				2009-10	
	q1	q2	q3	q4	q1	q2	q3	q4	q1	q2
GDP	9.2	9.0	9.3	8.6	7.8	7.7	5.8	5.8	6.1	7.9
PFCE					-3%	-5%	-4%	-1%	-4%	-1%
GFCE					-8%	-5%	49%	17%	3%	18%
Investment					2%	5%	1%	2%	-2%	-5%
Current Account					63%	51%	69%	-37%	-231%	-60%

## Growth Upsides

- **Financial sector** robust and not highly leveraged
- **Less dependence on export** sector compared to several other EMEs.
- Robust **farm sector** and growth in rural incomes on account of shift in terms of trade, MSP hike and NREGS
- Domestic enterprises have become more internationally **competitive** because of trade policy reforms
- **Commercial banks** have healthy balance sheets
- **External payments** situation comfortable because of huge reserves
- Softening of **commodity prices**.
- **Monetary space** available

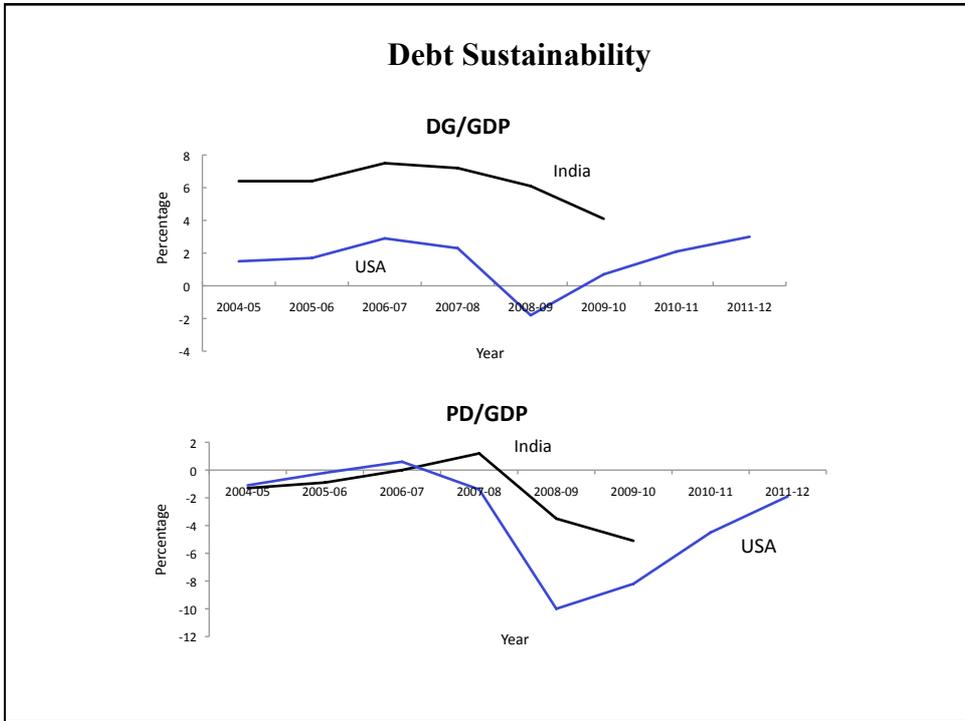
## Growth Downsides

- Uncertain **external environment**
- Bank credit growth weak : lagging indicator?
- Limited **fiscal space**:
  - Domar Gap comfortable
  - Main danger ahead is crowding out
  - Interest rate threat
- Weak **monetary policy transmission** because of absence of corporate bond market and continuation of key administered interest rates.
- **Monsoon** uncertainties and food prices

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## Macro Policies Going Forward

- Institutionalization of G 20
- Reemergence of Fiscal Policy
- Additional targets and tools for monetary policy



Thank You!