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The Global Crisis - An Indian Perspective

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A Few Comments on the Present Crisis

Excellent lesson on how the basic
rules of success can be forgotten even
by the oldest of practitioners



Underlying imbalances

- Between consumption and savings
- Resulting in large capital flows involving the US on the one hand and mostly Asian and oil exporters on the other
- **Appetite for US dollar assets facilitated the crisis**
- However the argument can be made that this imbalance could have been run down in a much more orderly fashion over time.



A conflation of factors

- A down-cycle was due after an extended run of above-trend growth 2002—2007, widely distributed across geographies.
- Runaway rise in commodity prices from oil to wheat to steel damaging many corporate, household & fiscal balance sheets.
- Brewing crisis in sub-prime & other problem assets (& liabilities) in western banking system.
- Triggered by the decision to let Lehman fail.



An explosive combination

- All indicators of an overdue correction, viz. record low unemployment, rising prices of commodities and assets in 2006—2007 were pointing to a correction. Central banks were also responding.
- **By itself such a correction would have been relatively mild.**
- What has made it so deep & damaging is the weakness caused by the twins elements of a powerful banking crisis and runaway inflation
- **Lehman was the detonator to this bomb. Date of explosion 15th Sept 2008.**



Mortgages are as old as the hills

- In the US mortgages and mortgage related financial crisis go back to the nineteenth century.
- **What distinguishes this one is (a) magnitude and (b) global reach**
- Result of a collective failure to stem dilution of standards for loan origination and securitisation by banks, rating agencies, regulators, US Congress and institutional investors
- **It could have, and should have, been averted**



US monetary policy tripped up

- The sub-prime mortgage crisis that broke (into the open) in August 2007, caused the US Federal Reserve to suddenly change course – from tightening to easing on a massive scale. Huge cuts in unscheduled meeting on 21 Jan 2008.
- This happened in the middle of inflation and fed its fires, literally with petroleum. Oil prices soared by 50% after the about-turn.
- Runaway inflation across the world weakened almost all economic agents, including governments





Other policies compounded matters

- US bio-fuel subsidy policies resulted in prices of corn and then other cereals to soar. By March 2007 they reached record levels only to rise further over the next 12 months.
- By March 2008, rice was being quoted at \$1,000/mt and wheat at \$600/mt.
- Food riots broke out in many poor developing economies



Failure to check mortgage defaults

- Despite announcing policies to help deserving home-owners to avoid default at the end of August 2007, the US government failed to implement these intentions.
- Defaults mounted, home prices fell, refinance dried up and the vicious cycle began to spiral out of control.
- The other cracks – relating to funding type/duration and management of derivatives on the balance sheet – in the western banking system then began to come to the surface.



Mr. Paulson's match box ...

- In this troubled conditions the decision of the US Treasury to let Lehman go set off the cataclysm.
- Inter-bank markets froze up, the rest of the financial system went into shock. Rapidly the banking system of the US & Europe began to crumble. Governments rushed in to shore them up.
- For us in Asia who lived through 1997/98 it was eerily and ironically familiar.



The aftermath ...

- 3 + 3 months of unmitigated horror.
- Frozen inter-bank markets, no credit, no trade
- International / domestic trade collapsed first due to this, then due to falling demand in West
- Corporates stared at the abyss, as their share prices fell through the floor and credit conditions deteriorated (CDS spreads doubled & trebled)
- US\$ rose (safe-haven effect). EM currencies plunged, making funding conditions even harder



Financial conditions ...

- Loan markets began to ease in Jan-Feb, evidenced by 3 month Libor falling to <1.5% and CDS spreads declining. Helped by assistance lent to their banks by Western governments and the absence of further bank failures
- Equity markets after the funk of early March 2009 have rallied strongly in April through June.
- In my opinion EM stock index levels have recovered to allow “normal” (i.e. capital raising) functioning. Developed markets still some 15% short of that level.
- Exchange rates have begun to normalise, i.e. US\$ weaker vis-à-vis EM currencies
- Rally in oil & other commodity prices cause for concern.



Prospects are many faceted ...

- Recession in the US and some EU economies should end in H2 of 2009, most likely in Q3/2009.
- **However, economic and financial conditions will continue to be challenging in 2010**
- The image and leadership of the USA in financial matters has been tarnished
- **Need for large debt is also likely to weaken its hand**
- The flux in the rules of the game is on the increase
- **Despite some perceptions, Europe does not offer viable alternatives**
- Opportunities and many challenges await Asia – leadership & co-operation are both issues



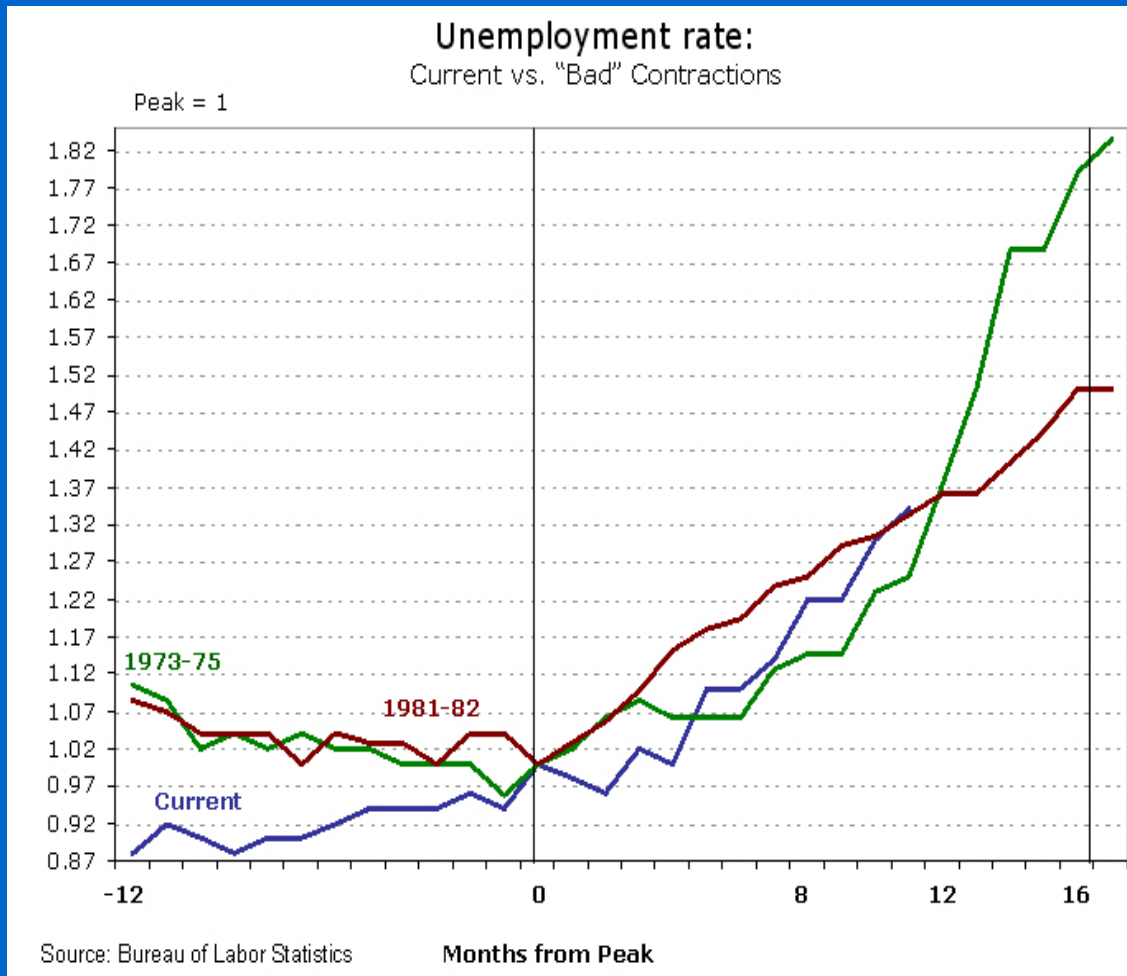


The end of the US recession

- Plenty of dire forecasts have been made.
- US economy in recession (private domestic demand) since Q4/2007. With Q2/2009 likely to be a small negative this will make it 7 successive negative quarters – the longest since the Depression.
- There are enough indicators to suggest that a turnaround is round the corner.
- However, some of the structural weaknesses are likely to persist for longer.



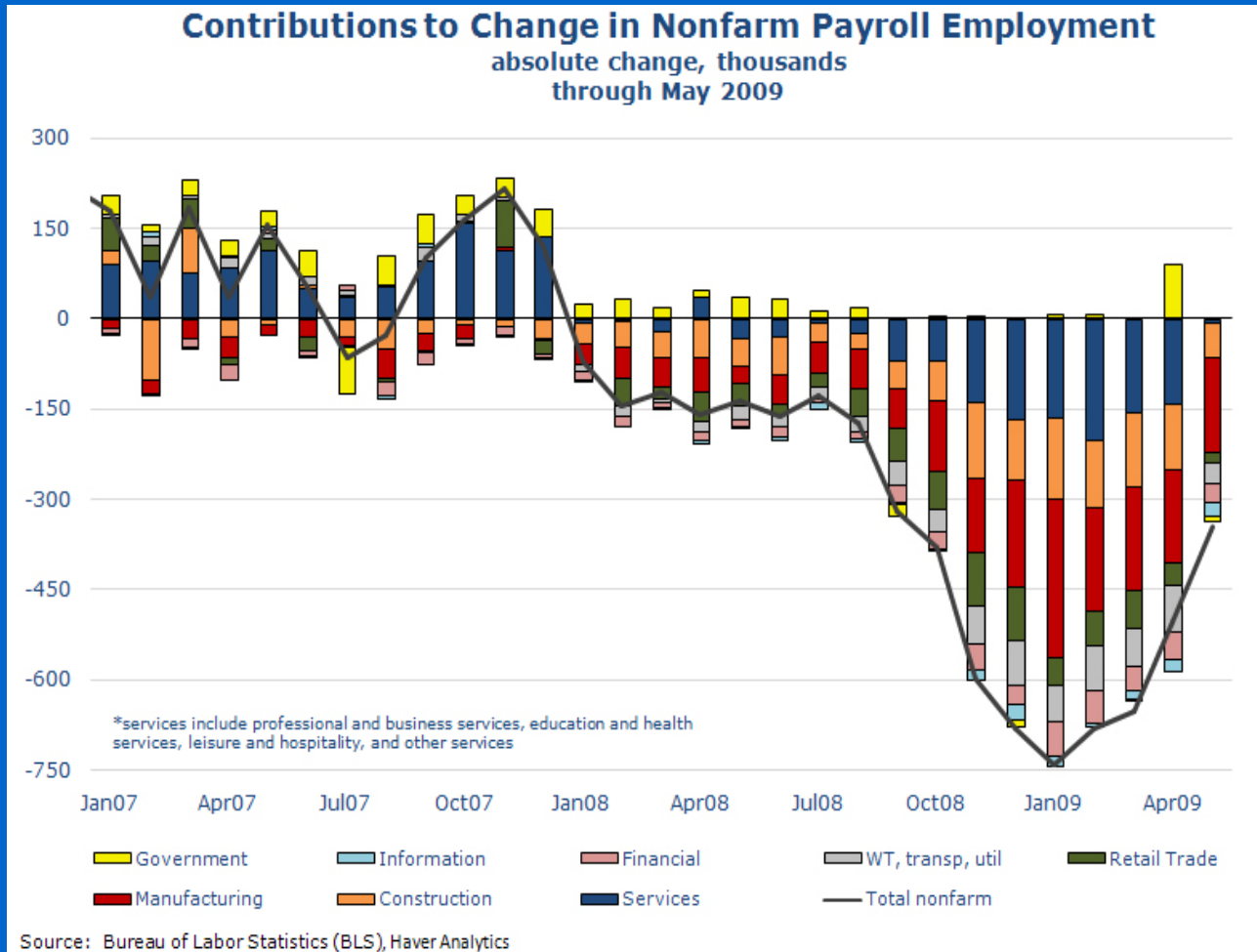
US unemployment rate ...



The rising unemployment rate is comparable to the seventies recession which was worse than that in the late 1980s



US job losses



Has begun to turn the corner. Jan 2009 was clearly a trough. But June data broke the trend



Economists have been poor guides

- First, the regulatory failures underlying the financial component of the crisis derived somewhat from prevalent views regarding implications of efficient finance markets theory.
- Second, they mostly failed to see the mutually reinforcing dangers coming from different sides.
- Third, they did not acknowledge the decision to let Lehman fail as a policy error.
- Finally, when the crisis did hit they panicked and panicked guides in the wilderness are poor guides.



Difficulties facing forecasters

- There were genuine difficulties here. The worsening of economic conditions had been very rapid and unexpected after the failure of Lehman, especially in Asia. What does one take as a given in these circumstances?
- Predicting worse, instead of median scenarios, is attractive because the error would be a happy one.
- This was especially true for multilaterals who can (along with their constituent governments) hope to take the credit for having averted an even worse outcome.
- The unexpected developments of 2007/2008 have seriously undermined the confidence of people in this business.



Emerging economies okay ...

- Principal emerging economies (other than Eastern Europe) were not exposed to the bad financial assets problem.
- Structural conditions in most of these economies were sound, except to the extent of dependence on export-led growth paths
- Their internal financial systems were also reasonably sound – in part a by-product of the crises of the 1990s
- As a result except for the impact from a sharp decline in exports and some financing problems, most EM's can look ahead to early recovery and reinforced growth prospects in late 2009 and 2010.



Issues that need to be dealt with ..

- There are many issues that need to be dealt with in the aftermath of the financial and economic crisis
- First is the issue of export dependence as a policy option vis-à-vis domestic demand-led growth
- Second is the issue of insurance against future financial shocks which directly lead to the questions about foreign currency reserves and reserve currencies
- Third is the issue of regional and global co-operation and co-ordination on policies and crisis management
- Fourth is an intelligent improvement upon some standard widely accepted conventional ideas in economic theory, especially that dealing with financial markets and cross-border monetary, fiscal and exchange rate linkages.



India's Response to the Crisis ...

- Rapid change in monetary stance – early October 2008 – rates, CRR and OMO operations
- Provided liquidity both generally and to specific sectors
 - Mutual Funds – bank CDs; refinancing through NHB and SPV for NBFC's
 - Relaxed a number of rules governing ECB and FII participation in corporate debt market
- Widespread tax cuts, expenditure re-prioritisation & some additional focused higher expenditure
- A large fiscal expansion was already in place

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Thank you

For your patience

