# THE GREAT RECESSION 2007-2008

# INDIA’S RESPONSE TO THE CRISIS

HANSRAJ COLLEGE, UNIVERSITY OF DELHI

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**ABSTRACT**

This research evaluates the policy response of India towards the 2008 financial crisis. By the virtue of globalization, the moment of financial crisis hit the real economy and became a global eco- nomic crisis; it was rapidly transmitted to many developing countries. The crisis emerged in India at the time when Indian economy was already preoccupied with adverse effects of inflationary pressures and depreciation of currency. India was confronted with daunting macroeconomic challenges. However, the timely actions taken by the Indian policymakers helped to surf the tide. The government had been highly proactive in managing the crisis with a slew of fiscal and monetary measures to stabilize the financial sector, ensure liquidity and stimulate the domestic demand

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## LITERATURE REVIEW

- LITERATURE REVIEW 1: Sumanjeet Singh (January, 2010), The Indian response to the global financial crisis (a literature review about India's response to the global financial crisis.)
- LITERATURE REVIEW 2: Rajiv Kumar and Pankaj Vashisht (November 2009), The Global Economic Crisis: Impact on India and Policy Responses (a literature review about policy responses towards the 2007-08 financial crisis.)

## RESEARCH OBJECTIVE

The main focus of this study is to evaluate the fiscal and monetary policy responses of the Indian government against the- The great repression 2007-08. The study aims to explain the resilience of the Indian economy to the recessionary impacts of the global crisis. Also, assessment of the policies adopted and the lessons learnt from this event are the objectives of the study.

## RESEARCH METHODOLOGY

Secondary data has been used as a tool to carry out the research work. Existing data is summarized and collated to increase the overall effectiveness of research. Major source of this data has been extracted digitally but the genuinity of data is ensured.

## INTRODUCTION

The Indian economy looked to be relatively insulated from the global financial crisis that started in August 2007 when the sub-prime mortgage crisis first surfaced in the United States (US). In fact, the Reserve Bank of India (RBI) was raising interest rates until August 2008 with the explicit objective of cooling the economy and bringing down the gross domestic product (GDP) growth rate, which visibly had moved above the rate of potential output growth and was contributing to the build-up of inflationary pressures in the economy. But when the collapse of Lehman Brothers on 23 September 2008 morphed the US financial meltdown into a global economic downturn, the impact on the Indian economy was almost immediate. External credit flows suddenly dried up and the overnight money market interest rate spiked to above 20% and remained high for the next month. Other challenges were contraction in trade, a net outflow of foreign capital, fall in stock market, a large re-duction in foreign reserves, slowdown in domestic demand, slow-down in exports, sudden fall in growth rate and rise in unemployment.

**FINDINGS**

POLICY RESPONSES

- FISCAL POLICY RESPONSE

It was emphasized that a fiscal stimulus to overcome recession and slowdown in economic growth was needed. This fiscal stimulus is in keeping with Keynesian macroeconomics as Keynes emphasized increase in government expenditure to get rid of depression in the nineteen thirties. The most common policy response by countries was to create a stimulus package that would target the most affected sectors of the economy. Stimulus packages involved the release of funding by the government to act as cheap credit and stimulate demand for products and services in a particular sector so that there would be enough reasons to increase supply. With the rise of the sectors out of the recession, economies would be able to return to their normal functioning as employment rates would improve, and people would find full employment and stop being in underemployment.

The initial fiscal stimulus was actually provided in the budget for FY2008–2009, announced in February 2008. Electoral considerations made this into an expansionary exercise that included massive increases in public outlays in support of employment guarantee schemes, farm loan waivers, pay commission rewards, and increases in food and fertilizer subsidies. This fiscal expansion is expressed by the revenue deficit increasing from 1.4% of the GDP in FY2007–2008 to 4.3% in FY2008–2009. The expansionary public outlays included some measures that implied a hefty transfer of purchasing power to farmers and to the rural sector in general. These included farm loan waivers, funds allocated to the National Rural Employment Guarantee Program (NREGP), Bharat Nirman (targeted for improving rural infrastructure) Prime Minister's Rural Road Program, and a large increase in subsidies for fertilizers and electricity supplied to the farmers. All of these measures were taken because of political considerations and not in response to the global crisis. Nevertheless, they have helped to shore up rural demand for both consumer durables and non-durables. In effect the higher-than-expected GDP growth rate in both the third and fourth quarters of FY2008–2009 could be attributed to the budgetary splurge announced in February 2008.

While this has succeeded in shoring up GDP growth by raising rural demand, it did not leave much fiscal space for the Government of India to respond in any significant manner to counter the impacts of the global downturn. However, some efforts were still mounted to counter the effects of the global economic slowdown.

Three fiscal stimulus packages—one each in the months of December, January, and March—were announced. These in aggregate amounted to Rs crore 106,050 or US$21 billion,14 which is approximately 2% of the GDP. This can be compared to the 4% of GDP that was provided as stimulus in the FY2008–2009 budget.

The three post-December 2008 stimulus packages mainly are comprised by increased government spending on infrastructure, reduction in indirect taxes, and some assistance for export-oriented industries.

In an attempt to boost the infrastructure spending that has been acknowledged as the most effective tool to counter economic downturn, the Government of India has increased its planned spending by US$4 billion and has also allowed the state governments to borrow an additional amount of US$6 billion from the market. Apart from this, the India Infrastructure Finance Company Limited (IIFCL), a special purpose vehicle (SPV) established in 2007, was allowed to issue interest free bonds worth US$6 billion for refinancing the long-term loans for various infrastructure projects.

Secondly, to prop up domestic demand the central excise duty was gradually slashed from 14% in December 2008 to 8% in March 2009 on all products except petroleum products. Likewise, the services tax rate has also been brought down from 12% to 10%. The government has also provided some relief to export-oriented industries through subsidizing interest costs of exporters by up to 2%, subject to a minimum rate of 7% per annum.

The direct fiscal burden of all the aforementioned measures adds up to about 2% of total GDP. This looks rather small in comparison to the size of the stimulus in some other economies like the PRC and the US. If the stimulus provided in the FY2008-09 budget is included then it can be said that the Indian government has in effect expanded its fiscal outlay by 6% of GDP during FY2008–2009.

- MONETARY POLICY RESPONSE

The RBI acted firmly on monetary policy to signal to markets that its previous priority of fighting inflation would be replaced by that of preventing the economy from going into recession.

RBI worked with the objective of maintaining price stability alongside a reasonable rate of economic growth. After a comfortable period of low inflation, the Indian economy started feeling the pressure of rising global commodity prices in the first quarter of FY2004–2005. In response to this rise in inflation, the RBI started tightening monetary policy in September 2004, raising the cash reserve ratios from 4.5% to 5.0%. As the inflationary situation worsened in the subsequent period, the tightening of monetary policy became even more aggressive. Consequently, inflation declined from around 8% in the middle of 2004 to less than 4% in September 2007. Nevertheless, coinciding with the rising global inflation trends, domestic inflation once again started increasing towards the end of 2007 and became a major headline in the first week of June 2008 when it entered the double-digit range for first time since the 1991 BOP crisis. It drew a sharp reaction from the RBI and the speed of monetary tightening was further increased. This credit tightening from FY2004–2005 onward ensured a soft landing of Indian economy, with the actual growth rate exceeding its potential growth rate. As a result, the growth rate began to slow down from the middle of FY2007–2008.

In the wake of global financial crisis and its potential adverse effects on the Indian economy, monetary policy shifted gear and became expansionary from October 2008. The rapid decline in Wholesale Price Index (WPI) inflation, which has come down from its peak level of around 13% in August 2008 to less than 1% in April 2009, allowed the RBI to completely shift its focus from inflation to growth. Since October 2008, the RBI injected a considerable amount of liquidity into the economy through a series of policy rate cuts. The cash reserve ratios of banks was brought down from 9% to 5%, while the repo rate has been slashed by 425 basis points. Further, in order to discourage the banks from parking overnight funds with the RBI, the reverse repo rate16 has been gradually reduced from 6.0% in November 2008 to 3.25% in April 2009. The statutory liquidity ratio (SLR) has been lowered by one percentage point. Apart from this, some special refinancing schemes have also been announced to improve the liquidity for certain sectors. The cash reserve ratios reduction of 400 basis points since September 2008 alone has led to an injection of US$32.7 billion. In addition, another sum of US$12.9 billion has been injected through unwinding the market stabilization scheme. As of April 2009, a cumulative amount of nearly US$80 billion has been pumped in to the system.

As a result of the policy rate cuts, the prime lending rates of commercial banks have come down from 13.75–14.0% in October 2008 to 12.0–12.5% January 2009. The call money rates have also remained stable at low levels and the overnight money market rate has remained within the liquidity adjustment-facility corridor.

The RBI also liberalized the ECBs and FII related norms. To attract the foreign portfolio investors, the FII limit on corporate bonds was increased from US$6 billion to US$15 billion.

At the same time, in an attempt to boost the construction sector, developers were permitted to raise ECBs for integrated townships projects, while NBFCs dealing exclusively with infrastructure financing were allowed to access ECBs from multilateral or bilateral financial institutions.

## THE ROAD AHEAD

The global recession in 2007-09 operated as a dampener on the prospects of a faster growth. India's high degree of resilience and capacity to manage a severe external shock was evident from the strength and pace of recovery in GDP growth rate after 2007-08. India's growth rate fell to 6.7 per cent in 2008-09 but it recovered to 8.6 per cent growth in GDP in 2009-10 and 9.3 per cent in 2010-11. However, due to slow recovery in the US and Eurozone crisis in 2010, 2011 and 2012, India GDP growth rate fell to 6.2 per cent in 2011-12 and to 5 per cent in 2012-13.

## ASSESSMENT OF THE POLICY RESPONSES

The Indian fiscal policy response to the crisis can at best be summarized as having been pre-empted by political considerations that resulted in a fiscal expansion ahead of the global crisis and left only limited space to respond in the aftermath of the crisis. Hence the fiscal response after December 2008 could be argued to not have been as large as required. The fiscal stimulus worsened the fiscal deficit further, increasing it to 11.4% in FY2008–2009. The increase in fiscal deficit had two implications. First, it drew a strong response from international credit rating agencies and the sovereign credit rating of India was in the danger of being lowered. Any further reduction in India's credit rating could have serious implications for capital inflows. Secondly, the high fiscal deficit naturally led to an increase in government borrowings. Higher government borrowing also put a lot of pressure on the interest rate, as reflected in the 10- year bond yield rate going up along with the announcement of the new stimulus packages. The long run interest rate increase could have serious implications for private investment.

In sharp contrast to the fiscal policy response, the monetary authorities in India acted aggressively once it was clear that inflationary pressures had subsided and growth was beginning to slacken. Unfortunately, because of the government's large borrowing requirement and the stickiness in deposit rates that keep the cost of funds high for the banks, the policy rate cuts have not filtered into the retail credit market. The positive impact of monetary policy actions has therefore been somewhat limited.

## LESSONS TO BE LEARNT

The government continued with the stimulus in 2009-10 too, and the fiscal deficit touched 6.4% of the GDP. This is when India faltered. The government did not close the tap. The fiscal stimulus was never withdrawn. On top of it, India let the current account deficit swell. However, much credit India gets for a sharp recovery from the biggest crisis that hit the world since the Great Depression of 1930, a lesson it did not learn was to budget for greater coordination amongst financial sector regulators, and between the regulators and the government. The government set up the Financial Stability and Development Council (FSDC) in December 2010 that would settle disputes among regulators and deal with issues including financial stability, financial sector development, inter-regulatory coordination, and macro-prudential supervision of the economy including the functioning of large financial conglomerates. FSDC has not meant much shows in the fact that the financial sector has witnessed little product innovation over the years.

## CONCLUSIONS

Three main reasons explain the resilience of the Indian economy to the recessionary impacts of the global crisis. The first is that Indian foreign exchange regulations, in spite of being relatively open to investments in the stock market, are still highly restrictive to investments in both government treasuries and most fixed-income assets. Therefore, under a regime which somewhat restricts external financial integration – a rare situation in most developing countries in the late 2000s – policymakers were able to restore positive expectations more effectively, even though the global economy was being driven in the opposite direction. The second reason is related to the speed and intensity with which the RBI reduced the basic interest rates. This decision was essential to signal to markets that the priority was to prevent a sharp slowdown or even a possible shrinking of economic activity. The third reason is that the first round of fiscal stimuli was adopted quicker and with much more intensity. It could be argued that the three fiscal stimulus packages, in conjunction with the transfer of purchasing power to the rural economy through increased budget outlays on the rural sector and the hike in minimum support prices of various crops, have saved aggregate demand and prevented GDP growth from plummeting in to negative territory. This has also been helped by the quick monetary policy response discussed above.

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