Global Developments and the Indian Economy, 2008-09

Commodity prices and inflation

2.4 During the five-year period of high growth from 2003-04 to 2007-08, WPI inflation has gone through two cycles. The first peak in August 2004 was followed by a trough in August 2005 and the second peak in March 2007 followed by a trough in October 2007. The subsequent upturn in prices therefore followed the upturn in total capital inflows during 2007, which peaked at nearly 13 per cent in the July-September quarter of 2007-08. The focus of macro management in general, and monetary management in particular, has been on the implication of capital inflows on foreign exchange reserve accumulation, sterilization and the exchange rate. As capital inflows were far in excess of the current account financing requirements, and given the history of capital flow volatility into emerging markets, prudence required that a part of these excess inflows be accumulated as reserves. This also has the effect of moderating any potential volatility in exchange rates arising from capital flow reversals. However, the accumulation of foreign exchange reserves by increasing the monetary base also raised the issue of the degree to which the accumulation should be sterilized. The authority given to RBI to issue Market Stabilization Scheme (MSS) bonds backed by the Government of India was adjusted (in April and August 2007) to provide the required flexibility to RBI. The attempt to manage the build-up of liquidity over this period by running a cautious monetary policy, while balancing the liquidity requirements of a fast growing economy, bore fruit for most part of fiscal 2007-08 as the 52-week average WPI inflation remained at about 4.7 per cent and the GDP growth rate for the economy was 9 per cent. However, a sudden spurt in international commodity prices in the last quarter of calendar year 2007 started creating pressures on domestic prices of tradable goods, though an appreciation of the rupee during the last quarter of 2007-08, partly dampened the pass through of global commodity price increases.

2.5 Crude oil prices rose from an average of 90.7 US$/bbl in January 2008 to a monthly average peak of 132.8 US$/bbl in July 2008, touching a high of 147 US$/bbl in this period. Similarly, among the imported edible oils, namely, palm and soyabean the prices rose from 1,059 US$/MT and 1,276 US$/MT in January 2008 to a monthly average high of 1,213 US$/MT and 1,537 US$/MT in June 2008, respectively. Inflation, which had declined to less than 4 per cent in the middle of August 2007 and had remained so for 20 consecutive weeks thereafter, started firming up from December 2007. During December-March 2007-08, there was an increase in the prices of coal, iron ore, iron and steel products and prices of petroleum products not covered under the administered price mechanism. The rising oil prices necessitated an upward revision in the administered prices of petrol, high-speed diesel and LPG in first week of June 2008. Together with a continued hardening of global commodity prices these developments led to a sharp increase in the headline WPI inflation rate, touching double digit level by the middle of June 2008. It persisted at that level for the next 21 weeks with a high of 12.9 per cent in early August 2008. Nearly two-thirds of this rise in inflation was due to three sets of commodities namely, edible oils (including oilseeds and oilcakes), iron and steel (including iron ore) and mineral oils and refinery products (Figures 2.1 to 2.4).

Figure: 2.1 : Global supply shock Edible oil (palm)

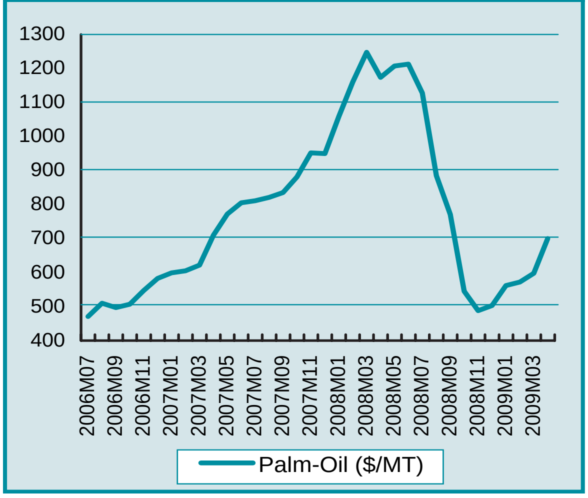


Figure 2.2 : Global supply shock-oil price

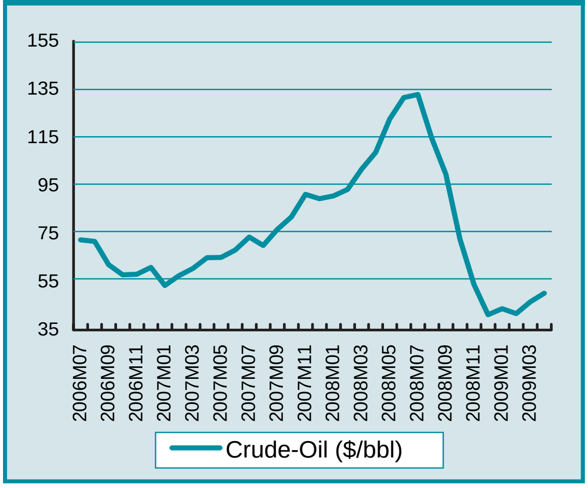


Figure 2.3 : Global supply shock- iron ore

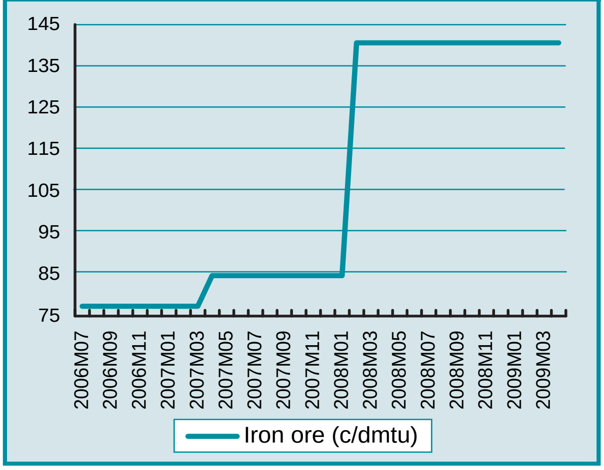
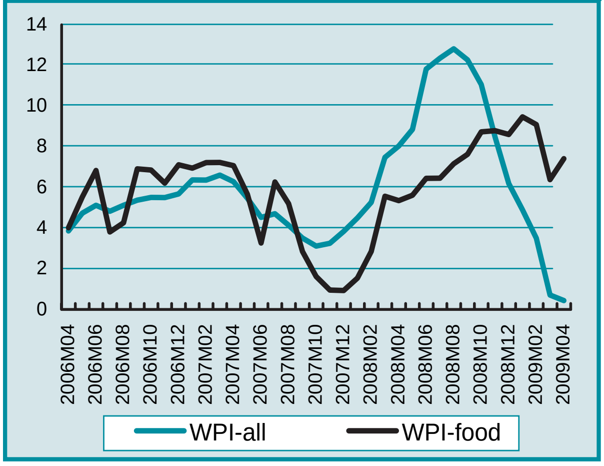


Figure 2.4 : Global cost push



2.6 Given the global origins of this inflationary episode, a judgement had to be made about the relatively temporary versus the relatively permanent elements. Appropriate fiscal and monetary measures had to be introduced to meet these elements. Given the degree of uncertainty about the exact proportion of temporary and permanent elements, a perfect response would have been unrealistic. On the monetary side, given the lags in monetary policy, the primary objective had to be the moderation in inflationary expectations and to ensure that money supply did not accommodate the permanent elements of the global cost push.

2.7 On the fiscal side, the temporary elements had to be met by making temporary reductions in the import duties on tradable goods whose prices showed unprecedented increases. Import duties were consequently reduced on the three sets of commodities mentioned earlier. The fiscal management of agricultural commodities subject to higher duties and some elements of quantitative intervention in the domestic or international sphere was more complicated. This is particularly true of basic agricultural consumer goods like cereals and pulses that affect millions of poor consumers and small farmers (producers). A combination of import tariff reductions, export duties and changes in quantitative measures for import and/or export had to be used to manage the trade-off between poor consumers and the livelihood concerns of poor producers. Though the management proved largely successful, a rational long-term framework needs to be developed, which balances the concerns of poor consumers and producers to promote efficient growth and livelihood security. One possible approach is to have an announced price band for domestic prices (which could itself evolve gradually over time) within which imports and exports are freely allowed without any duties and controls. If international prices change beyond this band, domestic prices would be systemically dampened through imposition of variable import and export duties, depending on whether international prices fell below the lower band or rise above the upper band respectively. This along with targeted subsidies, such as the PDS, would help balance the interests of farmers who need a predictable price regime to plan their cropping patterns and those of low income households.

2.8 The rise in global oil price, along with the rise in prices of other imported commodities, had a strong adverse impact on the balance of trade. Oil imports are the predominant driver of total imports. Given the administered price mechanism for petrol and diesel, the sharp rise in oil, petrol and diesel prices required a decision on how much of this price could be passed through to users/consumers. Conceptually this too requires a judgement on how much of the rise is permanent. Ideally, the entire permanent element of the price rise should be passed through along with part of the temporary increase. With oil prices overshooting to double the long-term supply price of oil, the question of (directly or indirectly), temporarily taxing resource rents is also relevant. In practice, these issues were addressed somewhat imperfectly through a sharing formula that represented a mix of government subsidy, taxation of rents and some pass through. Consequently, the fiscal deficit, adjusted for below the line items, was negatively impacted by the global price developments. This also gave rise to a dilemma between two aspects of fiscal policy. From a macro perspective, the external shock could have been addressed by accommodating the short-term shock and tightening the fiscal policy to give a long-term signal that the one time (temporary) price increase would not be allowed to translate into inflation (a continuing rise in prices). However, the political constraints and social arguments for dampening price pass through necessitated an increase in the fiscal gap. This in turn put greater pressure on monetary and other policies to moderate inflation (e.g. temporary controls under the Essential Commodities Act) that had little to do with domestic factors. Monetary management was also complicated by the fact that capital flows changed course in the first quarter of 2008-09 and trended down throughout the year. This affected foreign exchange reserves, exchange rate expectations and reserve money accumulation.

2.9 GDP growth was also affected by these developments as the worsening of terms of trade arising primarily from the rise in oil prices acts as an implicit tax on the citizens of the country, thereby reducing private consumption demand in the first half of 2008-09. Moreover, efforts to curb inflationary expectations necessitated a rise in interest rates and mopping up of liquidity in the economy, which influenced the growth rate, both from the demand side, as well as from the supply side.

2.10 The global financial meltdown resulted in a bursting of the commodity bubble, leading to a dramatic drop in most commodity prices. Crude prices dropped to around 40 US$/bbl by December 2008. Thus, the global cost push that was primarily responsible for raising WPI inflation to double digit levels during 2008-09, went into reverse gear after July 2008. Consequently, by end-March 2009, the WPI Index was virtually back to the level that prevailed a year before.

Financial crisis and the global slowdown

2.11 The global financial crisis surfaced around August 2007. Its origin lay in structured investment instruments (Collateralized Debt Obligations, synthetic CDOs) created out of subprime mortgage lending in the United States. The securitization process however was not backed by due diligence and led to large-scale default. The complexity of the instruments and the role of credit rating agencies played a contributory role. The high ratings assigned to certain CDO tranches, which were then quickly reversed with the onset of the crisis, created a panic situation among investors and precipitated the crisis.

2.12 While the initial effect of the crisis was profound on the US financial institutions and to a lesser extent on European institutions, the effect on emerging economies was less serious. In the initial stages, the capital flows to the emerging economies actually increased, giving rise to what is termed as “positive shock” and the “decoupling” debate. In the case of India, for example, the net FII flows during the five-month period from September 2007 to January 2008 was US$ 22.5 billion as against an inflow of US$ 11.8 billion during April-July 2007, which were the four months immediately preceding the onset of crisis.

2.13 The effect of the financial crisis on emerging economies thereafter was mainly through reversal of portfolio flows due to unwinding of stock positions by FIIs to replenish cash balances abroad. Withdrawal of FII investment led to stock market crash in many emerging economies and decline in the value of local currency vis-à-vis US dollar as a result of supply-demand imbalances in domestic markets. In the case of India, the extent of reversal of capital flows was US$ 15.8 billion during five months (February-June, 2008) following the end of “positive shock” period in January 2008.

2.14 Following the collapse of Lehman Brothers in mid-September 2008, there was a full-blown meltdown of the global financial markets. It created a crisis of confidence that led to the seizure of inter-bank market and had trickle-down effect on trade financing in the emerging economies. Together with slackening global demand and declining commodity prices, it led to fall in exports, thereby transmitting financial sector crisis to the real economy. Countries with export-led model of growth, as in many South-East Asian countries, and that depended upon commodity exports, were more severely affected. The impact on Indian economy was less severe because of lower dependence of the economy on export markets and the fact that a sizeable contribution to GDP is from domestic sources. India’s trade reforms since 1991 have moved progressively towards a neutral regime for exports and imports, eschewing tax and other incentives for exports.

2.15 The direct impact of the crisis on financial sector was primarily through exposure to the toxic financial assets and the linkages with the money and foreign exchange markets. Indian banks however had very limited exposure to the US mortgage market, directly or through derivatives, and to the failed and stressed international financial institutions. The deepening of the global crisis and subsequent deleveraging and risk aversion however affected the Indian economy leading to slowing of growth momentum.

2.16 The overall balance of payment situation however remained resilient despite signs of strain in the capital account that manifested in the net reversal of FII flows of US$ 15.0 billion during fiscal 2008-09 and on current account through decline in exports. In 2008-09, the merchandise exports recorded a growth of 3.4 per cent reaching US$ 168.7 billion. While export growth was robust till August 2008, it became low in September and became negative from October 2008 to March 2009. The rupee depreciated by 21.2 per cent against the US dollar during fiscal 2008-09. The US dollar however appreciated by 17 per cent against the broad index (FRB, New York) between March 2008 and March 2009, suggesting that only 5 percentage points of the rupee depreciation was due to India-specific factors.

2.17 Money and credit markets have been affected indirectly through the dynamic linkages. The drying up of liquidity, a fallout of repatriation of portfolio investments by FIIs, affected credit markets in second half of 2008-09. This was compounded by the "risk aversion" of banks to extend credit in the face of a general downturn. The extent of the external financial and monetary shock on the Indian monetary-financial system is best captured by the precipitous contraction in reserve money by more than 15 per cent between August 2008 and November 2008 (compared to 0.5 per cent increase in the corresponding period of the previous year). Reserve money growth (y-o-y) collapsed from 26.9 per cent in August 2008 to 10.3 per cent in November 2008 and further to 6.4 per cent in March 2009. The various monetary policy measures taken by RBI kept narrow money M_1 and broad money M_3 from falling as precipitously. Despite these, however, M_1 growth decelerated from 19.4 per cent in August 2008 to 10.3 per cent in November 2008 and further to 8.2 per cent in March 2009, while M_3 growth decelerated from 21 per cent in August 2008 to 18.7 per cent in March 2009. A series of unconventional measures actually helped to push up the rate of growth of bank credit from 25.4 per cent in August 2008 to 26.9 per cent in November 2008. However, this only partly offset the effects on short- and long-term credit to Indian companies in the United States and EU markets, because of the freezing of financial markets. Subsequently, credit growth decelerated sharply to 17.1 per cent in March 2009, partly because of transmission of OECD recession effects to Indian exporters and organized manufacturing.

2.18 Despite these developments, the macro-economic impact of the global financial turmoil, particularly on the GDP growth, has been relatively muted due to the overall strength of domestic demand and the predominantly domestic nature of investment financing.

Impact on domestic growth

2.19 In the last two decades fluctuations in India's economic growth were not closely linked to the cycles in high-income OECD countries or the developed countries (Figure 2.5). The upward hump in Indian growth between 2003-04 and 2008-09, however, seems to coincide with a similar hump in global and OECD growth. The sharp decline in growth to 5.8 per cent in the second half of 2008-09 from 7.8 per cent in the first half of 2008-09, following the US and global financial meltdown in August 2008, seemed to support this perspective. Following the global recession, there was a view among global market analysts, that growth in emerging markets and developing countries was driven by the global excess liquidity/monetization, the associated capital flows from developed countries and the demand for commodities. Consequently, with the bursting of the bubble the initial impact would be a growth collapse, followed by a return in the medium term to growth rates that prevailed before 2004-05, because of the painful process of de-leveraging and collapse of capital flows. It was therefore concluded by some of

Fig.2.5 : GDP Growth - India, world & OECD countries

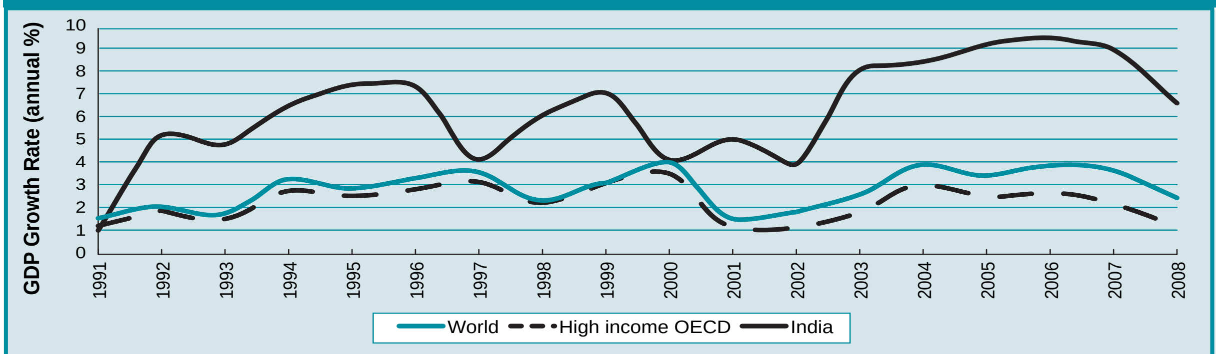
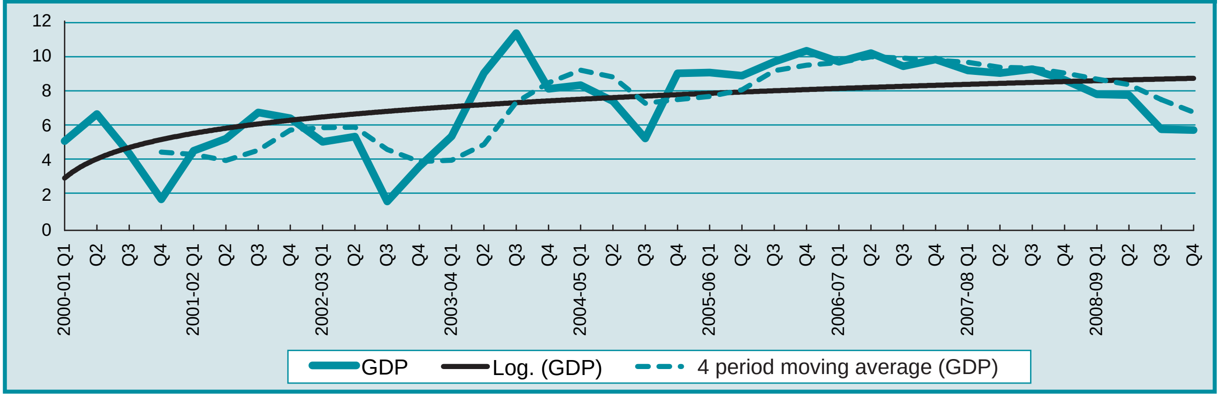


Fig.2.6 : GDP growth (factor cost) quarterly



these analysts that India's growth would collapse to around 4 per cent during the subsequent four to six quarters and thereafter it may revert to around 5 to 5.5 per cent over the medium term. An analysis of the growth history of India suggests that this superficial generalization of a plausible global analysis to India is erroneous.

2.20 The first half (H1) of 2008-09 saw the Indian economy recording a growth of 7.8 per cent in GDP, despite the build-up of uncertainty in the international commodity and financial markets. Among the domestic growth drivers, gross fixed capital formation (GFCF) retained some of its momentum from the preceding years with a growth of nearly 11 per cent. Consumption – both private and government – however declined significantly. The growth in private final consumption expenditure (PFCE) in H1 2008-09 was 3.3 per cent, which was less than half of the corresponding period in 2007-08. Similarly, government final consumption expenditure (GFCE) grew at less than 1 per cent, or just one-third of the growth in H1 of 2007-08.

2.21 In the second half (H2) of 2008-09, GDP growth declined to 5.8 per cent, with a further decline in private consumption growth to 2.5 per cent and a significant moderation in growth rate of GFCF to about 6 per cent over the corresponding period of 2007-08. However, with the roll-out of the fiscal stimulus, primarily in the shape of implementation of the Sixth Pay Commission recommendations in Q3, as well as the second round of fiscal expansion announced in Q4, the growth in government final consumption expenditure shot up to nearly 36 per cent, partly making up for the shortfall in other components of the domestic aggregate demand. The overall GDP growth for the fiscal 2008-09 at 6.7 per cent surpassed all estimates and forecasts, mostly ranging from 5.5 per cent to 6.5 per cent, made by international agencies and analysts.

2.22 An expected outcome of the recession in the economies of India's major export destination and consequent global excess capacity has been the sharp fall in the growth of organized manufacturing. The downtrend in the manufacturing sector started in the second quarter of calendar year 2007, with the slowing of the US economy and its imports of several products from India. The trend was merely accelerated after the US meltdown and the onset of the global recession. Services sector growth was not expected to slow sharply (as explained in the Mid-Year Review), because of its well known insensitivity to demand cycles and the relatively small contribution of service exports to GDP. There was a sharp increase in the growth of community, social and personal services, which includes GDP from government administration.

2.23 It is useful to compare the 2008-09 growth slowdown to earlier slowdowns in 2002-03, 1997-98 and 1991-92 (Table 2.1). If we use the difference between the five-year moving average growth rate and growth rate of the last of the five years as a measure of the slowdown, the 1991-92 slowdown was the sharpest, while the other three were of similar orders of magnitude. The growth rate of GDP at factor cost (GDP_{FC}) is about 65 per cent higher than the average of the last two slowdowns. On all other previous occasions, agriculture GDP declined significantly and barring 2002-03 the decline in manufacturing GDP in earlier slowdown years was also sharper than in 2008-09. The deceleration of private consumption growth in 2008-09 is of concern, but it can be seen that growth rate is higher than in earlier years. The GDCF growth rate has however fallen to about half of what it was in the last two slowdowns. This is perhaps an indication of how strongly the heightened global uncertainty, risk perception and risk aversion have impacted Indian entrepreneurs. Despite the collapse in exports in

Table 2.1 : Growth of GDP components during growth slowdowns

(per cent)

Items	1991-92	1997-98	2002-03	2008-09
GDP_{FC}	1.4	4.3	3.8	6.7
GDP_{agri}	-2.0	-2.6	-7.2	1.6
GDP_{mfg}	-2.4	0.1	6.8	3.6
GDP_{MP}	1.0	4.1	3.8	6.1
PFCE	2.1	2.3	2.6	2.9
GFCE	-0.2	11.2	-0.4	20.2
GDCF	-15.6	12.1	17.0	7.4
Export (G & S)	9.7	-2.3	21.8	12.8
Imports (G & S)	0.0	13.2	10.4	17.9

the second half of 2008-09, export growth for the year as a whole was fairly robust, while import growth was the highest among these slowdown years. This suggests that the deflationary effect of oil price increase played a greater role than analysts have acknowledged, though an indication was given in the Mid-Year Review. Though exports are in a downturn, the downtrend in imports has accelerated in the last quarter of 2008-09 and net exports have started to increase.

Policy response to the slowdown

2.24 To counter the negative fallout of the global slowdown on the Indian economy, the Government responded by providing a substantial fiscal expansion in the form of tax relief to boost demand and increased expenditure on public projects to create employment and public assets. The net result was an increase in fiscal deficit from 2.7 per cent in 2007-08 to 6.2 per cent of GDP in 2008-09. The difference between the actuals of 2007-08 and 2008-09 constituted the total fiscal stimulus, notwithstanding the fact that some expenditure was on account of the implementation of the Sixth Pay Commission award and the agriculture debt relief scheme (small farmers' debt waiver) announced in the Union Budget 2008-09. Together about 0.5 per cent of the GDP was committed prior to the dramatic deterioration of the international financial markets in September 2008.

2.25 In implementing the fiscal stimulus, the Government increased its spending on the plan, both for Central sector as well as on Central assistance to state and Union Territories plans, by nearly 1 per cent of the GDP. There was an increase of nearly 2.5 per cent of GDP on non-plan expenditure that included increased spending on fertilizers and food subsidies, agriculture debt waiver, defence, salaries and pensions. The Government renewed its efforts to increase infrastructure investments in tele-communications, power generation, airports, ports, roads and railways.

2.26 Questions are sometimes raised about the quality of the fiscal deficit. In making this judgement one has to be clear about the multiple dimensions on which quality can be assessed. One is the lag between fiscal action and increase in effective demand. Another is the degree to which the medium term productivity of the economy is increased. Expenditure such as debt relief, which has short lags, may have little or no effect on productivity, while productive infrastructure expenditure takes much longer to translate into effective demand. The approach of the government has therefore been to use a mix of fiscal measures, including reductions in indirect taxes (excise and service tax) which could be reversed subsequently.

2.27 The RBI took a number of monetary easing and liquidity enhancing measures including reduction in cash reserve ratio, statutory liquidity ratio and key policy rates. The objective was to facilitate the flow of funds from the financial system to meet the needs of productive sectors. In well developed financial markets like the United States, monetary policy instruments and their effectiveness in meeting the objectives is well known. However, the financial crisis in the US market had the effect of fragmenting these markets, so that conventional instruments were no longer effective. This was only partly an issue of the Keynesian liquidity trap. In a relatively less developed financial markets like India's the effectiveness of instruments is constrained by missing and imperfect financial markets. The global crises accentuated the non-integrated nature of the markets, requiring more careful attention to the different channels, namely interest rate, money supply and credit and the instruments appropriate to each. Further it became imperative to use both traditional (considered outdated by some) and unconventional instruments. The breadth and depth of the global crisis and the uncertainty and the fear surrounding it, required use of fiscal policy to supplement monetary policy. It was therefore necessary to ensure adequate coordination between the two, so that they did not work at cross-purposes. Though it would be far from the truth to claim perfection, by and large the conceptually sound approach was eventually implemented.

2.28 The Government also announced specific measures to address the impact of global slowdown on India's exports. These included extension of export credit for labour-intensive exports, improving the pre- and post-shipment credit availability, additional allocations for refund of terminal excise duty/CST and export-incentive schemes, and removal of export duty and export ban on certain items. Though it is not possible to substitute for the dramatic fall in foreign demand, these measures would be helpful in facilitating the adjustment of companies and workers to the new reality and to survive the temporary setbacks.

Box 2.1 : Policy response to the financial crisis

Time frame	Objective/means	Policy options	Government's response
Immediate	Addressing financial panic and uncertainty	Guaranteeing of bank deposit Guarantee inter-bank loans. Providing liquidity to banks Forbearance on regulations	Not required due to the limited direct exposure of Indian financial institutions to the US financial markets. Top policymakers and the RBI reassured the market in right earnest.
	Trade policy	Maintaining competitive exchange rates and encouraging free trade. Reversing protective measures introduced during the year for inflation management	Government did not intervene in the foreign exchange market, allowing the market to determine the rupee exchange rate
Short term	Monetary policy	Reductions in the costs of borrowing, improving market liquidity & credit flows	Between August 2008 & March 2009, RBI's successive policy announcements reduced reverse-repo and repo rates from 6 to 3.5 and 9 to 5 per cent, respectively; CRR reduced from 9 to 5 per cent. This helped in improving liquidity in the system
	Fiscal policy	Expansionary fiscal policy with increase in public spending on works, social safety nets and employment	Overall fiscal stimulus of nearly 3.5 per cent of GDP
	Institutional measures	Recapitalization of banks Consolidation of financial sector institutions	The Central Government contributed to recapitalization of RRBs; 196 RRBs merged into 85 RRBs. Government recapitalizing public sector banks over two years to maintain CRAR of 12 per cent; NPAs for these banks declined from 7.8 per cent on March 31, 2004 to 2.3 per cent on March 31, 2008.
Medium term	Domestic financial sector reforms and other measures	Increasing access to finance Improving domestic resource mobilization Improving efficiency of banking sector Avoiding financial repression Improving supervision and regulation Strengthening property and contract rights, judiciary and rule of law	Interest subvention extended on pre- and post-shipment credit for specific sectors Improving regulatory oversight of capital markets; putting a divestment plan for PSEs in place.
	Reform of international financial architecture	Deepening of financial markets and reforms Moving towards a more inclusive system of global financial governance Satisfactory conclusion of Doha WTO Round Improving aid effectiveness and development cooperation architecture reform of Bretton Woods Institution	Initiatives under the G-20 forum of which India is an active participant

2.29 By deciding to relax the FRBM targets for 2008-09 in order to provide the much needed demand boost to counter the situation created by the global slowdown, the Government may have succeeded in arresting the decline in the growth rate of GDP to around 7 per cent. There has been a good rabi harvest and the agriculture sector has recorded a growth of 1.6 per cent in 2008-09 over a high growth of around 5 per cent in 2007-08. The forecast for the monsoon is normal though its progress so far seems to be behind the usual schedule. There has been an increase in Foreign Direct Investment (FDI) during 2008-09 over the previous year. More importantly, there are signs that Foreign Institutional Investors who had recorded net outflows in 2008-09 may have returned to the Indian market in the last two months. The credit market appears to be working normally and there is no dearth of liquidity in the economy. Inflation is no longer an area of concern. With the Index of Industrial Production showing clear sign of revival in the month of April, it is likely that the two worst quarters since the global financial meltdown in September 2008 are behind us. Indeed, the stock market in the last few weeks (of May-June 2009) may have already picked up these early signs of the rebound.