RECENT GLOBAL FINANCIAL CRISES: A STUDY OF IMPACT OF RBI MONETARY POLICY IN INDIA

Varali Kaushal and Geetika Reliya

Abstract

This paper examines the impact of Global Financial Crises on RBI monetary policy. Since themid of Sep 2008, when the major financial institutions were collapsed, the India's central bank has reduced its policy rates and CRR by number of times and SLR by 100 bps since than to prop the Indian economy up. The globalisation of financial markets over the last 15 years has had major implications for the conduct of monetary policy. The first part reviews the evolution of the Financial Crises on RBI monetary policy over time. The crisis has certainly questioned the efficacy of the existing institutional framework and available policy instruments at the national as well as international levels in ensuring global financial stability. This paper gives a brief account of the Monetary Policy response in Indian context. On the one hand developed world is facing a challenging task of not having a proper regulatory mechanism to control the crisis at this critical juncture and on the other way developing economies such as India is directly and indirectly involved in taking strong precautionary steps to avoid and reduce the impact of such crisis. This paper presents the view that global financial crisis has called into question several fundamental assumptions and beliefs governing economic resilience and financial stability. With the increasing integration of the Indian economy and its financial markets with rest of the world, there is recognition that the country does face some downside risks from these international developments. The paper argues that globalization have affects the transmission mechanism of monetary policyThe paper also presents the policy responses in India which were adapted to domestic growth outlook, inflation conditions and financial stability considerations. The last part analyzes the effects of Policy change on economic development of India.

Key Words: Global Financial Crisis, Monetary Mechanisms, Indian Monetary Policy.

*Lecturer in Economics, MBA Dept., Modern Institute of Engineering & Technology, Mohri, Shahabad, Kurukshetra, Haryana
E-mail: varali.kaushal@gmail.com; Contact: 09888892825, 09034429552
**Lecturer, MBA Dept., Modern Institute of Engineering & Technology, Mohri, Shahabad, Kurukshetra, Haryana
E-mail: geetikareliya@gmail.com; Contact: 09996078769

crisis is an inevitable outcome of such a distorted and unsustainable growth process which is based upon bubbles rather than on broad-based economic expansion.

Experience of India

It is only partly true that it was only the international financial crisis that brought India's growth to a certain halt: there were palpable signs of the economy losing steam long before the outbreak of the crisis: India's growth decelerated from the first quarter of fiscal year 2007/08 (starting in April), fully twelve months before the climax of the crisis. This loss of steam did occur mainly in the manufacturing sector, in spite of relatively satisfactory agricultural growth. The major reason was slowing growth of demand for investment goods, starting already in 2004/05 and compensated only partly by increasing public investments (Patnaik, 2008).

Exports also were increasing more slowly, their contribution to overall growth turned negative since 2005/06 (Kumar et al. 2009). Only growth in total consumption held pretty steady at just over 8% in the last two years before the crisis, but this masked a cooling of private consumption growth, compensated by a doubling of government consumption growth which did partly reflect generous pay revisions for government employees in 2007/08, the debt waiver for small farmers and the full implementation of the National Rural Employment Guarantee Scheme (Development Bank, 2009).

The Impact of the Crisis on India

There were two distinct phases in 2008-09 during which the transmission of global shocks – through trade, finance and expectations channels – posed different but significant challenges for the Reserve Bank. In the first half of the year, the world experienced simultaneous increase in both food and commodity prices, and there was a return of inflation after a phase of "great moderation". Dealing with supply side sources of inflation posed challenges for the conduct of the Reserve Bank's monetary policy. In the second half of the year, the global financial crisis and the subsequent global recession dramatically changed the nature of the challenge emanating from globalisation.

- ***Impact on the Financial Markets :***

The financial sector includes the banking sector, equity markets (which are directly affected by foreign institutional investment [FII] flows), external commercial borrowings (ECBs) that drive corporate investments, FDI, and remittances. The global crisis had a differentiated impact on these various sub-sectors of the financial sector. While it is true that the Indian banking sector remained largely unaffected because of its very limited operations outside India or exposure to sub-prime lending by foreign investment banks, the global crisis has affected India through three distinct channels. These channels are financial markets, trade flows, and exchange rates (Singh, 2009). The Indian banking sector has remained more or less unaffected, at least directly, by the global crisis. The imposition by the RBI of a higher provisioning requirement on commercial bank lending to the real estate sector helped to curb the growth of a real estate price bubble. Against an absolute decline in the profitability of non-financial corporate enterprises, the banking sector witnessed a jump of 43% in its profitability.

- ***Impact on the Real Economy:***

Indian Economic Outlook India is experiencing the knock-on effects of the global crisis, through the monetary, financial and real channels – all of which are coming on top of the already expected cyclical moderation in growth. Our financial markets – equity market, money market, forex market and credit market – have all come under pressure mainly because of what we have begun to call 'the substitution effect' of : (i) drying up of overseas financing for Indian banks and Indian corporates; (ii) constraints in raising funds in a bearish domestic capital market; and (iii) decline in the internal accruals of the corporates. All these factors added to the pressure on the domestic credit market. Simultaneously, the reversal of capital flows, caused by the global de-leveraging process, has put pressure on our forex market. The sharp fluctuation in the overnight money market rates in October 2008 and the depreciation of the rupee reflected the combined impact of the global credit crunch and the de-leveraging process underway (IMF, 2008).

Overall, the Indian economic outlook is mixed. There is evidence of economic activity slowing down. Real GDP growth has moderated in the first half of 2008/09**.**

Table 1: GDP Growth Projections

(**Overall Real GDP (% change)**)

	2008-2009	2009-2010	2010-2011
World	-1.2	2.9	6.3
Advance countries	-3.2	0.03	3.6
Emerging economies	0.01	3.2	5.7
India	6.8	7.5	8.5

Source: IMF, World Economic Outlook, April, 2010

The advance estimates of the Central Statistical Organisation (CSO) released in February 2009 have placed the real GDP growth for 2010-11 (Table 1) at 8.5 per cent (Mohanty, 2009).

Table 2: Impact of financial crises on industrial and service sector of the economy.

Sector	**2008-2009**	**2009-2010**	**2010-2011**
Industrial production (%age change in manufacturing and infrastructure sector)	2.5	5.3	8.2
Services (%age change)	9.5	9.7	9.2

*Source: website**: http://indiabudget.nic.in***

Industrial activity, particularly in the manufacturing and infrastructure sectors, is decelerating. Though growth of the industrial sector started to slow down in the first half of 2007-08, the overall growth during that year remained as high as 8.5 per cent. The index of industrial production for the year 2008-09 points towards a sharp slowdown with growth being placed at 2.5 per cent. Manufacturing growth was placed at 2.3 per cent in 2008-09 as compared to 9.0 per cent in 2007-08. Slower growth in all use-based categories, except consumer durables, contributed to the deceleration in the industrial sector. The services sector too, which has been our prime growth engine for the last five years, is slowing, mainly in construction, transport & communication, trade and hotels & restaurants subsectors. But overall growth is still manageable in service sector, although the financial crisis in the advanced economies and the slowdown in these economies have some adverse impact on the IT sector (Global Economic Outlook 2010-2011).

GDP Outlook

Economic activity in India slowed down in Q1 and Q2 of 2008-09 as compared with over 9.0 per cent growth in the previous three years. However, growth decelerated sharply in Q3 following the failure of Lehman Brothers in mid-September 2008 and knock-on effects of the global financial crisis on the Indian economy.

The latest projections from the IMF World Economic Outlook are shown in Table 3 (Singh, 2009).

Table 3: Key Macroeconomic Indicators – India in terms of real GDP growth (%)

	Q1		Q2		Q3		April-December	
Sector	(April-June)		(July-September)		(October-December)			
	2007-08	2008-09	2007-08	2008-09	2007-08	2008-09	2007-08	2008-09
Agriculture	4.4	3.0	4.4	2.7	6.9	-2.2	5.5	0.6
Industry	8.5	5.2	7.5	4.7	7.6	0.8	7.9	3.5
Services	10.7	10.2	10.7	9.6	10.1	9.5	10.5	9.7
Overall	9.1	7.9	9.1	7.6	8.9	5.3	9.0	6.9

Source: Central Statistical Organisation (CSO).

Consequently, the growth rate during the first three quarters (April-December) of 2008-09 slowed down significantly to 6.9 per cent from 9.0 per cent in the corresponding period of the previous year (Table 3). The advance estimates of the Central Statistical Organisation (CSO) released in February 2009 have placed the real GDP growth for 2008-09 at 7.1 per cent.

Monetary policy response

As the crisis intensified, the Reserve Bank of India, like most central banks, took a number of conventional and unconventional measures to augment domestic and foreign exchange liquidity, and sharply reduced the policy rates. Since October 2008, the RBI has injected a considerable amount of liquidity into the economy through a series of policy rate cuts. The cash reserve ratios of banks has been brought down from 9% to 5%, while the repo rate15 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. Below mentioned figure [Table 4] shows about the movements of the key policies rates i.e. .RRR, RR, CRR. in 2010-2011 .

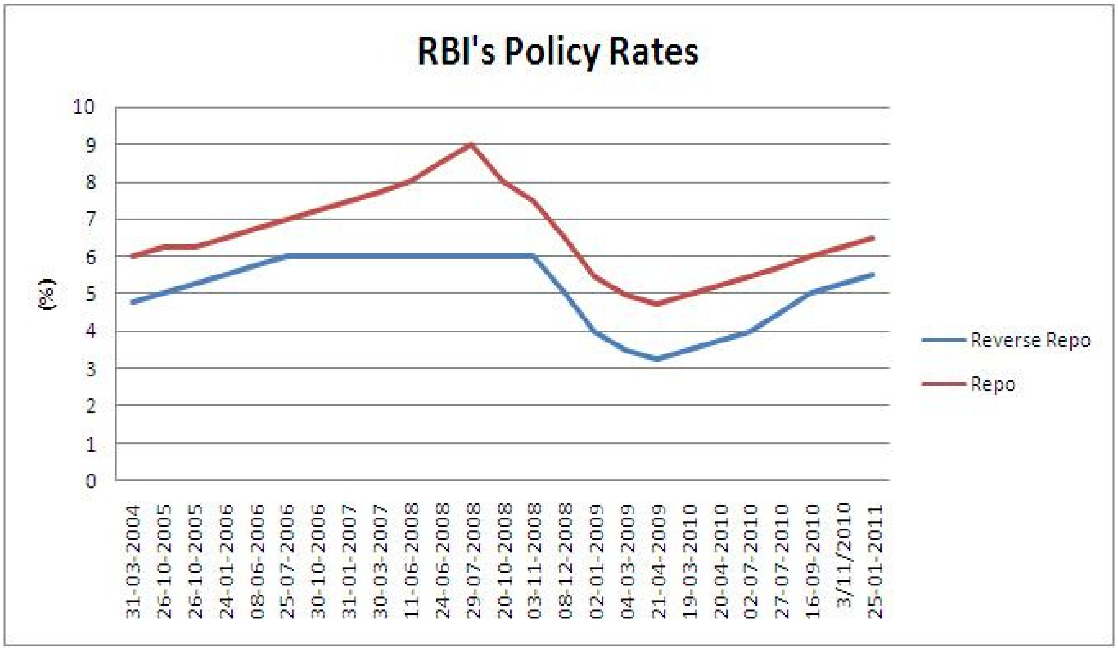
Table 4: **Key policy rates 2010-2011.**

Rates	Percentage (%)	w.e.f
Bank rate	6.00 %	29.4.2003
Repo Rate	8.50%	25.10.2011
Rev. Repo Rate	7.50%	25.10.2011
CRR	6.00%	03.11.2010
SLR	24.00%	18.12.2010

Source: http://www.bankingonly.com/index.php?page=rbi-current-rates.php

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 (Table 4).

Figure 1: RBI's Policy rates 2010-2011



Source: World Economic Outlook database (sept.2011),IMF

Table 4: Actual/Potential Release of Primary Liquidity since Mid-September 2008

1	CRR Reduction	**32.7 %**
2	MSS Unwinding	**12.9%**
3	Term Repo Facility	**12.2%**
4	Increase in Export Credit Refinance	**5.2%**
5	Special Refinance Facility for SCBs (Non-RRB)	**7.9%**
6	Refinance Facility for SIDBI/NHB/EXIM Bank	**3.3%**
7	Liquidity Facility for NBFCs through SPV	**5.1%**
Total (1to 7)		**79.2%**

CRR = cash reserve ratios, EXIM = export import, MSS = market stabilization scheme, NBFCs = non-banking financial companies, NHB = national housing bank, RRB = regional rural banks, SCBs = scheduled commercial banks, SIDBI = small industries development bank of India SLR = statutory liquidity ratio, SPV = special purpose vehicle.

Note: *Values are in US$ billion.*

Source*: Compiled from Reserve Bank of India (2009d).*

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 (RBI 2009d).

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.

In brief, there is increasing evidence that the bank credit and lending rate channels of monetary transmission are gaining in strength with the widening and deepening of the financial system and the progress towards greater price discovery. A number of constraints continue, however, to interfere with monetary transmission.

Major Challenges :

The major challenge before the India's central monetary authority in the context of the present financial turmoil is that of "liquidity management".

A. Responding to the crisis, the Reserve Bank of India has been focusing on active demand management of liquidity through appropriate use of the CRR stipulations, open market operations (including the Market Stabilization Scheme) and the Liquidity Adjustment Facility – using all these policy instruments at its disposal flexibly, as and when the situation warrants. Liquidity modulation through a flexible use of above stated instruments has, to a significant extent, cushioned the impact of the international financial turbulence on Indian financial markets by absorbing excessive pressures and ensuring orderly conditions (Mohanty, 2009).

B. As the international experience indicates, a prudent fiscal policy remains the single largest pre-requisite for monetary stability. Reforms in the monetary-fiscal interface during the 1990s have been a key factor that imparted greater flexibility to monetary policy.

C. An environment of sustained low and stable inflation is conducive for financial savings, with beneficial impact on investment in the economy and for sustained growth and employment. Price stability is all the more important for an economy like India, with a large proportion of poor population that has no hedges against inflation (Mallya, 2008).

D. Through active liquidity management, the central bank can drain any surplus liquidity in the inter-bank markets to keep interest rates close to the policy rate (or within a policy corridor). This gives the central bank the ability to control to a large extent short-term nominal rates and therefore real rates if inflation is sticky in the short run (The Hindu, 2009).

E. By shaping expectations about short-term nominal rates, central banks can influence long-term rates (which can be viewed as the weighted average sum of expected future short-term rates plus a term premium). If the central bank is also able to anchor inflation expectations, by employing consistent and predictable policies, this in turn gives the bank control over long-term real rates. There is a need to sharpen monetary policy effectiveness in a financially open economy with the help of Central bank policies.

F. There could be a trade-off between a monetary framework (Subbarao, 2009) with fewer instruments, which would promote simplicity and make it easier to predict what any policy moves would accomplish, and one with a broader range of instruments e.g., for fine-tuning. In either case, it is important that the central bank clearly communicate the framework, the objectives, and the ways in which different instruments will be used to achieve the goals of monetary policy. Any changes in the framework should be pre-announced and their rationale explained as well.

G. Rebalancing global demand holds the key. In economies with excess external deficits, public and private saving must increase. And in economies with excess current account surpluses—including many in Asia—domestic demand needs to increase. Stronger financial safety nets and financial market development can promote this shift from external to internal demand. In many emerging economies—including China—currency appreciation is also an important part of the solution. Finally, structural reforms remain essential in India to raise productivity and boost growth.

The Options Ahead

(i) Diversifying Exports

There is an imperative need to boost the exports, keeping in view its growth impulses and employment potential. Emphasis has been laid on renewing efforts not only to improve competitiveness, but also diversify the export basket and destinations. We need to be cognizant of the fact that due to financial turmoil, the consumption pattern of the developed countries and their demands for goods and services have undergone a sea change and this will be less likely to be reversed in near future. We need to imaginatively think where else can we sell our products and what would be the preferred consumption patterns of these newer markets.

(ii) Boosting Domestic Consumption

It has been suggested by many experts that unless we boost domestic consumption, it will be difficult to compensate for the loss of external demand arising out of export squeeze. But, it is not that easy to replace exports by domestic consumption. It is a common knowledge that the products and processes of goods and services meant for exports are significantly different from the one preferred by domestic consumers. Changing production systems to suit domestic demand requires in-depth analysis and commencing new lines of production and processes.

(iii) Provisioning Credit to Productive Sectors

What is needed at present is to focus on the financial system and enable it to fulfill adequately its functions in terms of the provision of credit to productive sectors. The domestic credit system must also fill the gap created by the drying up of external sources. We ought to be thinking of a scheme to provide additional funds for long term capital requirements, since the ability to raise funds from the capital market is bleak.

We need to pursue a conscious policy of expanding credit to the Small and Micro Enterprises (SMEs). This sector with only 10 per cent import content and with a proven ability to expand production through small amount of investment can very rapidly increase output and employment in our system. This sector has suffered most when the banks are in no mood to support SMEs with limited profitability and with practically no collateral. Only a directed public policy of providing financial support can galvanize them.

(iv) Need for Structural Reforms

Along with monetary and fiscal policies, there is a need to bring about structural reforms to sustain the growth momentum. For instance, we need to pursue agrarian reforms. Agriculture has had declining Government investment for years. Government spending in agriculture has not led to building durable assets that could help agricultural production and diversify rural employment. Similarly, we must invest in inducting environment friendly technology and promoting environment friendly projects for sustainable development. We also need to improve regulatory framework so that the economy is revived to move along a high growth trajectory.

Conclusion

India was not hit very hard by the international financial crisis, but more than the government first assumed. The country was already too densely integrated into the world market to escape the shock effects of the crisis, although economic fundamentals and especially the health of India's financial sector were above the median of other developing countries. India was one of the first countries to emerge from the global crisis, but Asia's third largest economy is now facing policy trade-offs earlier than other countries and should return to its longer-term reform agenda, according to the IMF.

With signs of the recovery becoming well entrenched, the IMF said that conditions were "ripe for a progressive normalization of the monetary stance." It welcomed the recent decision by the Reserve Bank of India (RBI) to begin the process of monetary tightening, and called for a further gradual withdrawal of monetary accommodation that "will require fine judgments by the RBI."

India has been consciously pursuing a high growth path in order to achieve the key objectives of rural regeneration, poverty alleviation, inclusiveness and sustainable development. Only growth without inclusiveness, or growth without jobs, will not ensure balanced and all-round development of all sections of the society. That's why, in the current crisis, the questions that how long it would last and how much it would impinge on the growth rates has assumed critical significance. The present impact of the slowdown on India's growth rate is certainly not alarming. India still is one of the fastest growing economies in the world. There is a just prediction in the World Bank's report 'Global Development Finance 2009' that India would clock the highest GDP growth rate of 8 per cent in the year 2010.

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