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GLOBAL FINANCIAL CRISIS - PERSPECTIVE 2007 TO DATE & BEYOND (LEADERSHIP OF INDIA'S FINANCIAL SYSTEM)

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ABSTRACT
This article based on secondary research is an attempt to trace the genesis of the global imbalances in the financial and economic system, and how this imbalance is at the very root of the turmoil that the world is experiencing since 2007.Tracing the chronological sequence of events that triggered the global shocks, from the Lehman crisis to the current Euro zone crisis, and transmitted through the financial, trade and confidence channels, the focus is on why, how and to what extent has it manifested itself in the Indian economy, despite the generally held belief about the Indian markets being decoupled from the global economy. The major policy measures, conventional and unconventional, taken by India's central banker and the Government have been studied in terms of the relevance, context and extent to which this has helped to mitigate the adverse impact of the continuing crisis, and contributed to the continuation of the India growth story, notwithstanding the underpinnings of high inflation, lower investment, reduced private final consumption expenditure, growing fiscal deficit, exchange rate volatility, lower business confidence and policy paralysis being the final frontier of the challenges facing the nation. Finally, a bit of crystal gazing in backdrop of current global uncertainty, geo political tensions, slowdown in developed economies, softening of commodity prices on the back of an expected soft (or hard?) landing of Chinese economy, lack of political leadership and will in Europe, all seem to be throwing up more conundrums, rather than innovative solutions to an unprecedented chapter in human history and economics.

KEYWORDS
global imbalances, financial crisis, decoupling, policy measures, leadership, India growth story, economic slowdown, deleveraging.

GENESIS OF GLOBAL FINANCIAL CRISIS
There is something inherently wrong if the richest country in the world (US) needs to live beyond its means, by way of consumption binge, to support global prosperity. That is exactly what seems to be at the very root of the economic turbulence that we seem to be wading through since 2007.
Let us see why and how this is manifested in terms of economic and financial data that needs to be scanned through to understand the underpinnings of this major recessionary trend the world is grappling with.
Mutual interdependency between America, one of the world's largest debtors (95% of GDP) and China, large creditor nation due to burgeoning trade surplus as a result of its export growth led economic model has contributed to this unsustainable reserve currency phenomenon, perpetuating the myth of the American consumer having in satiated spending power to keep the wheels of the global economy running in smooth gear. This vicious cycle of the Middle Kingdom's continued focus on keeping the RMB from appreciating in order to keep their exports cheaper, has resulted in them buying up dollars and investing in US treasury bonds to the extent of almost 35% of US bonds, thus keeping the credit pipes unclogged and at very low prices (interest rates) for the US consumer binge to continue (or so it seemed…) till August 2007 jolted us out of the slumber and forced economists, bankers, credit rating agencies, executives and sovereign states to look deeper into their systems to initiate the immediate root cause analysis.

CHINESE ECONOMY
Any appraisal of China's prospects must begin by admitting that the Middle Kingdom is the most astonishing development success story in the world today.
China is enduring the sort of problems other countries can only dream of. Like everywhere else, GDP has been disappointing of late – but that means a growth rate of 8.9%, rather than 9.1%. Exports are rather under par, too: Beijing estimates the trade surplus dropped to about $160bn. And the big worry is whether Beijing can check overheating to engineer a "soft landing" – as opposed to the crash that hit the west in 2008, whose tremors are still being felt.
But it has been the slump in Europe, the US and Japan that has most dramatically underlined the yawning gap in performance between the world's long-established economic powers and China. In the four years from 2007 to 2011, US national income increased by less than 0.6% (the figure is still being revised down), the EU shrank by 0.3% and Japan declined by 5.2%. In the same period, despite the decline in export markets in those economies, China grew by more than 42%.
But crucially – unlike Britain, the US and the stricken eurozone economies – China has a modest budget deficit of around 2%. Which points to the central reason why China was able to ride out the global crisis of 2007-8 with such dramatic success? China's response was to launch the biggest stimulus programme in the world, investing heavily in infrastructure.
Although the Chinese government does not make public the dollar composition of its FX holdings, many analysts estimate this level to be around 70%.10 U.S. assets have generally been favored by China for its investment needs for a number of reasons. First, in order to maintain the exchange rate effects that lay behind the acquisition of U.S. dollars, those dollars must be invested in dollar-denominated securities. Second, the United States is the world's largest economy and has the biggest capital market. In 2009, the combined value of U.S. private and public debt securities was $31.7 trillion (compared with $11.9 trillion for Japan and $5.7 trillion for Germany) and accounted for 34.4% of global debt securities. Many analysts contend that the U.S. debt securities market is the only global market that is big enough to absorb a big part of China's large and growing FX holdings. U.S. securities have also been favored by China because, historically, they have been considered to be safe and liquid (i.e., easily sold) relative to other types of investments.
The broader issue for China is whether its current unbalanced economic policies, especially those that have contributed to its large savings rate, over-reliance on exports for its economic growth, and accumulation of huge FX reserves, are sustainable in the long-run, especially given economic slowdowns in Europe and the United States.
Some have argued that these factors may induce China to accelerate efforts to boost consumer demand and improve domestic living standards, which could include further appreciation of the RMB against the dollar. Such policies could lessen China's need to buy U.S. securities.
Because of its low savings rate, the United States borrows to finance the federal budget deficit and its private capital needs. It therefore depends on countries with high savings rates, such as China, to invest some of its capital in the United States. Such investments help to keep U.S. interest rates relatively low and enable the United States to consume more than it produces. According to the International Monetary Fund (IMF), in 2009, the United States was the world's largest importer of foreign capital (at 38.2% of global total), while China was the largest exporter of capital (at 24.2%). From FY2001 to FY2010, the amount of U.S. public debt that is privately held grew from $3.3 trillion to $9.0 trillion; as a share of GDP, this level rose from 32.5% to 62.9%. Of the U.S. public debt that is privately held, more than half is held by foreigners. Many analysts argue that heavy U.S. reliance on foreign savings is not sustainable and may undermine U.S. economic interests over time. (Annexure 1 and 2)

CONCERNS OVER CHINA'S LARGE HOLDINGS OF U.S.SECURITIES
The growing U.S. dependency on China to purchase U.S. Treasury securities to help fund the U.S. budget deficit has become a major concern to many U.S. policymakers. Some have raised concerns that China's large holdings may give it leverage over the United States on economic as well as noneconomic issues.

Others have expressed concern that China might lose faith in the ability of the United States to meet its debt obligations, and, thus, might seek to liquidate such assets or significantly cut back on purchases of new securities; a move some contend could damage the U.S. economy. Still others contend that China's purchases of U.S. securities was a major contributing factor to the U.S. sub-prime mortgage crisis and subsequent global economic slowdown because such purchases helped to keep real U.S. interest rates very low and increased global imbalances. Some warn that similar bubbles could occur in the future if imbalances between the United States and China are not addressed.
Chinese officials, on the other hand, have expressed concerns over the safety of their large holdings of U.S. debt, and some have argued that China should either diversify away from U.S. Treasury securities or implement policies that slow the accumulation of FX reserves, which would lessen the need to buy U.S.assets.

WHAT IF CHINA REDUCES ITS HOLDINGS OF U.S.SECURITIES?

As the previous data illustrate, China has accumulated large holdings of U.S. assets in recent years. These accumulations are the result of U.S. borrowing to finance its large trade deficit with China (the gap between U.S. exports and Chinese imports). All else equal, Chinese government purchases of U.S. assets increases the demand for U.S. assets, which reduces U.S. interest rates.
What might happen if China no longer purchased U.S. securities and/or tried to sell a significant share of its dollar holdings?
If China stopped buying U.S. securities, the United States would need other investors (foreign and domestic) to fill in the gap. Such investors would presumably require higher interest rates than those prevailing today to be enticed to buy them. One economist in 2007 estimated that a Chinese move away from long-term U.S. securities could raise U.S. interest rates by as much as 50 basis points. Higher interest rates would cause a decline in investment spending and other interest-sensitive spending. All else equal, the reduction in Chinese Treasury holdings would cause the overall foreign demand for U.S. assets to fall, and this would cause the dollar to depreciate. If the value of the dollar depreciated, the trade deficit would decline, as the price of U.S. exports fell abroad and the price of imports rose in the United States. The magnitude of these effects would depend on how many U.S. securities China sold; modest reductions would have negligible effects on the economy given the large size of U.S. financial markets.
Since China held $1.6 trillion of U.S. securities (largely U.S. Treasury securities) as of June 2010, any reduction in its U.S. holdings could potentially be large. If there were a large reduction in its holdings, the effect on the U.S. economy would still depend on whether the reduction was gradual or sudden. It should be emphasized that economic theory suggests that a *slow decline* in the trade deficit and dollar would not be troublesome for the overall economy. In fact, a slow decline could even have an expansionary effect on the economy, if the decrease in the trade deficit had a more stimulative effect on aggregate demand in the short run than the decrease in investment and other interest-sensitive spending resulting from higher interest rates. Historical experience seems to bear this out—the dollar declined by about 40% in real terms and the trade deficit declined continually in the late 1980s, from 2.8% of GDP in 1986 to nearly zero during the early 1990s. Yet economic growth was strong throughout the late 1980s.
A potentially serious short-term problem would emerge if China decided to *suddenly* reduce their liquid U.S. financial assets significantly. The effect could be compounded if this action triggered a more general financial reaction (or panic), in which all foreigners responded by reducing their holdings of U.S. assets. The initial effect could be a sudden and large depreciation in the value of the dollar, as the supply of dollars on the foreign exchange market increased, and a sudden and large increase in U.S. interest rates, as an important funding source for investment and the budget deficit was withdrawn from the financial markets. The dollar depreciation by itself would not cause a recession since it would ultimately lead to a trade surplus (or smaller deficit), which expands aggregate demand. (Empirical evidence suggests that the full effects of a change in the exchange rate on traded goods take time, so the dollar may have to "overshoot" its eventual depreciation level in order to achieve a significant adjustment in trade flows in the short run.
However, a sudden increase in interest rates could swamp the trade effects and cause (or worsen) a recession. Large increases in interest rates could cause problems for the U.S. economy, as these increases reduce the market value of debt securities, cause prices on the stock market to fall, undermine efficient financial intermediation, and jeopardize the solvency of various debtors and creditors. Resources may not be able to shift quickly enough from interest-sensitive sectors to export sectors to make this transition fluid. The Federal Reserve could mitigate the interest rate spike by reducing short-term interest rates, although this reduction would influence long-term rates only indirectly, and could worsen the dollar depreciation and increase inflation. In March 2007, Federal Reserve Chairman Ben Bernanke reportedly stated in a letter to Senator Shelby that "because foreign holdings of U.S. Treasury securities represent only a small part of total U.S. credit market debt outstanding, U.S. credit markets should be able to absorb without great difficulty any shift of foreign allocations."
U.S. financial markets experienced exceptional turmoil beginning in August 2007. But as the turmoil deepened and spread to the rest of the world in 2008, the value of the dollar began rising. Interest rates on U.S. Treasuries fell close to zero, implying excessive investor demand. Other interest rates also remained low, although access to credit was limited for some. Although comprehensive data will not be available for some time, a "sudden stop" in capital inflows does not appear to have been a feature of the downturn. Problems experienced in U.S. financial markets over the past few years have been widely viewed as "once in a lifetime" events. If these events failed to cause a sudden flight from U.S. assets and an unwinding of the current account deficit by China or other countries, it is hard to imagine what would. Some economists view China's purchases of U.S. securities as a type of subsidy that is transferred from Chinese savers to U.S. consumers in the form of lower-cost Chinese products and lower U.S. interest rates. That subsidy helps to boost U.S. consumption of Chinese products, which supports China's export industries. However, the subsidy is at the expense of Chinese consumers and nonexport industries, largely because China's undervalued RMB makes imports more expensive than they would be if the RMB was a floating currency. The lack of a social safety net forces Chinese workers to save a significant part of their income. That savings is used to finance the Chinese government's purchases of U.S. securities. Chinese purchases and holdings of U.S. securities have reportedly been controversial in China according to some media reports, many of which cite complaints among some Chinese Internet bloggers over low return on Chinese investment of its FX reserves. Many analysts (including some in China) have questioned the wisdom of China's policy of investing a large level of FX reserves in U.S. government securities, which offer a relatively low rate of return, when China has such huge development needs at home. One Chinese blogger reportedly wrote: "Chinese people are working so hard, day in and day out, the economic environment is so good, but people's livelihoods are not so great — turns out it is because the government is tightening people's waist belts to lend money to the United States." Some Chinese analysts have argued that the debt problems in Europe and the United States will decrease their demand for Chinese products, and that a depreciating dollar will lower the value of Chinese dollar assets. Thus, they argue, China will need to accelerate its economic reforms in order to boost domestic consumption (including increased imports), lower its dependency on exporting for economic growth, and slow or reduce China's FX reserves and holdings of U.S. securities. If China consumed more and saved less, it would have less capital to invest overseas, including in the United States. Thus, if the United States did not reduce its dependence on foreign savings for its investment needs, and China reduced its U.S. investments, the United States would need to obtain investment from other countries, and the overall U.S. current account balance would likely remain relatively unchanged but U.S. interest rates would be expected to rise.

CHRONOLOGICAL SEQUENCE OF CATACLYSMIC EVENTS

9 AUGUST 2007

Phase one on 9 August 2007 began with the seizure in the banking system precipitated by BNP Paribas announcing that it was ceasing activity in three hedge funds that specialised in US mortgage debt. This was the moment it became clear that there were tens of trillions of dollars worth of dodgy derivatives swilling round which were worth a lot less than the bankers had previously imagined.Nobody knew how big the losses were or how great the exposure of individual banks actually was, so trust evaporated overnight and banks stopped doing business with each other.We did not recognise a housing bubble that had grown hugely out of line with the fundamentals of the housing market. There was no explanation that passed the laugh test for the fact that house prices had diverged sharply from their long-term trend, and from rents – creating a housing bubble that peaked at more than $8tn. This was recognisable at least as early as 2002.And, it was easy to see that this bubble was driving the economy, both by pushing construction to record levels as a share of GDP and leading to a consumption boom that depressed the saving rate to zero. There was nothing in the Fed's bag of tricks that could replace the 8% of GDP (that was, $1.2tn) of bubble-driven demand that the economy stood to lose when the housing bubble burst.

15 SEPTEMBER 2008

It took a year for the financial crisis to come to a head but it did so on 15 September 2008 when the US government allowed the investment bank Lehman Brothers to go bankrupt. Up to that point, it had been assumed that governments would always step in to bail out any bank that got into serious trouble: the US had done so by finding a buyer for Bear Stearns while the UK had nationalised Northern Rock.When Lehman Brothers went down, the notion that all banks were "too big to fail" no longer held true, with the result that every bank was deemed to be risky. Within a month, the threat of a domino effect through the global financial system forced western governments to inject vast sums of capital into their banks to prevent them collapsing. The banks were rescued in the nick of time, but it was too late to prevent the global economy from going into freefall. Credit flows to the private sector were choked off at the same time as consumer and business confidence collapsed. All this came after a period when high oil prices had persuaded central banks that the priority was to keep interest rates high as a bulwark against inflation rather than to cut them in anticipation of the financial crisis spreading to the real economy.

2 APRIL 2009

The winter of 2008-09 saw co-ordinated action by the newly formed G20 group of developed and developing nations in an attempt to prevent recession turning into a slump. Interest rates were cut to the bone, fiscal stimulus packages of varying sizes announced, and electronic money created through quantitative easing. At the London G20 summit on 2 April 2009, world leaders committed themselves to a $5tn (£3tn) fiscal expansion, an extra $1.1tn of resources to help the International Monetary Fund and other global institutions boost jobs and growth, and to reform of the banks. From this point, when the global economy was on the turn, international co-operation started to disintegrate as individual countries pursued their own agendas.

9 MAY 2010

9 May 2010 marked the point at which the focus of concern switched from the private sector to the public sector. By the time the IMF and the European Union announced they would provide financial help to Greece, the issue was no longer the solvency of banks but the solvency of governments. Budget deficits had ballooned during the recession, mainly as a result of lower tax receipts and higher non-discretionary welfare spending, but also because of the fiscal packages announced in the winter of 2008-09. Greece had unique problems as it covered up the dire state of its public finances and had difficulties in collecting taxes, but other countries started to become nervous about the size of their budget deficits. Austerity became the new watchword, affecting policy decisions in the UK, the eurozone and, most recently in the US, the country that stuck with expansionary fiscal policy the longest.

5 AUGUST 2011

the morphing of a private debt crisis into a sovereign debt crisis was complete when the rating agency, S&P, waited for Wall Street to shut up shop for the weekend before announcing that America's debt would no longer be classed as top-notch triple A. This could hardly have come at a worse time, and not just because last week saw the biggest sell-off in stock markets since late 2008. Policymakers are confronted with a slowing global economy and a systemic crisis in one of its component parts, Europe. And they have yet to tackle the issue that lay behind the 2007 crisis in the first place, the imbalances between the big creditor nations such as China and Germany, and big debtors like the US.In the circumstances, it is hard to be wildly optimistic about how events will play out. Markets are bound to remain highly jittery, although it seems unlikely that American bond yields will rocket as a result of the S&P downgrade. Japan lost its triple A rating long ago and has national debt well in excess of 200% of GDP but its bond yields remain extremely low. The reason for that is simple: Japan's growth prospects are poor. So are America's, which is why bond yields will remain low in what is still, for the time being, the world's biggest economy. The dressing down given to Washington by Beijing following the S&P announcement was, however, telling. Growth rates of close to 10% mean that the moment China overtakes the US is getting closer all the time, and the communists in the east now feel bold enough to tell the capitalists in the west how to run their economies. Whatever it means for financial markets, 5 August 2011 will be remembered as the day when US hegemony was lost.

16 JANUARY 2012

France, Spain, Italy downgraded. Greece likely to default on Euro 200 billion sovereign debt/ with Debt to GDP 180% to target 120% by 2020?? Danger of Euro breaking up.

There is no happy ending to this story. At best there will be a long period of weak growth and high unemployment as individuals and banks pay down the excessive levels of debt accumulated in the bubble years. At worst, the global economy will be plunged back into recession next year as the US goes backwards and the euro comes apart at the seams. The second, gloomier scenario looks a lot more likely now than it did a while ago. Why? Because there is no international co-operation. There are plans for austerity but no plans for growth. Even countries that could borrow money for fiscal stimulus packages reluctant to do so. Europe lacks the political will to force the pace of integration necessary to avoid disintegration of the single currency. Commodity prices are coming down, but that is the only good news. We are less than halfway through the crisis that began on 9 August 2007. That crisis has just entered a dangerous new phase.

FOR GREECE IS DEFAULT THE ONLY OPTION?

The dreadful debt saga will only come to a close when Greece takes charge of its predicament Negotiations to reduce Greek debt have been suspended after no agreement could be reached. At some point in the near future Greece seems certain to default on its obligations. But the drama surrounding the talks in Athens, Berlin and Paris shows that there will be nothing co-operative about Greek default. It is a ruthless contest dominated by the so-called troika: the European Union, the European Central Bank, and the International Monetary Fund.

The troika has accepted that Greek debt must be reduced to sustainable levels; but it also wants the reduction to appear voluntary because, if the lenders were coerced, Greece would be declared in formal default, and banks and financial markets would be thrown into crisis. The troika would also like the reduction to be on terms that would allow immediate fresh loans to Greece – an urgent step if the country is not to stop repayments altogether – and wants Greek debt held by official bodies, including the ECB, to remain intact. Not surprisingly, the circle is proving hard to square. The debt in question is €200bn. About half belongs to Greeks – banks, social security funds and others – who are first in line to bear the costs of reduction (the "haircut"). Less than a quarter belongs to international banks, and a good part of the rest to hedge funds. The deal proposed by the troika is geared to the interests of lenders, particularly international banks. The face value of the debt would be reduced by 50%, and the remaining debt would be replaced by new long-term bonds bearing a low interest rate, perhaps less than 4%. The new bonds would be subject to British law, which favours lenders.

The losses for international banks would be modest. Even so, they are angling for a higher interest rate, although their bargaining power is weakened by reliance on the state for liquidity and capital. The real blow would fall on Greek banks, which would effectively go bankrupt. The Greek state is thus desperately seeking fresh loans to replenish its banks' capital. Much of the expected reduction of its debt would, therefore, be immediately voided. A cruel blow would also fall on Greek social security funds and small bondholders, with losses probably passing on to pensions and savings. Meanwhile, hedge funds have been buying Greek debt at low prices in the hope of being paid at, or near, full value. Since Greece has to make debt repayments of almost €15bn in March, huge amounts of European taxpayers' money could potentially be transferred to these vulture funds. The speculators could possibly be coerced into the deal by applying Greek law, but if the reduction were not voluntary, there could be a chain reaction across financial markets. The worst aspect of the deal is that it is unlikely to benefit Greece long term. The original plan was to bring debt down to 120% of GDP by 2020, but the "rescue" programmes of the past two years have forced the country into a real depression. The IMF now thinks that Greek debt will be on a much higher level by 2020 – clearly unsustainable. It is seeking deeper reductions, but the price would be even harsher cuts in wages, pensions, and public spending. The social repercussions on an already weakened country would be horrendous, quite apart from the political difficulties of introducing further severe austerity. It is clear that Greece has little to expect from a debt-reduction process led by the troika. It should take charge of its own predicament, abandoning the charade of voluntary haircuts. For that, it needs to default in a sovereign and democratic way by immediately declaring a cessation of payments. Greece should then publicly audit its debts to decide what should be paid and how. The objective should be to restart economic growth and to avoid disruption of basic social services. Debt would inevitably be cancelled, including official debt held by the troika, and there should be negotiations with the lenders under full public scrutiny. Only then could this dreadful saga come to a close, allowing Greek society to take the first steps on the long path to recovery.

HOW THE WORLD ECONOMY CAN SOLVE ITS CREDIT CRISIS?

The current situation embodies two narratives that seem contradictory, but are not.

One speaks to the reality that most large companies with access to capital markets have no problem securing new funding. In fact, they have been remarkably successful in lengthening their debt maturities, accumulating cash, and lowering their future interest payments. In sum, they now have "fortress" balance sheets.
The other narrative speaks to an opposing, but equally valid reality. Too many small companies and households still find it difficult to borrow at reasonable terms. This includes those reliant on bank credit, as well as many mortgage holders with very high legacy interest rates and balances that exceed their homes' market value.
From every angle, the extremity of this state of affairs – in which those with access to credit do not need it, and those who do cannot get it – is highly problematic.
If left unattended, it leads to a gradual, and then accelerated, renewed deleveraging of the economic system, with the highest first-round costs – a longer unemployment and growth crisis – borne disproportionately by those least able to suffer them.
In the next round, as the system slowly implodes, even those with healthy balance sheets would be impacted, accelerating their disengagement from a deleveraging world economy.
All of this slows social mobility, tears already-stretched safety nets, worsens inequality, and accentuates genuine concerns about the functioning and sustainability of today's global economic system.
This is not just about socio-economic issues. There is also a political angle. With two competing, yet simultaneously valid narratives, ideological extremes harden. The result is even greater dysfunction in process and content, ruling out any sustained policy attempt to make things better.
The problem has become acute in Europe, whose crisis has been belatedly recognised as reflecting something more than turmoil in the eurozone's weakest countries. It also reflects broad-based contamination, resulting, most recently, in France's loss of its vaunted AAA sovereign credit rating.
In the process, the efficacy of pan-European rescue mechanisms is being undermined. And, as fragilities increase – and as a financial wedge is driven into the eurozone's core (Germany and France) – growth and employment prospects dim.
Central banks have recognised all of this for some time, prompting them to take enormous reputational and operational risks to slow the process. They have implemented a host of "unconventional policies" that previously would have been deemed unthinkable, even outrageous – and that can be seen in the enormous growth in their balance sheets.
In the last four years, the United States Federal Reserve's balance sheet has more than tripled, from under $1 trillion (£645bn) to a mammoth $3tn. The growth relative to the size of the economy is even more stunning – from slightly more than 5% of GDP to 20%. The Bank of England's balance sheet is also at 20% of GDP. And both seem to be itching to do even more.
The European Central Bank is often viewed as a laggard. No longer. Its balance sheet has now doubled, to a whopping 30% of GDP – and it, too, appears set to do even more. Mario Draghi, the ECB's new president, recently said that he expects heavy take-up on the next three-year long-term refinancing operation, a powerful tool to pump cheap liquidity into the banks.

FIVE AREAS WHERE CENTRAL BANKS COULD ACT

Rather than just pumping liquidity into clogged pipes, countries can and should do more to build a more effective network of compensating conduits. In doing so, their main objective (indeed, the test for effectiveness) would be the extent to which new private-sector investment is "crowded in".

- It is high time to move on five fronts, simultaneously:
- Countries such as Spain and the US need to be more forceful in unblocking the housing sector by making overdue decisions on burden sharing, refinancing, and conversion of idle and foreclosed housing stock.
- Countries with excessive debt, such as Greece and Portugal, need to impose sizeable "haircuts" on creditors to have a reasonable chance of restoring medium-term debt sustainability and growth.
- In several western countries, public-private partnerships should be formed to finance urgently needed infrastructure investment.
- Regulators should stop bickering about the future configuration of key financial institutions, and instead set a clearer multi-year vision that is also consistent across borders.
- Finally, governments should inform their electorates explicitly and comprehensively that a few contracts written during the inadvisable "great age" of leverage, debt, and credit entitlements cannot be met, and must be rewritten in a transparent way that strikes a balance between generations, labour and capital, and recipients and taxpayers.

Such policies would allow healthy balance sheets around the world, both public and private, to engage in a ***pro-growth and pro-jobs process.*** They require leadership, focus, and education. Absent that, plumbing problems will become more acute, and the repairs more complex and threatening to virtually everyone – including both the "one percenters" and those who worrisomely are struggling at the margins of society.

GLOBAL JOBS MARKET MUST ABSORB 400M NEW WORKERS OVER NEXT DECADE

The global economy will need to create 600m jobs over the next decade to meet the "urgent challenge" of tackling the legacy of unemployment left by recession and to find work for those entering the labour force, according to the International Labour Organisation.
In its annual report on the state of the global jobs market, the ILO said that three years of "continuous crisis conditions" had left 200m people jobless.
It estimated that a further 400m jobs – 40m a year – would be needed over the next decade to absorb growth in the international labour force.
The Global Employment Trends 2012 report said that 900m workers, mostly in developing countries, were living with their families on less than the $2-a-day global poverty line, half of them surviving below the $1.25-a-day extreme poverty line. The ILO urged policymakers to take steps to create better-paid jobs.
With global growth slowing, the ILO said the pick-up in employment after the deep slump of 2008-09 had been short lived and there were still 27m more people unemployed than at the start of the crisis. The lack of jobs had resulted in some giving up hope of finding work, with 29m fewer people in the global workforce than would have been expected had the pre-crisis rate of employment growth continued. The ILO said that if discouraged workers had been included, the global unemployment total would have been 225m rather than 197m and the jobless rate would have been 6.9% rather than 6%.
Young people continue to be hardest hit by the lack of jobs, with almost 75m of those aged between 15 and 24 out of work in 2011, a 4m increase since 2007. The report added that the under-25s were three times as likely as adults to be unemployed.
Progress in reducing the number of working poor had slowed markedly, the ILO said. Nearly 30% of workers were living with their families on less than $2 a day, up by 55m since the start of the crisis.
The report said that with demand faltering it was important for governments to stimulate their economies further, adding that this could be achieved in a way that did not put the sustainability of public finances at risk.

IMPACT OF THE INTERNATIONAL BANKING CRISIS ON THE INDIAN FINANCIAL SYSTEM

EMERGING ECONOMIES

Contrary to the 'decoupling theory', emerging economies too have been hit by the crisis. The decoupling theory, which was intellectually fashionable even as late as a year ago, held that even if advanced economies went into a downturn, emerging economies will remain unscathed because of their substantial foreign exchange reserves, improved policy framework, robust corporate balance sheets and relatively healthy banking sector.
In a rapidly globalizing world, the 'decoupling theory' was never totally persuasive. Given the evidence of the last few months – capital flow reversals, sharp widening of spreads on sovereign and corporate debt and abrupt currency depreciations - the 'decoupling theory' stands totally invalidated. Reinforcing the notion that in a globalized world no country can be an island, growth prospects of emerging economies have been undermined by the cascading financial crisis with, of course, considerable variation across countries.

QUESTIONS THAT ARE ADDRESSED

India too has been impacted by the crisis – and by much more than it was suspected earlier.

1. Why has India been hit by the crisis?
2. How has India been hit by the crisis?
3. How have we responded to the challenge?
4. What is the outlook for India?
5. How has leadership within India's financial and political system helped it to soften the blow of the financial crisis?

WHY HAS INDIA BEEN HIT BY THE CRISIS?

There is, at least in some quarters, dismay that India has been hit by the crisis. This dismay stems from two arguments.

The Indian banking system has had no direct exposure to the sub-prime mortgage assets or to the failed institutions. It has very limited off-balance sheet activities or securitized assets. In fact, our banks continue to remain safe and healthy. So, the enigma is how can India be caught up in a crisis when it has nothing much to do with any of the maladies that are at the core of the crisis.

The second reason for dismay is that India's recent growth has been driven predominantly by domestic consumption and domestic investment. External demand, as measured by merchandize exports, accounts for less than 15 per cent of our GDP. The question then is, even if there is a global downturn, why should India be affected when its dependence on external demand is so limited?

The answer to both the above frequently-asked questions lies in globalization. First, India's integration into the world economy over the last decade has been remarkably rapid. Integration into the world implies more than just exports. Going by the common measure of globalization, India's two-way trade (merchandize exports plus imports), as a proportion of GDP, grew from 21.2 per cent in 1997-98, the year of the Asian crisis, to 34.7 per cent in 2007-08.(Annexures 3,4,5,6)

Second, India's financial integration with the world has been as deep as India's trade globalization, if not deeper. If we take an expanded measure of globalization, that is the ratio of total external transactions (gross current account flows plus gross capital flows) to GDP, this ratio has more than doubled from 46.8 per cent in 1997-98 to 117.4 per cent in 2007-08.

Importantly, the Indian corporate sector's access to external funding has markedly increased in the last five years. In the five-year period 2003-08, the share of investment in India's GDP rose by 11 percentage points. Corporate savings financed roughly half of this, but a significant portion of the balance financing came from external sources. While funds were available domestically, they were expensive relative to foreign funding. On the other hand, in a global market awash with liquidity and on the promise of India's growth potential, foreign investors were willing to take risks and provide funds at lower cost.

HOW HAS INDIA BEEN HIT BY THE CRISIS?

The contagion of the crisis has spread to India through all the channels –the financial channel, the real channel, and importantly, as happens in all financial crises, the confidence channel.

India's financial markets – equity markets, money markets, forex markets and credit markets - had all come under pressure from a number of directions. First, as a consequence of the global liquidity squeeze, Indian banks and corporates found their overseas financing drying up, forcing corporates to shift their credit demand to the domestic banking sector. Also, in their frantic search for substitute financing, corporates withdrew their investments from domestic money market mutual funds putting redemption pressure on the mutual funds and down the line on non-banking financial companies (NBFCs) where the MFs had invested a significant portion of their funds. This substitution of overseas financing by domestic financing brought both money markets and credit markets under pressure. Second, the forex market came under pressure because of reversal of capital flows as part of the global deleveraging process.

Simultaneously, corporates were converting the funds raised locally into foreign currency to meet their external obligations. Both these factors put downward pressure on the rupee. Third, the Reserve Bank's intervention in the forex market to manage the volatility in the rupee further added to liquidity tightening.

Now the real channel. Here, the transmission of the global cues to the domestic economy has been quite straight forward – through the slump in demand for exports. The United States, European Union and the Middle East, which account for three quarters of India's goods and services trade are in a synchronized down turn. Service export growth is also likely to slow in the near term as the recession deepens and financial services firms – traditionally large users of outsourcing services – are restructured. Remittances from migrant workers too are likely to slow as the Middle East adjusts to lower crude prices and advanced economies go into a recession.

Beyond the financial and real channels of transmission as above, the crisis also spread through the confidence channel. In sharp contrast to global financial markets, which went into a seizure on account of a crisis of confidence, Indian financial markets continued to function in an orderly manner. Nevertheless, the tightened global liquidity situation in the period immediately following the Lehman failure in mid-September 2008, coming as it did on top of a turn in the credit cycle, increased the risk aversion of the financial system and made banks cautious about lending.

HOW HAS INDIAN LEADERSHIP RESPONDED TO THE CHALLENGE?

The failure of Lehman Brothers in mid-September was followed in quick succession by several measures. Both the government and the Reserve Bank of India responded to the challenge in close coordination and consultation. The main plank of the government response was fiscal stimulus while the Reserve Bank's action comprised monetary accommodation.

MONETARY POLICY

The Reserve Bank's policy response was aimed at containing the contagion from the outside - to keep the domestic money and credit markets functioning normally and see that the liquidity stress did not trigger solvency cascades. In particular, three objectives were targeted: first, to maintain a comfortable rupee liquidity position; second, to augment foreign exchange liquidity; and third, to maintain a policy framework that would keep credit delivery on track so as to arrest the moderation in growth. This marked a reversal of Reserve Bank's policy stance from monetary tightening in response to heightened inflationary pressures of the previous period to monetary easing in response to easing inflationary pressures and moderation in growth in the current cycle.

GOVERNMENT'S FISCAL STIMULUS

Over the last five years, both the central and state governments in India have made a serious effort to reverse the fiscal excesses of the past. At the heart of these efforts was the Fiscal Responsibility and Budget Management (FRBM) Act which mandated a calibrated road map to fiscal sustainability. However, recognizing the depth and extraordinary impact of this crisis, the central government invoked the emergency provisions of the FRBM Act to seek relaxation from the fiscal targets and launched two fiscal stimulus packages in December 2008 and January 2009. These fiscal stimulus packages, together amounting to about 3 per cent of GDP, included additional public spending, particularly capital expenditure, government guaranteed funds for infrastructure spending, cuts in indirect taxes, expanded guarantee cover for credit to micro and small enterprises, and additional support to exporters. These stimulus packages came on top of an already announced expanded safety-net for rural poor, a farm loan waiver package and salary increases for government staff, all of which too should stimulate demand.

EVALUATING THE RESPONSE

In evaluating the response to the crisis, it is important to remember that although the origins of the crisis are common around the world, the crisis has impacted different economies differently. Importantly, in advanced economies where it originated, the crisis spread from the financial sector to the real sector.

In emerging economies, the transmission of external shocks to domestic vulnerabilities has typically been from the real sector to the financial sector. Countries have accordingly responded to the crisis depending on their specific country circumstances. Thus, even as policy responses across countries are broadly similar, their precise design, quantum, sequencing and timing have varied. *In particular, while policy responses in advanced economies have had to contend with both the unfolding financial crisis and deepening recession, in India, response has been predominantly driven by the need to arrest moderation in economic growth.*

Over the last five years, India clocked an unprecedented nine per cent growth, driven largely by domestic consumption and investment even as the share of net exports has been rising. True, the benign global environment, easy liquidity and low interest rates helped, but at the heart of India's growth were a growing entrepreneurial spirit, rise in productivity and increasing savings. These fundamental strengths continue to be in place.

Nevertheless, the global crisis will dent India's growth trajectory as investments and exports slow. Clearly, there is a period of painful adjustment ahead. However, once the global economy begins to recover, India's turn around will be sharper and swifter, backed by our strong fundamentals and the untapped growth potential. Meanwhile, the challenge for the government and the RBI is to manage the adjustment with as little pain as possible.

WAY FORWARD-GLOBAL ECONOMY

"The world faces significant and urgent challenges that weigh heavily on prospects for future growth and on the cohesion of our societies," said the statement by the global issues group of the World Economic Forum. It was published ahead of the forum's annual meeting in Davos , amid concerns that 2012 will see the global economy flirt with recession as a result of the eurozone crisis. "Our shared objective is the strengthening of growth, employment and the quality of life in every part of the world," said the statement. "But entering 2012, we worry about: decelerating global growth and rising uncertainty; high unemployment, especially youth unemployment, with all its negative economic and social consequences; potential resort to inward-looking protectionist policies."

In addition to Lagarde, Zoellick and Lamy, the signatories were Mark Carney of the Financial Stability Board, Margaret Chan of the World Health Organization, Angel Gurría of the Organisation for Economic Co-operation and Development, Donald Kaberuka of the African Development Bank, Haruhiko Kuroda of the Asian Development Bank, Luis Alberto Moreno of the Inter-American Development Bank, Josette Sheeran of the United Nations World Food Programme, and Juan Somavia of the International Labour Organisation. The forum said it was the first time the heads of the world's major institutions had come together in such a way. Reflecting the IMF's concern about over-aggressive deficit reduction programmes, the joint statement said governments should "manage fiscal consolidation to promote rather than reduce prospects for growth and employment. It should be applied in a socially responsible manner." The 11-strong group said it wanted to see a comprehensive action plan that could be agreed and implemented at the meeting of the G20 gathering of developed and developing nations in Mexico in June 2012.

"We call on leaders to devote the necessary political energy to deliver concrete actions to exit the crisis and boost growth. Every country, working through its regional economic organisations and development banks and through the international financial and UN institutions, has a role to play."

The World Bank has warned that the crisis in the eurozone will lead to a sharp slowdown in growth in rich and poor countries this year and could spiral into a rerun of the 2008-09 recession.

In its half-yearly health check on the global economy the Washington-based institution said the world had "entered a very difficult phase characterised by significant downside risks and fragility". The bank lowered its forecast for global growth in 2012 from 3.4% to 2.5% but said governments should be preparing for a downturn as bad as that which followed the collapse of Lehman Brothers in 2008.

"An escalation of the crisis would spare no one," said Andrew Burns, manager of global macroeconomics at the World bank and the report's author. "Developed and developing country growth rates could fall by as much or more than in 2008-09. The importance of contingency planning cannot be stressed enough. It is clear that whatever probability is attached to this downside scenario, it has increased since June last year.

"Developing countries should hope for the best and plan for the worst. If these downside risks materialised there is not much developing countries can do to prevent it. But they can prepare for it." He added that such countries should be drawing up list of public spending priorities and stress testing their banks.

The forecasts contained in the half-yearly Global Economic Prospects report reflect the slowdown in the global economy seen in the second half of 2011, which was already evident in weakening trade flows, declining capital flows to developing countries and lower commodity prices. A similar picture is likely to be painted by the bank's sister organisation, the International Monetary Fund, when it releases updated predictions for global growth.

The bank said the eurozone was already in recession and was likely to contract by 0.3% this year. High-income countries would grow by 1.4% as a result of a recovery in Japan from a tsunami-affected 2011 and a slight pickup in activity in the US. Even so, rich countries are expected to grow in 2012 at only half the 2.7% expected when the Bank last published forecasts in June 2011.

It added that there had also been a slackening in the pace of activity in some of the leading developing countries – such as Brazil, India and Turkey – as a result of action taken by governments to tackle inflation. There was a risk, the bank said, of the crisis in the eurozone and weaker growth in developing countries reinforcing each other at a time when the ability of policymakers to respond to a downturn was much diminished compared with three years ago.

"While contained for the moment, the risk of a much broader freezing up of capital markets and a global crisis similar in magnitude to the Lehman crisis remains," the World Bank report said. "In particular, the willingness of markets to finance the deficits and maturing debt of high-income countries cannot be assured. Should more countries find themselves denied such financing, a much wider financial crisis that could engulf private banks and other financial institutions on both sides of the Atlantic cannot be ruled out. The world could be thrown into recession as large as or even larger than that of 2008-09."

A second global downturn would again have its epicentre in high-income countries, it said, but it added that developing countries would feel its effects deeply through trade, commodity prices, remittances, financial pressures and capital flows. Many developing countries would see outright falls in output and overall developing country gross domestic product in 2013 would be more than 4% lower than in the bank's baseline projection.

"In the event of a major crisis, activity is unlikely to bounce back as quickly as it did in 2008-09, in part because high-income countries will not have the fiscal resources to launch as strong a counter-cyclical policy response as in 2008-09 or to offer the same level of support to troubled financial institutions. Developing countries would also have much less fiscal space than in 2008 with which to react to a global slowdown (38% of developing countries are estimated to have a government deficit of 4% or more of GDP in 2011). As a result, if financial conditions deteriorate, many of these countries could be forced to cut spending pro-cyclically, thereby exacerbating the cycle."

The co-ordinated global response to the 2008-09 slump saw interest rates slashed, money created through quantitative easing, public spending increased and taxes cut. "Monetary policy in high-income countries will also not be able to respond as forcibly as in 2008-09, given the already large expansion of central bank balance sheets," the Bank said. "Among developing countries, many countries have tightened monetary policy, and would be able to relax policy (and in some cases already have) if conditions were to deteriorate sharply."

Burns said China had the resources and the political will to mount a counter-cyclical policy, but was unlikely to be able to boost its economy as quickly as it did three years ago. "There was a big response in 2008-09 but it is not obvious that the same mechanisms can be used as effectively as they were in 2008-09. Those parts of the economy that were stimulated in 2008-09 are already over-heating."

WAY FORWARD-INDIAN ECONOMY

- Interest rates expected to soften after March 2012 on the back of reduced food inflation rates. However much depends on evolving growth-inflation dynamics
- Fiscal deficit (1.5 lac crores/ 5.6% GDP due to higher subsidies & lower tax receipts which may continue), current account deficit, disinvestment targets not being met, dampeners to overall scenario
- Depreciation of rupee partly offset by global softening of commodity prices due to moderation of growth across developed and developing markets, including China
- Measures like QFI, FDI policy relaxation, auction of PSU shares, NRI remittances going up are likely to soften the landing
- Dampened investment and growth, coupled with policy paralysis, confidence levels low among industry groups in spite of huge cash reserves. Infosys (USD 6 bn/ RIL USD 25 bn/ Apple Inc USD 97 bn-more than US treasury.RIL cash pile of 1.25 lac cr is close to India's fiscal deficit of 1.5 lac cr. Shows how imbalanced the economies are.
- Second generation of reforms stalled due to political pressures, especially retail, aviation, insurance and pension funds and basic sectors like education, healthcare and infrastructure
- Need for fiscal reforms, like DTC and GST to contain deficits in 2012-13.Fiscal consolidation-public to private debt/ consumption to capital formation required

CONCLUSION

In retrospect, it seems that the Indian financial system and bureaucracy has shown remarkable leadership and vision in charting out a roadmap without excessive risk, and balancing out growth moderation with inflationary expectation and systemic risks in regulatory oversight. While this is being borne out by the

fact that India did not bear the full brunt of the financial crisis, it remains to be seen whether we can weather another brewing crisis, if it comes, in terms of deleveraging and painful transition to growth over the next few years.

Having said that, the jury is still out on whether the same regulatory oversight and financial prudence will succeed in not killing the entrepreneurial spirit, innovativeness of the population and lead us to the next trajectory of growth and sustainability.

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ANNEXURE

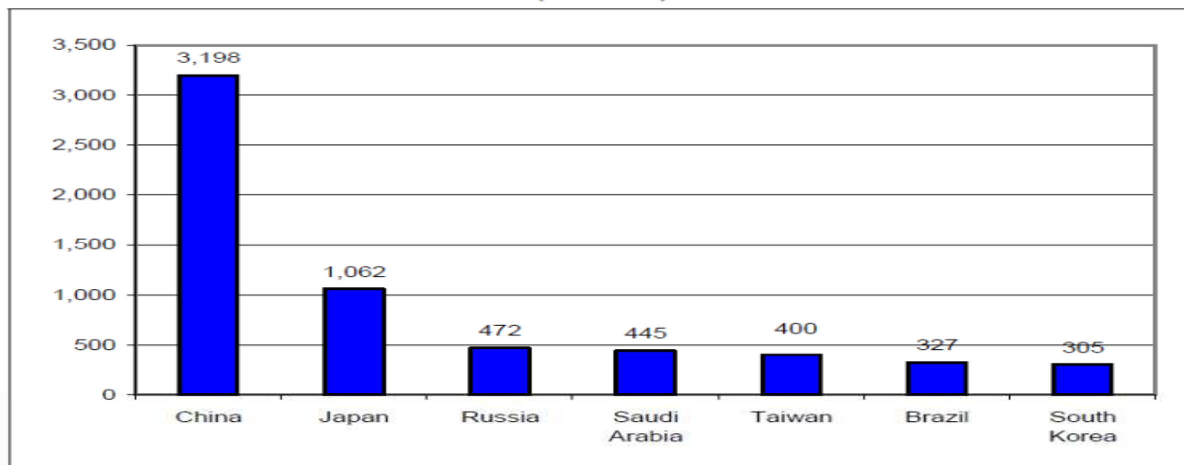
Table 1. China's Foreign Exchange Reserves: Totals and as a Percent of GDP, 2001-2010 and as of June 2011

Year	Billions of U.S. Dollars	As a % of Chinese GDP
2001	215.6	16.3
2002	291.1	20.0
2003	403.3	24.6
2004	609.9	31.6
2005	818.9	36.5
2006	1,068.5	40.2
2007	1,528.2	45.2
2008	1,946.0	45.0
2009	2,399.2	48.1
2010	2,847.3	48.4
June 2011	3,197.5	NA

Source: Global Insight and Chinese State Administration of Foreign Exchange.

Note: Year-end or end of month values.

Figure 1. Major Holders of Foreign Exchange Reserves as of June 2011
($ billions)



Sources: IMF International Financial Statistics, and Central Bank of the Republic of China (Taiwan).

Notes: Ranked according to total holdings as of June 2011. Data for Saudi Arabia are through December 2010.

Table 3. China's Year-End Holdings of U.S. Treasury Securities: 2002-2010

($ billions and as a percent of total foreign holdings)

	2002	2003	2004	2005	2006	2007	2008	2009	2010
China's Holdings ($billions)	118.4	159.0	222.9	310.0	396.9	477.6	727.4	894.8	1,160.1
Holdings as a % of Total Foreign Holdings	9.6%	10.4%	12.1%	15.2%	18.9%	20.3%	23.6%	24.2%	26.1%

Source: Department of Treasury, Major Foreign Holders of Treasury Securities Holdings, July18, 2011.

Table 1: Growth Rate of Components of Aggregate Expenditure

(Per cent)

Items/Year	Average		Crisis Period	
	2000-01 to 2009-10	2003-04 to 2007-08	2008-09	2009-10
Private Final Consumption Expenditure	6.2	7.6	6.8	4.3
Government Final Consumption Expenditure	5.8	5.6	16.7	10.5
Gross Capital Formation	9.8	16.8	-1.7	7.1
Exports	14.6	17.9	19.3	-6.7
Imports	13.6	20.1	23.0	-7.3
GDP at market prices	7.1	9.0	5.1	7.7

Source: Central Statistics Office, Government of India.

Table 2: Expenditure Composition of GDP

(Percentage shares of GDP at constant market prices)

Items/Year	Average		Crisis Period	
	2000-01 to 2009-10	2003-04 to 2007-08	2008-09	2009-10
I. Domestic (i+ii+iii)	**103.1**	**103.7**	**106.5**	**104.8**
of which:				
(i) Private Final Consumption Expenditure	60.7	59.5	59.5	57.6
(ii) Government Final Consumption Expenditure	11.3	10.7	11.5	11.8
(iii) Gross Capital Formation	31.1	33.5	35.6	35.4
II. External (iv-v)	-2.4	-2.6	-6.1	-5.1
(iv) Exports	18.5	19.5	24.5	21.3
(v) Imports	20.9	22.1	30.7	26.4
Discrepancies	-0.7	-1.2	-0.4	0.3

Source: Central Statistics Office, Government of India.

Table 3: Fiscal Deficit

(Per cent of GDP)

	Average		2007-08	2008-09	2009-10	2010-11 (Projected)
	2000-01 to 2009-10	2003-04 to 2007-08				
			Gross Fiscal Deficit			
Central Government	4.9	3.6	2.6	6.0	6.7	5.5
State Governments	3.2	2.7	1.5	2.4	3.4	2.9
Combined (Centre plus States)*	7.9	6.3	4.1	8.5	10.0	8.3

*: Deficits of Centre and States may not add up to combined deficit because of netting out of inter-governmental transfers between the Centre and States.

Table 4: Key Monetary Policy Measures in India since the Global Financial Crisis

(Per cent)

Effective since	Reverse Repo Rate	Repo Rate	CRR	SLR
1	2	3	4	5
October 11, 2008	6.00	9.00	6.50 (-2.50)	25.0
October 20, 2008	6.00	8.00 (-1.00)	6.50	25.0
October 25, 2008	6.00	8.00	6.00 (-0.50)	25.0
November 3, 2008	6.00	7.50 (-0.50)	6.00	25.0
November 8, 2008	6.00	7.50	5.50 (-0.50)	24.0
December 8, 2008	5.00 (-1.00)	6.50 (-1.00)	5.50	24.0
January 5, 2009	4.00 (-1.00)	5.50 (-1.00)	5.50	24.0
January 17, 2009	4.00	5.50	5.00 (-0.50)	24.0
March 4, 2009	3.50 (-0.50)	5.00 (-0.50)	5.00	24.0
April 21, 2009	3.25 (-0.25)	4.75 (-0.25)	5.00	24.0
November 7, 2009	3.25	4.75	5.00	25.0
February 13, 2010	3.25	4.75	5.50 (+0.50)	25.0
February 27, 2010	3.25	4.75	5.75 (+0.25)	25.0
March 19, 2010	3.50 (+0.25)	5.00 (+0.25)	5.75	25.0
April 20, 2010	3.75 (+0.25)	5.25 (+0.25)	5.75	25.0
April 24, 2010	3.75	5.25	6.00 (+0.25)	25.0
July 2, 2010	4.00 (+0.25)	5.50 (+0.25)	6.00	25.0
July 27, 2010	4.50 (+0.50)	5.75 (+0.25)	6.00	25.0
September 16, 2010	5.00(+0.50)	6.00(+0.25)	6.00	25.0

Note: 1. Reverse repo rate indicates rate for absorption of liquidity and repo rate indicates rate for injection of liquidity. Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) are per cent of net demand and time liabilities of banks.

2. Figures in parentheses indicate change in policy rates in per cent.

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