# National Manufacturing Competitiveness Council (NMCC)

## Current Global Financial Crisis and its impact on India-

## Measures for Ensuring Growth of the Real Sector of the Economy

# Steps suggested by the NMCC on 20th November 2008

The Prime Minister has been stressing on the need to ensure that the impact of the financial sector problems on the real sector should be addressed on priority. For this purpose, rightly a group has been constituted under the Chairmanship of the Prime Minister which includes Finance Minister, Commerce & Industry Minister, Deputy Chairman, Planning Commission and Governor, Reserve Bank of India. A Committee under the Chairmanship of the Finance Secretary has also been constituted with Commerce Secretary, Industrial Policy & Promotion Secretary, and Planning Commission Secretary as members for attending to day-to-day issues in this regard.

## I. Background

2. The slow down of the industry as well as the economy from its peak in 2006-07 started from the first quarter of 2007-08. In other words, the economic slowdown has been taking place for the past 18 months. The manufacturing industry, which registered a 12.6% growth in the year 2006-07, has been declining continuously quarter after quarter. The growth of manufacturing in the quarter ending September 08 is 5.74 per cent. Thus, the slow down process in India began much before the impact of rising oil prices and financial crisis in the West and its impact on Indian stock markets.

3. The oil prices rose and impacted on inflation and on the growth of manufacturing sector during the past three quarters. The economic slow down which began in the first quarter of 2007-08 got accentuated by the abnormal increase in oil prices from the beginning of 2008 and further by the financial melt down particularly in the past couple of months in the Western countries. Therefore, it is necessary to look at all the causes which contributed to the slow down of manufacturing.

4. The chief reasons for the beginning of the slow down of the Manufacturing sector in particular, were undoubtedly the rising interest rates and the appreciating rupee. The interest rates had to be increased because of the excessive liquidity in the system and to contain inflation. The excessive liquidity was caused due to abnormal inflow of capital flows during the past couple of years particularly of the less stable variety. In particular in the year 2007-08 as much as US$ 92 billion were

added to the Foreign Exchange reserves. Quite a substantial part of this money was inflows due to FII investments, private equity investments and External Commercial Borrowings (ECBs).

5. The FII money went into the stock market predominantly and increased the valuations of the stocks to historically high levels with the BSE Sensex reaching 21,000 mark in a relatively short period. It created unreal valuations for stocks which increased the net-worth of the companies and individuals. The ECBs also parallelly increased as companies have leveraged their bloated net worth to buy/invest in new ventures both in India and abroad.

6. The other impact of the flow of FII and other capital inflows and of the ECBs was to strengthen the rupee against dollar. The rupee appreciated by about 15% and reached a level of little over Rs.39 to a dollar by October, 2007. The unusual liquidity in the system created by external flows was also fuelling inflation which in turn required actions on the interest rates. All these developments had an adverse impact on the growth of the manufacturing sector, particularly more severely on the Micro, Small and the Medium Industries.

7. With the melt down in the financial sector in the West, the FIIs and other less stable flows are being withdrawn fairly abruptly particularly during the past two months causing turmoil in the stock markets resulting in the BSE Sensex touching as low a level as 8500 mark with the consequent impact on the net worth of the companies and of the individuals holding the stocks. The withdrawal by FII has also set in motion liquidity crunch bouts in the domestic markets. In other words, the present turmoil is substantially the result of disproportionate influence of unstable external flows in building up the stock market prices and the reserves.

8. The Reserve Bank of India in consultation with the Government has been taking actions to inject liquidity into the system through substantial reduction of CRR and some reduction of SLR. Parallelly, in order to encourage companies to borrow from the Banks and Financial Institutes and invest, the repo rate has been brought down to encourage softening of PLR rates. The impact of these measures in the first round have not been encouraging so far. The inter-bank call rate did not settle down to the acceptable 6 to 7 per cent level instead it has been fluctuating widely between 6 to 17 per cent. The recent cut of CRR and SLR has further increased liquidity in the system. However, the call rates still are above the acceptable range indicating need for further actions to stabilize the markets and give enough confidence for the banking sector to on lend to the real sector.

9. The root cause of the current crisis does not appear to be due to the classical business cycles. It is probably because of a highly

irresponsible overleveraging undertaken by the financial institutions abroad causing excessive liquidity in the system leading to large capital flows particularly to developing countries. These flows boosted the stock market and led to an unrealistic sense of well-being by the domestic corporates and others. What we are now witnessing is the impact of the pricked bubble due to deleveraging and not the classical downward cycle caused by the lags in consumption investment cycle. Hence, the solution to the present situation need to be different from what normally is advised in the case of a classical business cycle down turn.

## II. The Present Situation and Prospects

### Real Sector

10. The slow down of the real sector, in particular the manufacturing sector, is likely to continue in the wake of inadequate liquidity in the system as well as relative unwillingness of the banks to lend particularly to the SMEs. The pressure on the banks has also got accentuated in view of the fact that the larger companies are unable to access the external markets for their investments and, therefore, are turning to the domestic banks. The slow down has been occurring in almost all major sectors of manufacturing and it is expected that the growth rate in the manufacturing for October is likely to turn negative. There are reports of negative growth in respect of Automobile Industry including the Auto component Industry, Textiles and Garments, Leather, Gems and Jewellery, Construction Industry etc. The estimates indicate already nearly one million jobs have been lost in these sectors with several companies reducing their strength and many small industries particularly in the Export oriented sectors closing down. The situation is worsening day by day.

11. Now, it is clear that all major economies are in a recession mode and the reversal of the situation may take atleast 2 to 3 years, if not more. Given the recessionary conditions in India's export markets, the likelihood of external demand supporting growth and employment is bleak atleast for the next couple of years. In addition, the imports pressure from China is increasing. There has been a phenomenal growth of Chinese imports of manufactured goods and currently India is running about US $ 20 billion trade deficit with China. The Chinese are also likely to seek the markets in India more aggressively since their main export markets in the western countries are also slowing. Given the external conditions, support being given/under consideration to the exporters would at best ensure halting deterioration of the situation and ensuring that exports contribution to growth does not become negative.

The external demand would not in the near term be able to contribute additionally to growth of the manufacturing sector or of the economy.

12. The impact of recent reduction in International oil prices is also not being passed down since the oil companies have already incurred heavy budgetary deficits. Unless the current trend of lowering of International oil prices continues for some more time the possibility of reduction in energy costs is unlikely and therefore of any help to the domestic manufacturing sector. In these circumstances it is imperative to provide substantial stimulus to the domestic economy to create necessary demand. In this context the role to be played by the RBI and by the Government becomes important.

## External Sector

13. Non-oil trade deficit has been expanding since 2003 onwards. From a level of almost trade balance in 2003 the trade deficit is likely to reach five to six per cent of GDP in the current year. Even though, the reduction in oil prices could soften the impact on trade deficit it is unlikely to have a major impact. During the past few years, the trade deficit was financed through substantial invisible earnings and capital flows. Given the recessionary conditions in the developed countries the software industry which has been contributing substantially to the invisibles is not likely to post as robust a growth this year as in the recent past. Already there are several reports of the software exports slowing down in dollar terms and the companies postponing fresh recruitment due to slowdown Similarly, the other areas of the service sector such as travel, tourism, etc., are also unlikely to perform both due to global conditions and the slowing of the domestic economy. These developments would mean that unless appreciable correction takes place on the merchandise trade side the current account deficit is likely to enlarge substantially.

14. The capital flows are also under pressure. The Foreign Institutional Investments have turned negative. Large amounts are being withdrawn by the FIIs. The flows into NRI deposits can be made more attractive by increasing deposit rates but that would increase the cost of funds for the banks and thereby the elbow room for other monetary steps would decrease to that extent. The external commercial borrowings are also drying up while huge outflow of repayments under this head is expected in the coming year. The estimates show that within the next one-year as much as US $ 45 billion has to be repaid to foreign financial institutions.

15. Given the situation in the developed countries, there is no likelihood of positive FII inflows in the coming year of two. The resumption would depend on how quickly the financial sector recovers in

the major markets. As of now it is estimated that the FII investment in Indian markets is around $ 65 to 70 bn. If rapid withdrawal of these investments take place there would be immense pressure on balance of payments as well as liquidity. Eventhough the flow of FDI has been encouraging in the first half of the current year, it remains to be seen, given the lack of demand in the export markets and sluggishness in the domestic market, whether the FDI flows will remain robust. There are indications of slowing down in new capacity creation and postponing investments. If the developed countries act quickly in providing export finance, it could help exporters to some extent. Quick flows from International Financial Institutions like IMF and World Bank is unlikely. Even if new loans are sanctioned the fund flow will take at least 18 months to two years to materialize.

16. As a result of these developments on the balance of payments side we are already witnessing a huge draw down of reserves. As much as US $ 63 billion have been drawn down during the past few months. Since September the depletion has been over US $ 40 billion. Due to these pressures on the external front the rupee depreciated substantially in nominal terms from Rs.42 to over Rs.49 within past two months i.e. nearly 16 percent. Unless urgent measures are taken on the real sector side it would be difficult to hold the level of the rupee without losing the reserves heavily. That would in turn result in loss of confidence of the foreign investors which would hurt inflows. The answer to these issues would be in building up real reserves through posting trade surpluses. This would require enormous effort particularly in respect of the manufacturing sector which contributes to over 70 per cent of the merchandise exports. Plans need to be drawn up in this regard for ensuring long term stability of the external sector.

## Financial Sector

17. The Indian financial sector was affected fairly severely due to the conditions in the global financial sector particularly due to the withdrawal of funds by the FIIs. The slow down in export earnings and the other capital flows have induced a huge liquidity and credit crunch in the domestic markets due to heavy foreign exchange outflows. The steps taken by the Government and the RBI to improve liquidity though CRR reduction and SLR cut have temporarily improved the liquidity situation in spurts. These steps, however, have not so far contributed to stable liquidity conditions. The call money rate continues to be fluctuating because of the withdrawal by the FIIs.

18. The Banks in general have become extremely risk averse and not providing necessary credit to the Industry, in particular, to the SMEs even in respect of ongoing projects. They seem to be reappraising the

risks in the light of current developments. The liquidity provided by the RBI seems to have gone substantially into funding FII withdrawals and to the oil companies. The large Corporates who were banking on ECB flows earlier are also turning to domestic Banks for their fund requirement further squeezing the fund availability to smaller firms.

19. The financial sector developments also are having a huge fall out on the major infrastructure projects. For some months now the infrastructure projects in PPP mode have slowed down because of fund constraints mainly. The bidding for new projects is coming to a standstill with no bidder turning up particularly for highway projects. The position in respect of other major infrastructure projects is no better. These developments are another major drag on growth prospects including employment.

## <u>Public Spending</u>

20. The actions relating to public spending mainly concentrated on ensuring the funds already available in the Plan budget are spent particularly in respect of the infrastructure projects. Spending on the infrastructure projects taken up under Public-Private Participation (PPP) mode as well as purely on private sector mode are also being monitored for speedier implementation. How effective these steps would be for generating the necessary demand in the real sector and enable growth momentum to pick up quickly is a matter for debate. The financing issues that are bogging down the infrastructure have been highlighted at para 19 Above. Besides, it takes time for actual expenditure to take place even if additional funds are provided for infrastructure. There appears to be a need for taking actions for increased public expenditure/fiscal measures to support the employment/export-oriented sectors. However, this alone may not be sufficient. Additional measures for increasing domestic demand across the sectors would need to be put in place.

## <u>III. Measures suggested for immediate action</u>

21. Prudence demands that the Government should balance the growth aspirations and keeping inflation within reasonable limits. However, for the reasons enumerated in the previous paragraphs the scenario in respect of external sector is particularly disturbing. With the increased integration of India with the rest of the World the outfall of the external sector developments will continue to affect not only the domestic financial sector but also the real sector. It is felt that the severity of the impact is unlikely to diminish in the near future, thus calling for urgent and substantial actions.

22. In the absence of external demand stimulus it is imperative that the domestic demand is increased through a very substantial economic stimulus package. It would be wiser to undertake even somewhat larger stimulus actions early rather than wait till the situation further deteriorates needing even more drastic actions later. In order to ensure domestic demand growth particularly in the industrial sector which has a multiplier effect on the Agriculture as well as the Services sector, the following measures are suggested:

- **The measures to increase liquidity** by the Reserve Bank of India have given a temporary respite. However, given the fact that there is a continuous outflow of foreign exchange causing liquidity problems it will be necessary to **continue using this instrument** till liquidity conditions stabilize. In addition, the Reserve Bank of India should encourage domestic demand for credit through **further reduction of interest rates**. It is essential also to look at the sectors that should be supported through funding by the Banks. Funding sectors that originally caused the asset price bubble such as the Real estate sector should be approached with great caution to ensure no repetition of the asset prices reaching unreal levels once again. Instead public spending on housing needs to be increased.

  The above actions on the part of the Reserve Bank of India alone would not be sufficient to halt the deterioration in the situation. Despite recent efforts the flow of funds to the real sector has not been adequate in view of the high and understandable risk aversion of the banks and its impact particularly on the SME sector. **The efforts to instill confidence among the Banks for resuming normal lending need to be pursued vigorously** so that they respond to the task. Given the limitations of what the RBI can do the Government needs to take urgent actions for stimulating demand both on the external front as well as on the domestic front.

- Within the Manufacturing sector, MSME sector is the most vulnerable segment. The major fear the sector has and is suffering from is lack of adequate credit flow. In the current situation special efforts are needed to ensure that the sector is given all necessary help. These will include **reduction of risk weightage for MSMEs** by RBI and if necessary, Government should create a risk fund to be operated during the period of crisis. The RBI should also **create a separate refinance window for the MSMEs** to ensure that sufficient liquidity is available for this sector during these difficult times.

- The best way of **creating fiscal stimulus is through reduction of taxes.** There is a case for **reducing Excise Duties/VAT/Sales Tax** in most of the sectors that are facing severe slowdown. The Government should immediately move to take urgent actions **in the current**

**scenario co-ordinated action with State Government is essential. A meeting with the State Governments should be called to impress on them the need to reduce taxes** in the overall interest of growth of the economy and employment. An agenda should be got ready for the purpose. Once again the sectors that need priority actions are those that would generate immediate local employment.

- Government has been taking a number of steps in respect of the export oriented industry. However, a **comprehensive set of actions are required to ensure that the main export oriented sectors** like the textiles and garments, leather, auto components etc. **are given urgent support** since quite a bit of their production goes into exports. A sense of urgency is required in dealing with those industries which are mostly in the small scale sector.
- There is an urgent need for public spending which would immediately create demand. The areas for public spending mainly are the infrastructure and the social sector projects. It is essential to speed up the implementation of these projects. However, the bulk of the money has to be spent on infrastructure and the issues bogging down the infrastructure sector particularly the projects in PPP and Private sector mode have been listed out already at para 19 above. Given these constraints it would not be realistic to expect 'Express Spending' in this area. **This would require public spending in infrastructure through enhanced allocations to the public sector.** The main bottleneck in public sector spending happens to be the procedural labyrinth which needs to be over come. The fear of CVC, CAG etc. is one of the reasons for excess caution and red tape on the part of spending entities. Given the current exceptional circumstances a high level meeting may be called where the CAG and CVC should also be invited to find solutions to the problem. They also need to be alerted to the seriousness of the problem and the need for urgent action.
- **A massive programme of housing should be undertaken under public sector.** In the past the State Housing Boards, Housing Corporations as well as DDA have provided affordable housing to the Low Income and Middle Income Groups. This practice has been given up as the State Governments and DDA have gone in to making money by auctioning land in their possession. Infact, the high upset prices set by these bodies have been often cited as responsible for the real estate bubble creation as the private land developers exploited the situation. It is necessary to immediately take up massive public housing to stimulate demand.
- **The increase in public spending should be made in such a way that bulk of it is directed towards domestic manufacturing and not**

**imports**. Otherwise our public spending would be supporting the domestic demand of other countries. In this context the rapid inflow of Chinese imports which has been described at para No.11 needs to be kept in mind. Action should be taken to see that the demand created is not satisfied through the surging Chinese imports. Special provisions including countervailing duties need to be put in place by identifying sectorwise requirements. **If necessary, Government should be ready to levy appropriate import duties to support domestic manufacturing growth** in the current situation. When normalcy returns to the major world markets and our own domestic conditions ease these could be reversed.

- **The use of custom duty weapon should ensure domestic value addition.** It would not be desirable to unduly put tariff barriers in respect of inputs to the manufacturing industry, particular of commodities that have enjoyed a run of high profits recently when International prices were ruling high. It is necessary to keep in mind that **input costs need to be kept as low as possible** so that value added manufacturing remains competitive and growth takes place.

- The next stimulus that can be provided by the Government relates to **immediate release of the Central Pay Commission arrears in full to the Central Government employees** which number nearly 40 lakhs. Similar actions should also be taken by the State Governments that have adopted the Central Pay Commission Rules. This would provide an immediate and direct stimulus particularly for the consumer durables as well as for construction industry. This action coupled with a decrease in interest rates and increase of liquidity by the Reserve Bank of India would quickly provide necessary growth stimulus.

- **In the unlikely event of excessive capital outflow** causing worrisome depletion of foreign exchange reserves, the **Government should be ready with a set of temporary capital controls** (as was done by Malayasia during South-East Asian crisis in 1997) for use as needed. In this context, the **regulations regarding India's outward investment also need to be revisited** to prevent easy route for foreign exchange outflow.