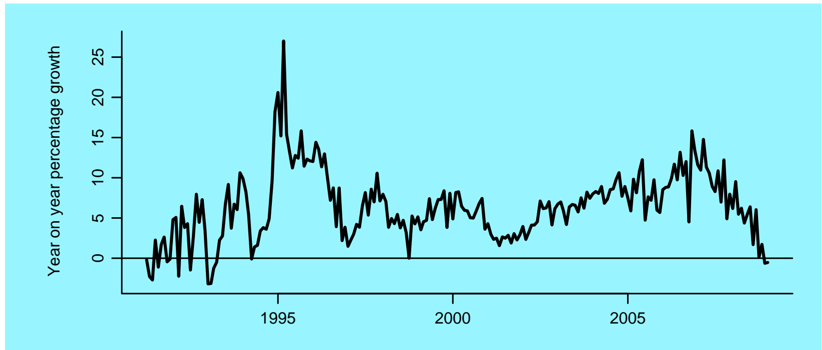
India in the Great Recession

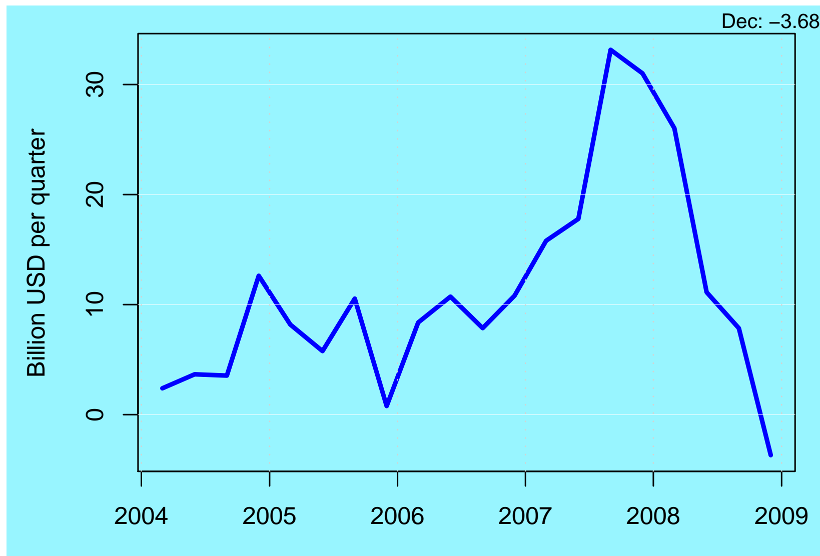
Ila Patnaik   Ajay Shah

April 15, 2009

YOY IIP growth is back to the early 1990s



... just had a ‘sudden stop’ of capital flows



Palpable gloom on India's outlook

- Growth has stalled
- Potential stress on balance of payments
- Big problems with public finance.

Part I

Backdrop: the new Indian business cycle

The Old India

- A closed economy
- A sequence of monsoon shocks
- Stable investment since it was driven by government
- Everything we know about macroeconomics, business cycles, stabilisation, etc. was largely irrelevant

The new Indian business cycle

- India's opening up to the world: *de facto* convertibility.
- Rise of private sector, particularly investment
  In recent years, priv. corp. GCF bigger than public investment;
  Priv. corp. GCF is unstable.
- Interplay between private investment and stock market
- Cycles of inventory/investment
- Now we economists have something to say!

The new Indian macroeconomics

The Old India	The New India
Lehman's death would not have mattered	Hit Bombay before it hit London
Changes in global prices would not have mattered	Owing to trade reforms, impact is pervasive
1998: Hunker down, raise interest rates to defend the exchange rate	2008: Float the exchange rate
ΔI was small	ΔI is the heart of the story
Irrelevance of macroeconomics	Curiosity about macroeconomics

Summary of what has hit India

- Drop in global prices of tradeables has reduced profitability of local producers of these goods, and the viability of their investment projects.
- Most firms were betting on INR appreciation; the sudden INR depreciation has given losses.
- Watching the global crisis has led to a loss of confidence.

Summary of what has hit India

- Drop in global prices of tradeables has reduced profitability of local producers of these goods, and the viability of their investment projects.
- Most firms were betting on INR appreciation; the sudden INR depreciation has given losses.
- Watching the global crisis has led to a loss of confidence.
- India was a net importer of $92 billion of commodities in 2007-08 – so the global drop in commodity prices helps.
- Wealth effects on real estate and equities partially offset by the rise in gold prices.

Part II

Textbook economics of stabilisation is ineffective

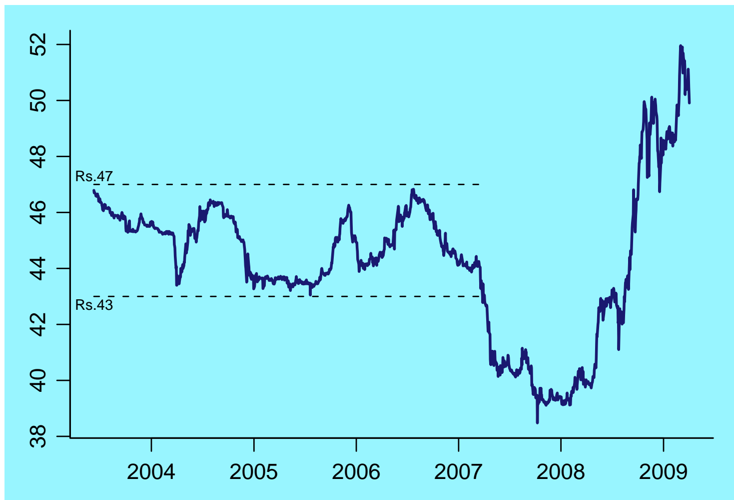
Fiscal policy

- Fiscal distress, which was made acute by the fertiliser and oil subsidies
- Automatic stabiliser: the corporation tax
- Relief owing to the drop in oil prices
- Little headroom or institutional capability for discretionary expansion.

Monetary policy

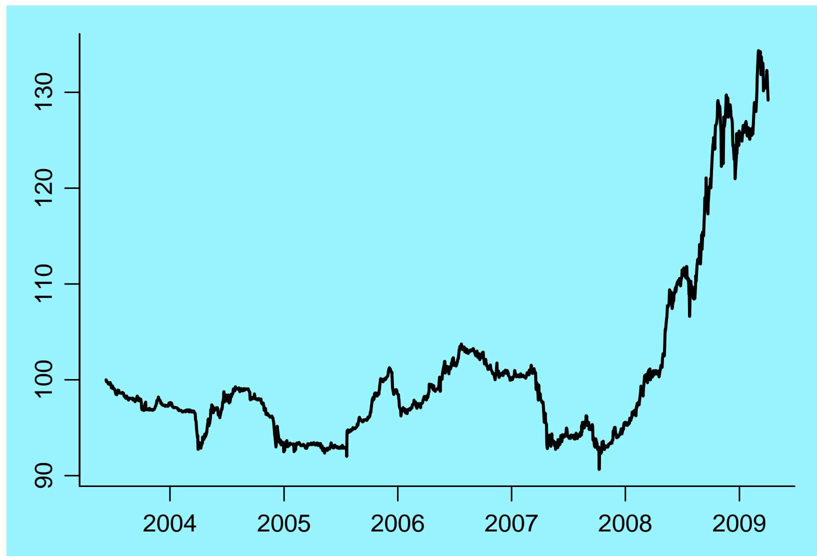
- Short rate has come down – but not in real terms
- Weak monetary policy transmission
- The really important story is the exchange rate

INR/USD fluctuations



Unhappy interaction between *One way bets on pegged exchange rates* and the abrupt currency depreciation.

Against the CNY



Institutional weaknesses are coming to prominence

Fraud E.g. Satyam

Debt management Conflicts of interest at RBI – monetary policy + banking + investment banking and the lack of a well specified monetary policy regime. E.g. March 2009.

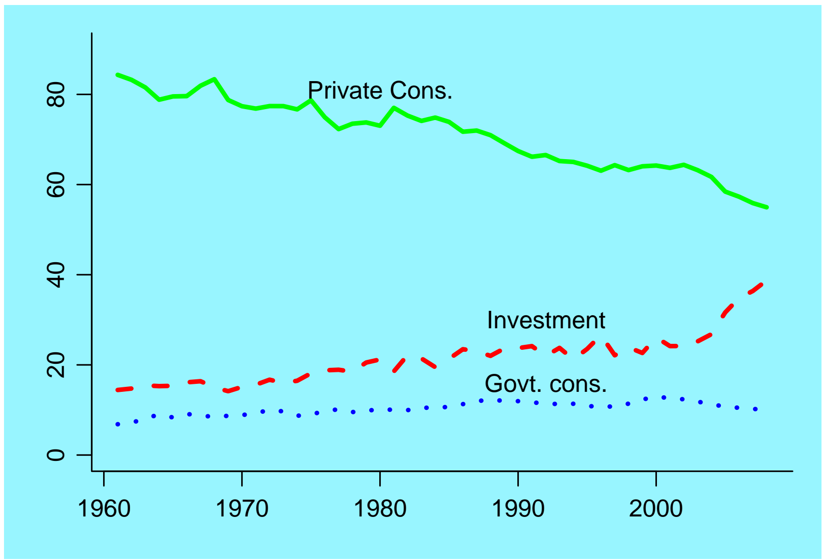
Ineffectiveness of monetary policy Bad financial system, so monetary policy transmission is ineffective.

In normal times, it seems that we can limp along with faulty institutional arrangements. At times like these, it hurts.

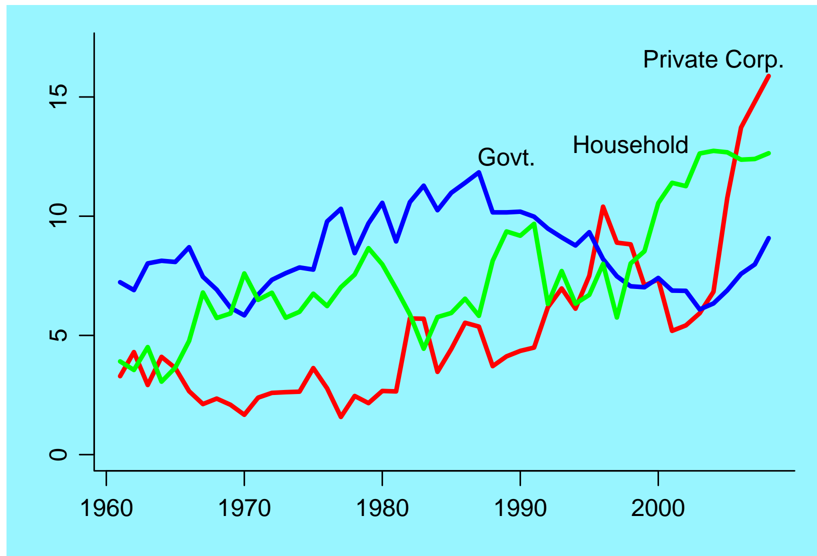
Part III

The heart of the problem: Investment

We are in very new terrain on investment - I



We are in very new terrain on investment - II



The heart of the problem

Residual standard deviation of a regression of share in GDP on time trend:

Component	Std. Dev.
C	1.29
G	0.32
$X - M$	0.66
I	2.18
Government	0.71
Private Corp.	2.19
Household	0.80

A 3σ shock is a drop in private corporate investment of 6.6% of GDP.

The questions for policy

1. What actions can reduce the size of ΔI?
2. How to reduce the *impact* upon the economy of a large ΔI?

Part IV

How to minimise ΔI?

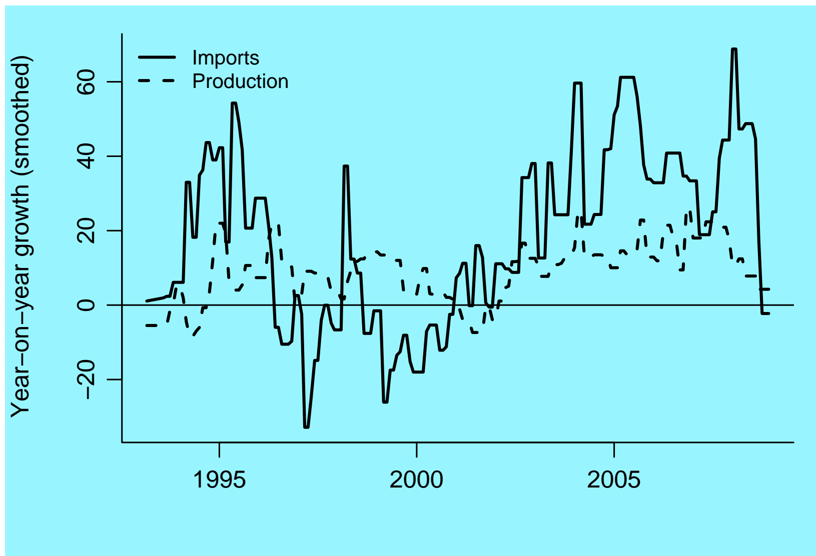
When times are good, all sins are forgiven

- In recent years, there was optimism that India would grow at $\geq$ 8%.
- The sense was that India will grow at 8% or more even if there is no progress in economic policy.
- Perception of low risk + high expected returns.
- Firms thundered ahead, investing.

When times are good, all sins are forgiven

- In recent years, there was optimism that India would grow at $\geq$ 8%.
- The sense was that India will grow at 8% or more even if there is no progress in economic policy.
- Perception of low risk + high expected returns.
- Firms thundered ahead, investing.
- Now that perception has been disrupted.
- Institutional weaknesses are visible.
- Now the sense is : India will get high growth if and only if we put our house in order.
- Now making progress in economic policy reforms, and in building a proper institutional framework for economic policy, is essential to persuading the private sector that the returns are high and the risk is low.

Is *I* tottering? Capital goods imports data (till Dec)



What influences ΔI?

The will to invest

- Animal spirits
- Optimism about the outlook for India
- Private and foreign investors have a low opinion of the interest or willingness of the Indian State to reform itself.
- We must unveil an economic reforms program that yields an effective State, that's focused on public goods.
- Are we willing to take on holy cows? Do we have common sense?
- Do we walk our talk?

What influences ΔI?

The will to invest

- Animal spirits
- Optimism about the outlook for India
- Private and foreign investors have a low opinion of the interest or willingness of the Indian State to reform itself.
- We must unveil an economic reforms program that yields an effective State, that's focused on public goods.
- Are we willing to take on holy cows? Do we have common sense?
- Do we walk our talk?

The ability to invest

- What holds back foreign or domestic investors, who believe in India, from getting invested?

The will to invest: The private sector needs to see India moving towards an effective State, that's focused on public goods

- Setup sound foundations of the State:
  Coordinated movement on fiscal, financial and monetary institution building.
- Proper financing of the State
- Sensible translation of expenditures into public goods
- Subsidy programs that genuinely get money to poor people.

Proper financing of the State

- FRBM-2
- Debt Management Office
- Goods and Services Tax
- Bad taxes e.g. education cess, securities transaction tax, stamp duty, customs
- Selling off atleast loss-making government companies
- Closing down departments and ministries.

Public goods

- Law and order – police and judiciary.
- Restructuring of existing agencies and laws in finance
- Fundamental transformation of urban governance
- Genuine execution capability on critical issues in infrastructure – NHAI, Bombay-Delhi industrial corridor, 3G, broadband, etc.
- Higher education
- Education and health: reformulate policies and institutions so as to get outcomes.

Subsidies

- Establish a cash transfer program that delivers Rs.300 per person per month to rural BPL households
- Remove existing subsidy programs or distortions that are done in the name of helping poor people.

The ability to invest

Assuming a private investor (domestic or foreign) believes in India, what holds him back from getting invested?

- Restrictions on FDI
- Labour law impedes the viability of labour-intensive projects
- GST + removal of cascading taxes is required for export-oriented manufacturing
- Problems of the land market
- Implementation of infrastructure projects
- Financial sector reforms – Patil, Mistry, Rajan reports.

Part V

What if a large ΔI does come about?

What can be done to minimise the damage, and bounce back effectively when the storm passes?

How can we absorb the shock better?

1. Watch out for pro-cyclicality of fiscal,financial,monetary

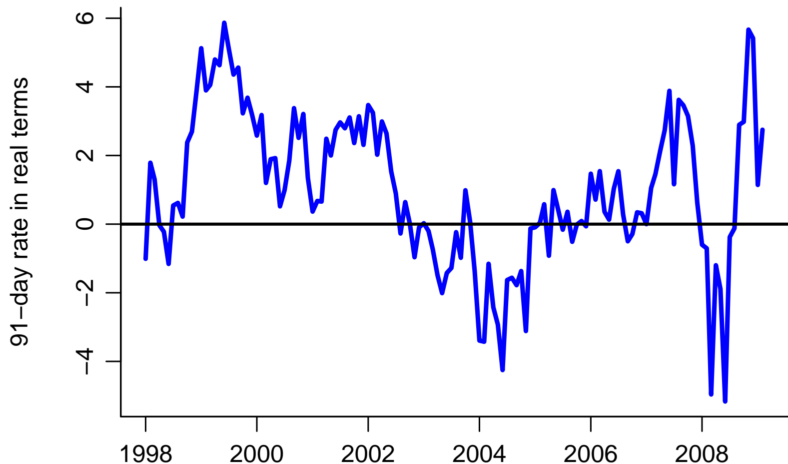
Feedback loops that amplify negative shocks:

Fiscal In good times, fiscal constraint is eased, spending is buoyant (and vice versa).

Financial In good times, capital flows come in, banks lend freely, financing is plentiful (and vice versa).

Monetary Exchange rate pegging generates procyclicality.

RBI's policy rate (in real terms)



2. Flexible exchange rate

- Macroeconomic stabilisation through fiscal policy is hard (requires good debt dynamics and a flexible fiscal system with large automatic stabilisers).

2. Flexible exchange rate

- Macroeconomic stabilisation through fiscal policy is hard (requires good debt dynamics and a flexible fiscal system with large automatic stabilisers).
- Macroeconomic stabilisation through monetary policy requires monetary policy reform. And, it requires financial sector reforms in order to get a monetary policy transmission.

2. Flexible exchange rate

- Macroeconomic stabilisation through fiscal policy is hard (requires good debt dynamics and a flexible fiscal system with large automatic stabilisers).
- Macroeconomic stabilisation through monetary policy requires monetary policy reform. And, it requires financial sector reforms in order to get a monetary policy transmission.
- The easiest low-hanging fruit in terms of a policy that yields stabilisation is : a floating exchange rate.
- In 2006 and 2007, floating exchange rate would have given:
  Lower profit rate for exporters and thus reduced investment,
  Higher interest rates and thus reduced investment,
  Less capital coming into the country owing to lack of one-way bet.

3. Strengthen external financing for firms

- Negative shocks appear
- In the short term, firms don't like to sack workers or disrupt supply chains
- So there are negative shocks to cashflow

3. Strengthen external financing for firms

- Negative shocks appear
- In the short term, firms don't like to sack workers or disrupt supply chains
- So there are negative shocks to cashflow
- *Firms don't die because of a downturn; firms die because they run out of cash*
- Finance is key for absorbing the blows: external equity/debt capital has to come in.
- External financing is the lubricant of mergers & acquisitions, which are of essence in obtaining flexibility of resource allocation.

3. Strengthen external financing for firms

- Negative shocks appear
- In the short term, firms don't like to sack workers or disrupt supply chains
- So there are negative shocks to cashflow
- *Firms don't die because of a downturn; firms die because they run out of cash*
- Finance is key for absorbing the blows: external equity/debt capital has to come in.
- External financing is the lubricant of mergers & acquisitions, which are of essence in obtaining flexibility of resource allocation.
- A well functioning financial sector is the difference between an orderly downturn and a big mess.
- Amplifies the importance of the Patil, Mistry and Rajan reports on financial sector reforms.

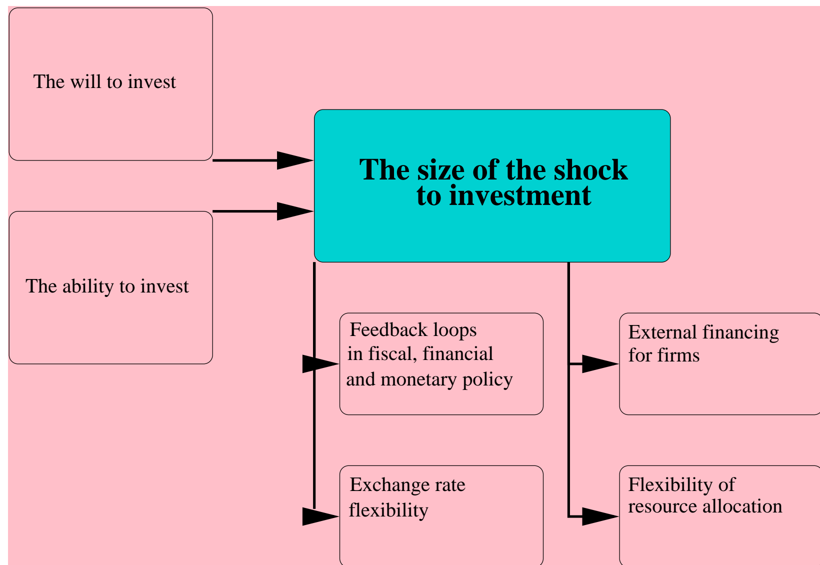
4. The really important issue: Flexibility in resource allocation

- Four shocks :
  reduction in global demand for goods & services
  reduction in prices of globally traded goods
  domestic shock of lowered investment demand
  a sharp rupee depreciation.
- In time, the economy will work out a new arrangement of labour and capital reflecting these new conditions.
- In the short run, things will be worse:
  prices that haven't been changed
  wages that are too high
  people who're out of job
  firms that shouldn't exist
  firms that are being created or are growing into new roles.
- The defining issue is: How flexible is the resource allocation?

Cautiously optimistic about flexibility

- While India has bad labour law, the labour is actually quite flexible
- People will get sacked
- Most workers will accept jobs at lower wages
- Downward adjustments of wages will happen
- Large unemployment will not crop up.
- Factories or brands or companies will get sold (M&A activity)
- The most damaging things that the government can do is to impede price flexibility, labour market flexibility, or creation/destruction of firms.

Summary



Related readings

New issues in macroeconomic policy, Ajay Shah. In “Business Standard India”, edited by T. N. Ninan. Business Standard Books, 2008.

Early warnings of inflation in India, Rudrani Bhattacharya, Ila Patnaik, Ajay Shah, EPW, November 2008.

The current liquidity crunch in India: Diagnosis and policy response, Jahangir Aziz, Ila Patnaik, Ajay Shah, 20 October 2008.

Papers from four conferences: `http://www.nipfp.org.in/nipfp-dea-program/meetings.html` including *One way bets on pegged exchange rates*.