



Welcome to the East Asian Bureau of Economic Research (EABER). EABER aims to be the premier East Asian economics research forum and provide a single point of reference for the economics, finance and governance research community throughout the region and beyond. Through building research capacity and partnering initiatives, EABER facilitates the creation of high-level analysis and forward thinking on issues of importance to the East Asian economy.

### Analysis

## India: Turning Crisis into Opportunity

Dr. Suman Bery\*

India's economic managers, and particularly the Reserve Bank of India (RBI), take considerable pride in having protected India from Asia's financial crisis in 1997-98. Although India did experience a prolonged period of slow growth in the years that followed that crisis, the basic financial machinery of the country remained relatively robust, providing a solid foundation for the much more rapid growth that has taken place this decade.

In common with its East Asian neighbours, India is grappling once again with many of the same challenges that the region faced a decade ago, creating difficult choices for domestic economic and financial policy. In a recent statement in Parliament India's Prime Minister, Dr. Manmohan Singh, himself one of India's most distinguished economists, said that the broad goal of India's policy is to try to ensure that any reduction in India's growth is temporary, so that the economy can return quickly to a nine per cent growth rate, the official medium-term target.

In charting its course, the Government is juggling multiple considerations: the state of the domestic business cycle; ensuring financing for the balance of payments deficit; the sharp shift in the availability of global risk capital for financing Indian investment; and the slowdown in growth in the world's rich economies.

After three years of buoyant, investment-led, growth, the Indian economy had started to slow down late last year (2007). This slowdown was particularly pronounced in the manufacturing sector, traditionally less buoyant in India than in other East Asian countries. The slowdown was mirrored in a deteriorating climate of business expectations. It was also captured by a sustained sell-off in the equity markets, which peaked in January 2008 after a torrid rise.

This growth slowdown was initially welcomed by the RBI, which had been gradually tightening monetary policy (since 2004) in a fight against inflation and excessive credit growth. As recently as this August it held the view that the economy was 'overheated', a view that reluctantly came to be shared in other parts of government.

Price pressures were further exacerbated by the sharp rise in commodity prices, (for India metals and oil, more than food, with the exception of edible oils), late last year and early this year. These pressures mounted despite the government's unwillingness fully to pass through the impact of higher prices on key consumer products (diesel, cooking gas, kerosene and lower grades of petrol). The net effect has been partially to reverse the measured (but inadequate) progress toward fiscal consolidation, as well as to increase the current account deficit in the balance of payments.

The political cycle is at an awkward point. The United Progressive Alliance (UPA) government is nearing the end of its five-year term. Parliamentary elections are due by next summer, and there is considerable uncertainty as to the composition, orientation and stability of the government that is to follow.

### Paper of the Month

The paper of the month for October 2008 is **Reducing Unemployment in Indonesia: Results from a Growth-Employment Elasticity Model** by Suryadarma et. al.

### Latest News

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Financial Sector Reforms and Economic Integration in Asia preliminary workshop - Mumbai, 17 November 2008.

Financial Sector Reforms and Economic Integration in Asia meeting - Beijing 14-15 May 2009.

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## NEWSLETTER

India continues to suffer a series of terrorist incidents in its larger cities, partly designed to stir a backlash among Hindu militant groups. Political and economic instability in India's neighbor, Pakistan, adds another layer of uncertainty.

Taking economic and political pressures together, it is perhaps not surprising that for many Indians the present moment is compared less with 1997 than with 1990-91. That was the year, at the time of the first Iraq war and amidst a messy domestic political situation, when India suffered a major external payments crisis and was obliged to apply to the International Monetary Fund for financial assistance. Thanks, however, to inspired political and economic leadership at that time, that payments crisis was turned into an opportunity for major structural reform from which India continues to benefit till this day.

The interesting question is whether a similar opportunity can be created again. Despite the economic slowdown and the stress in the equity markets, policy until late August operated on a business-as-usual basis, with inflation control being the government's main concern. Even though the transatlantic financial crisis had been underway for almost a year, policy action was based on the assumption that India could remain largely unscathed.

Government attitudes changed sharply in September with the bankruptcy of Lehman Brothers and the effect of this bankruptcy on global interbank liquidity and trust. Notwithstanding the generally sound domestic financial position of India's commercial banks and their relatively low dependence on foreign-sourced finance, bank liquidity came under strain as banks' overseas subsidiaries found their sources of wholesale finance withdrawn.

This effect was compounded by the intensified sell-off by foreign investors in domestic equity markets and the repatriation of funds to meet liquidity calls abroad. India operates a flexible, but managed, exchange rate.

Given continued strong concerns about inflationary expectations in the economy, and out of concerns for the currency going into free fall, the Reserve Bank has utilised a portion of its accumulated stock of international reserves to support the rupee while tolerating a fairly substantial depreciation of the rupee against the dollar. This intervention further drained domestic liquidity. Finally, populist actions taken by the government earlier in the year (waiver of agricultural debt by banks; subsidy on petroleum) further strained bank liquidity.

Over the course of October, the RBI has sharply reversed course on the two key instruments at its disposal: the cash-reserve ratio (that is, reserve requirements) that banks are required to hold in their accounts with the RBI; and the overnight secured lending rate (repo rate) at which the RBI lends to banks. In addition the Finance ministry and the RBI have between them taken several steps to welcome back short-term capital inflows that as recently as the beginning of this year were seen as a problem.

India's policy-makers have both the experience and the tools to ride out the present storm, notwithstanding its international origins. They will be helped by India's lower integration with world trade and finance, and by such institutional features as public ownership of a substantial part of the domestic banking system.

Yet by itself this is not enough: the larger challenge will be, as in 1991, to use this crisis also to resume the momentum of reforms that have largely stalled. Of this there is as yet little sign

*\*Dr. Suman Bery is the Director-General of the National Council of Applied Economic Research, (NCAER) based in New Delhi, India. The views expressed are his own and not of NCAER.*

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