CHAPTER - 2

BAILOUT POLICIES AND PROGRAMMES OF GOVERNMENT AND RBI TO COMBAT RECESSION.

2.1 Introduction

Financial crises have been a recurrent source of economic downturns for centuries. Frequently, they are associated with currency crises (so-called twin crises) and burst under a variety of different monetary and regulatory regimes. Recent banking crises include the Spain in 1977 and the Nordic countries in late 1980s and early 1990s, in particular, the Swedish and Indian crisis in 1991. The crisis was characterised by two distinct phases: a period of financial turmoil and limited spreading from July 2007 to 15 September 2008, followed by a total collapse of confidence phase, spreading the crisis throughout the globe. The policy response differed between these two phases. Authorities started by adopting a piecemeal approach, focused on conventional policy measures and ad hoc interventions. However, given that these failed to shore-up confidence in the markets, more concerted and systematic rescue packages were subsequently introduced worldwide.

Financial institutions which are too big to fail, too interconnected to fail, or too correlated to fail have an incentive to gamble: if they win, they walk off with the profits, if they loose, the public picks up the losses. But the problems are deeper: banks have an incentive to become too big, too intertwined, and too correlated to fail; and because of the implicit guarantee that is provided to such institutions, they have an advantage over other institutions. The private returns to growth in size and to interconnectedness exceed by a large measure the social
returns (which may, in fact, be negative). One aspect of ‘correlated’ risk taking is the herding behavior that marks credit bubbles. Such irrational bubbles are a major source of macroeconomic volatility.

2.2 Background of India on the eve of crisis

India’s engagement with the global economy became deeper from the 1990s. Total merchandise trade which was hardly 15 per cent of India’s GDP in 1990-91 (April-March) rose by nearly two and half times to 36 per cent of GDP in 2007-08; invisibles trade rose about fourfold from just 5 per cent of GDP to 19 per cent in the same period; and capital flows increased even faster at more than fivefold from 12 per cent of GDP to 65 per cent of GDP over the same period.

Indian economy began to slow down in 2007-08 (April-March) after reaching a GDP growth of 9.8 per cent in the last quarter of 2006-07. In fact, Indian economy grew at an annual average rate of 8.8 per cent during the five years ending 2007-08. In the first half of the financial year 2008-09, the growth rate dropped to 7.8 per cent.

The pre-crisis slowdown of the economy can be attributed to the tightening of monetary policy right from September 2004 in response to the fear that the Indian economy had been overheating and inflation rising. The monetary tightening became harder in 2006-07 and later in early 2008-09 as the huge rise in world commodity prices pushed India’s inflation also high.
The central bank balance sheet was the ultimate source of money and credit creation and expansion in the economy. It was therefore important that the central bank balance sheet and the monetary base reserve money continue to expand so as to meet the normal monetary requirements of a growing economy consistent with price stability. The reduction in Cash reserve ratio (CRR) was expected to increase the money multiplier. The various monetary and liquidity measures, taken together, have released actual potential liquidity.

It thus appears that the sharp swings in monetary policy, especially periods of prolonged accommodation, in the advanced economies are the underlying causes of the ongoing global financial crisis. While until recently, the ‘Great Moderation’ since the early 1990s – reduction in inflation and reduction in growth volatility - had been attributed, in part, to the rule-based monetary policy, it appears that the volatility in monetary policy can also have the side-effect of creating too much volatility in financial markets and financial prices,
which can then potentially feed into the real economy with dangerous consequences, as indicated by the ongoing global financial crisis.

Large volatility in capital flows to Emerging Market Economies (EMEs) has been a recurrent feature of the global economic landscape since the early 1980s. Periods of large capital inflows, well above the financing need, have been followed by a sudden drying up of capital flows. Such large swings in capital flows over a very short period of time impose significant adjustment costs and large output and employment losses on the EMEs. As was well-known, capital flows reflect both push and pull factors. The push factors are critically dependent upon the stance of monetary policy in the advanced economies, a factor over which domestic authorities have no control. In view of these factors, it would be better for the EMEs to manage their capital account. Contrary to the theoretical expectation, empirical evidence does not find any support that free capital movement leads to higher economic growth. While benefits from external debt flows remain unproven, equity flows, especially FDI, are found to be beneficial.

This suggests a relatively liberal regime for 25 percent direct investment flows. Progress in the liberalisation of debt flows, especially short-term debt flows, by EMEs would depend upon greater macroeconomic stability, convergence of inflation levels and development of financial markets.

The crisis had an adverse impact on some of the Indian banks. Some of the Indian banks have invested in derivatives which might have exposure to investment bankers in U.S.A. However, Indian banks in general, have very little exposure to the asset markets of the developed world. Effectively speaking, the
Indian banks and financial institutions have not experienced the kind of losses and write-downs that banks and financial institutions in the Western world have faced\(^2\). Indian banks have very few branches abroad.

Our Indian banks were slightly better protected from the financial meltdown, largely because of the greater role of the nationalized banks even today and other controls on domestic finance. Strict regulation and conservative policies adopted by the Reserve Bank of India have ensured that banks in India are relatively insulated from the travails of their western counterparts. The intensification of the global financial crisis, following the bankruptcy of Lehman Brothers in September 2008, has made the economic and financial environment a very difficult time for the world economy, the global financial system and for central banks.

The fall out of the global financial crisis was an epoch changing one for central banks and financial regulatory systems. The global crisis has hit India through a “sudden stop” of capital inflows and a collapse of both external and domestic demand. The growth of the economy dropped to 6.7 per cent in 2008-09 (April-March) from 9.3 per cent in the previous year 2007-08 and it was 9.6 per cent in the year 2006-07 decline further in 2009-10 to about 8.4 per cent including the bad monsoon effect. In the year 2011-12 it was again declined 6.9 per cent. It was pegged to 5 percent lowest in a decade.

The aggressive monetary and fiscal measures undertaken would not be able to secure a sound recovery for the Indian economy with the global economy unlikely to revive its growth soon. A strong recovery of growth to 8 to 9 percent,

\(^2\) Venkitaramanan 2008
however, is possible for India if it unveils a “second round of reforms” similar to what it had done in the early 1990s. The deepening global integration of India has made it vulnerable to the global financial crisis.

2.3 Policy response

The major policy response for the crisis came in the form of loosening of the monetary policy and administering fiscal stimulus packages. There were a few other measures like relaxation of external commercial borrowing rules, raising the cap of Foreign Institutional Investment (FII) in debt and permission given to India Infrastructure Financing Company Limited (IIFCL) in floating tax-free bonds for infrastructure funding, etc.

The policy stance of the RBI in the first half of the year was oriented towards controlling monetary expansion, in view of the apparent link between monetary expansion and inflationary expectations partly due to the perceived liquidity overhang. In the first six months of 2008-09, year-on-year growth of broad money was lower than the growth of reserve money. The Government also took various fiscal and administrative measures during the first half of 2008-09 to rein in inflation. The key policy rates of RBI thus moved to signal a contractionary monetary stance. The repo rate (RR) was increased by 125 basis points in three tranches from 7.75 percent at the beginning of April 2008 to 9.0 percent with effect from August 30, 2008. The reverse-repo rate (R-RR) was however left unchanged at 6.0 percent. The cash reserve ratio (CRR) was increased by 150 basis points in six tranches from 7.50 percent at the beginning of April 2008 to 9.0 percent with effect from August 30, 2008.


2.4 Monetary policy operations

The evolution of monetary policy operating framework in India, to place the discussion on interest rate rules in perspective. In India, as in most countries, monetary policy framework has evolved in response to and as a consequence of financial developments, openness and shifts in the underlying transmission mechanism. The evolution of monetary policy framework in India can be seen in phases. In the formative years during 1935–1950, the focus of monetary policy was to regulate the supply of and demand for credit in the economy through the bank rate, reserve requirements and open market operations (OMO). In the development phase during 1951–1970, monetary policy was geared towards supporting plan financing. This led to introduction of several quantitative control measures to contain consequent inflationary pressures. While ensuring credit to preferred sectors, the bank rate was often used as a monetary policy instrument. During 1971–90, the focus of monetary policy was on credit planning. Both the statutory liquidity ratio (SLR) and the cash reserve ratio (CRR) were used to balance government financing and the attendant inflationary pressure.

Subsequently, structural reforms and financial liberalisation in the 1990s shifted the financing paradigm for the government and commercial sectors with increasingly market-determined interest rates and exchange rate. By the second half of the 1990s, in its liquidity management operations, the Reserve Bank was able to move away from direct instruments to indirect market-based instruments. Starting in April 1999, the Reserve Bank introduced a full-fledged liquidity adjustment facility (LAF). It was operated through overnight fixed rate repo and reverse repo in November 2004. This process helped to develop interest rate as an instrument of monetary transmission. This framework was reinforced in May 2011 when the
weighted average overnight call money rate was explicitly recognised as the operating target of monetary policy and the repo rate was made the only one independently varying policy rate\(^3\). Monetary policy remained in the tightening mode till end-August 2009.

In mid-September the central bank started relaxing liquidity but no cuts were made yet in policy rates. Inflation measured in terms of wholesale price index (WPI) peaked at 12.9 per cent in early August 2008 and remained high for some time. From mid-September to till end-October 2008 the economy was in the grip of a serious liquidity crisis and credit crunch as detailed earlier. The Reserve Bank of India (RBI) acted aggressively from mid-October to ease the situation by a series of rate cutting and liquidity injecting measures till April 2009.

As the Reserve Bank has started explicitly targeting overnight interest rate as the operational objective with the instrument of policy repo rate. This issue received added impetus as the monetary system transited from gold standard to fiat money.

\(^3\) (Mohanty, 2011)
When Kydland and Prescott (1977) in their seminal article presented the time inconsistency argument in favour of rules, the debate became even sharper. Subsequently, Taylor (1993) demonstrated how even in the practical world of monetary policy making, the monetary policy reaction function could be modelled as predetermined rules with superior policy outcome.

A number of reasons have been advanced in the literature as to why rule-based monetary policy could be more effective. First, a rule towards a credible commitment by the central bank to maintain price stability can reduce the inflation bias from monetary policy. Second, rules enhance economic efficiency by reducing uncertainty about future policy. Third, rules help policymakers avoid pressures from special interest groups and facilitate action consistent with long-run goals. Fourth, rules facilitate communication, promote transparency and increase accountability.
Similarly, there are arguments against application of rules. First, the economic system is too complex to be characterised by any rule. Second, the same rule may not work over the business cycle. Third, rule-based policy reduces the flexibility to respond to exogenous shocks. Fourth, rules do not allow for policy surprises which may be desirable for policy effectiveness under certain circumstances. Fifth, rules are ill suited to developing economies characterised by underdeveloped financial markets and rapid structural transformation.

In practice, it is difficult to come across central banks, which explicitly spell out their policy rules. However, for modern central banks, empirical assessments and policy evaluations are increasingly based on rules ever since Taylor’s influential paper. In empirical work, original Taylor rule is modified and extended in a variety of ways for adapting to specific country set up and evolving monetary framework. These include forward-looking Taylor rule, Taylor-McCallum type rule, non-linear framework for addressing asymmetric behaviour of monetary policy and time-varying nature of its parameters.

In India there has not been much research on monetary policy rules partly because the underlying monetary framework largely relied on direct and quantity based instruments. Moreover, the commercial interest rate structure was highly regulated till recently. In the Indian context, Singh (2010) estimated Taylor rule using annual data for the period 1950-2009 and observed a shift in policy response towards inflation gap since the 1990s.

Empirical estimation of Taylor Rule will require a priori determination of three parameters: the desired level of inflation, potential output and equilibrium real policy rate. These parameters are country-specific, and hence need to be estimated.
First, in the mid-1980s the Chakravarty Committee (1985) had suggested a tolerable level of inflation of 4.0 per cent per annum to facilitate changes in relative prices necessary to attract resources to growth sectors.

Second, the potential output growth is estimated by using the Hordrick-Prescott (HP) filter. The estimated potential output is broadly comparable to the Reserve Bank’s assessment that India’s potential output may have dropped from 8.5 per cent during the high growth phase of 2003-08 to 8.0 per cent in the post-crisis period to around 7.0 per cent in 2012-13 (Figure 2.3).

Figure 2.3 Potential output is estimated to have been moderated in the post-crisis period

![Graph showing potential output in post-crisis period](image)

Source: Reserve Bank of India.

Third, the determination of the neutral real policy rate is a complex issue as it is not observed in real time. One way is to derive it from a comprehensive general equilibrium model of the Indian economy. Another simpler, though not very satisfactory, way of deriving it is from the Taylor rule estimate itself. The empirical estimate from the two alternatives of Taylor rule estimated suggests it to be in the
range of 0.5-0.9 per cent covering a longer period from 2000-01:Q1 to 2012-13:Q3, which encompassed the recent bout of high inflation.

When compare another measure of gap interest rate gap as the difference between quarterly average overnight call rate and interest rate obtained from the Taylor rule, and inflation gap as the difference between quarterly average inflation rate and target inflation (Figure 2.4). It showed statistically significant inverse correlation which implies that higher the deviation of policy rate from that implied by the simple Taylor rule, higher is the deviation of inflation from its desired level.

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<th>Figure 2.4: Interest rate gap mirrored inflation gap</th>
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<td>![Graph showing interest rate gap mirrored inflation gap](source: Reserve Bank of India)</td>
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Moreover, in the crisis period, the gap had widened which has since narrowed in 2012-13. Additional diagnostics suggested bi-directional causality between the interest rate gap and inflation gap. It is noteworthy that this gap was narrower during the high growth phase of 2003-08. The Reserve Bank’s current assessment suggests
that the threshold level of inflation for India is in the range of 4.4-5.7 per cent, implying a mid-point rate of 5.0 per cent\textsuperscript{4}

**Figure 2.5 Inflation in the post-crisis period has remained above the desired rate**

![Inflation Chart](image)

Source: Reserve Bank of India.

Drawing on the research in the Reserve Bank, the desired level of inflation rate in terms of year-on-year variation in the wholesale price index (WPI) is assumed at 5.0 per cent. The actual inflation rate, however, has remained above this threshold level in the post-crisis period.

While more specialised financial institutions may face a greater risk of bankruptcy, the risk of systematic failure was greater where all banks are universal banks, and the social costs of systematic failure was an order of magnitude greater than the costs of the failure of individual institutions (Much of that cost can be handled through diversification of the ownership shares).

Foreign portfolio investments (FPI) into Indian stock markets increased dramatically in the last decade (1999-2000) witnessed an inflow of 2.15 US

\textsuperscript{4} Subbarao, (2013)
$ billion dollars, by the end of 2008 India attracted more than 32 US $ billion (Reserve Bank of India, 2009), so it is worth investigating whether those flows of investment affected the integration of India’s financial markets with the equity markets of other countries. Secondly, the Indian stock market has not been immune, like many other countries, from the international financial crisis. For instance subprime mortgage crisis which triggered a global financial crisis also affected heavily the Bombay Stock Exchange, which lost 11.6% of its value on the ‘Black Friday’ of the October 24, 2008.

While the impact of global financial crisis was having a devastating impact on most economies of the world, but its impact on Indian economy was not that severe. The economic indicators in United States and European Union countries point to severe contraction in these countries, but the slowdown in emerging markets have been smaller. The strengths of Indian economy along with the timely and appropriate monetary and financial responses by Indian government helped manage the adverse effects of the crisis. Unlike other emerging economies; banking sector in India is highly regulated and RBI has number of tools at its disposal to intervene effectively.

Finally, the global financial crisis has again shown that markets can fail and such market failures have huge costs. The financial system was prone to excesses, given the high leverage of banks and other financial institutions. Within the financial system, banks are 'special', whether locally- or foreign-owned, because they effectively act as trustees of public funds through their deposit taking activities and are the lynch pins of the payments systems. The speed with which a bank under a run collapses is incomparable with any other organisation. A failure of one bank can have a strong contagion on the rest of
the banks, even if they are healthy. In this age of globalisation, as the Global Financial Crisis has revealed, the lack of confidence in banks in one country can also have a contagion on banks in the rest of the world. It is because of this that many governments in EMEs had to guarantee the deposits in their banking systems during the later part of 2008. Given the risks to financial stability, governments in advanced economies had to bail out their largest banks and financial institutions. The notion that markets will take care of weaknesses has once again been proven wrong. So far, the focus of banking regulation globally has been on capital adequacy. As this crisis has shown, liquidity issues are equally important and it is appropriate to note that.

Given the complex inter-linkages between banks and non-banks and the move towards conglomerates, it was important that regulatory arbitrage loopholes are fixed to avoid regulatory arbitrage. It was in this context that RBI has tightened the regulatory regime in regard to NBFCs over the past few years in a phased manner. It was therefore, important that banks and other financial sector players are well-regulated, while permitting them the necessary flexibility to grow and expand and meet the financing needs of a growing economy. A host of other issues such as accounting, auditing and compensation have also received attention in the aftermath of the global financial crisis. All these issues are engaging the active attention of policymakers and academics alike around the world (G-20, 2009). In view of the fast pace of technological and financial innovations, regulatory authorities would have to follow an approach that would have to be dynamic and adjust in response to changing economic environment.
2.5 Fiscal stimulus measures

The central government announced three successive fiscal stimulus packages one in early December 2008, the second one in early 2009 and the last one in early March 2009. These included: across-the-board central excise duty reduction by 4 percentage points; additional plan spending of Rs. 200 billion; additional borrowing by state governments of Rs. 300 billion for plan expenditure; assistance to certain export industries in the form of interest subsidy on export finance, refund of excise duties/central sales tax, and other export incentives; and a 2 percentage-point reduction in central excise and service tax. The total fiscal burden for these packages amounted to 1.8 per cent of GDP.

The fiscal accommodation led to an increase in fiscal deficit from 2.7 percent in 2007-08 to 6.2 percent of GDP in 2008-09. The difference between the actual figures of 2007-08 and 2008-09 constituted the total fiscal stimulus. This stimulus at current market prices amounted to 3.5 percent of GDP for 2008-09.

The central budget 2008-09 announced in February 2008 showed a low fiscal deficit of 2.5 per cent of GDP. But the actual deficit turned out to be much higher due to salary hike for the government staff, debt waiver scheme for farmers, additional expenditure on rural employment scheme, duty reductions for petroleum products and revenue shortfalls due to slowdown in the economy. There were off-budget items like the issue of oil bonds and fertilizer bonds which are to be added to give a true picture of fiscal deficit.
2.6 Issues & Lessons

- Avoid high volatility in monetary policy: After global recession RBI has rechecked its monetary policy operations. It has not created too much difference monetary policy operations before and after global recession. Currently Account Full but gradual opening up. It made economy to stabilise after recession also.

- Appropriate response of monetary policy to asset prices RBI has taken appropriate response of monetary policy to asset prices, equity flows encouraged, debt flows subjected to ceilings and endues restrictions. It has not created easy credit like US had done, it has limited to debt – fueled consumption.

- Manage capital flow volatility: Central bank of our country has managed capital outflow by progressively liberalise policy.

- Look for signs of over leveraging: Prudential regulations for financial sector especially banks; liquidity and capital, inter-bank liabilities in relation to their net worth. RBI has kept his eyes on commercial banks technique to multiply gains and losses. The most obvious risk of leverage is that it multiplies losses. RBI has always have a checking of the signs of over leverages by its monetary policy operations.

- Dynamic financial regulation: capital buffers, dynamic provisioning: RBI had controlled the capital amount of a financial institutions that is commercial banks which is operation in our country, needs to hold above minimum requirement, calculated on an assessment of forecast risk.
2.7 What has not happened in India

With the above issues and lessons in India there is no

- No Subprime
- No Toxic Derivatives
- No Bank losses threatening capital
- No bank capital crunch
- No mistrust between banks

2.8 Strong fundamentals of India

- Robust Financial sector
- Flexible Monetary policy with sufficient instruments
- Corporate sector not too much leveraged
- Buoyant FDI
- Improving Agriculture
- Domestically financed growth

Apart from the above fundamentals the three important features of economic performance of India were seen to warrant the impact of global crisis. First is the superior performance of GDP as compared to other developed countries. Other than the stimuli linked to global integration; higher growth have been linked to the alternative forces like potentially large domestic markets and ‘favourable’ policy environments. Second is that India is large in terms of population and geography. Although the per capita income of these countries is far behind many developing countries; but it implies that the growth of country will generate demand for many global economies and thus contributing to their growth. Third is the capability of economy by taking steps like; capital controls
and limited convertibility of currency to capital account transactions to prevent economy from global financial turmoil’s.

2.9. Policy Suggestions for Recovery

India’s GDP growth rate had dropped from 9 per cent in 2007-08 to 6.7 per cent in 2008-09 and the global crisis has been one of the factors behind this growth slowdown. The growth is estimated to drop further to 5 per cent in 2009-10 due to the continued impact of global crisis and a crop failure. Huge fiscal deficits and rising public debt are likely to hamper recovery prospects by putting an upward pressure on interest rates. Monetary easing measures are yet to show results. Lending rates have not fallen much for so many reasons including the high lending risk premium. No further monetary easing is not expected as inflation is rising rapidly in the context of the failure of the monsoon.

The global economy while showing some signs of leveling off is not expected to recover strongly anytime soon. A vigorous recovery is predicated on the unwinding of the severe imbalances among deficit and surplus countries and the repair of the broken financial system of developed countries (Blanchard, 2009). Those may take years and India may not able to return to the 9 per cent growth path on the back of a global recovery.

Nevertheless, the Indian economy can recover fast if can get a big boost in domestic business and consumer sentiments which are badly shaken by the global crisis. This was very well possible by undertaking structural and procedural reforms as has happened in the early 1990s. Indian economy recovered swiftly after it was hit by the severe external payments crisis in 1991-92 leading to a collapse in its growth rate. Then a series of structural reform measures were undertaken by the central
government which raised India’s potential growth rate to about 7-8 per cent. There has been a talk about the “second-generation reforms” that are considered necessary to raise India’s potential growth rate further to 9-10 per cent.

2.10. Sum Up

The study has made an effort to study the monetary and fiscal operation which has made by RBI and Central government to combat recession. Fortunately, though economy have stopped following the path of the Great Depression. Costly as this crisis will prove, it could have been worse. Because RBI is a very care full economist in addition to being a very good one. The view monetary policy had become much better, despite the efforts of the RBI on commercial banks remains under extraordinary stress. Action by RBI monetary policy was urgently required to stabilize the situation and avert what otherwise could be very serious consequences for our financial markets and for our economy.

The implication, perhaps unintended, was that with study, economy could do away with recession altogether. The financial sector was, in many ways the brain of a modern economy. When it functions well, it allocates resources and risk effectively and their by boosts economic growth while also making lives easier, safer and more fulfilling. It broadens opportunity and attack privilege.