Global Financial Crisis and Impact on Indian Economy

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Abstract-*The term financial crisis refers to the loss of confidence in a country's currency or other financial assets causing international investors to withdraw their funds from the country. There is every possibility of direct as well as indirect implications of the crisis on all the economies of the world. The crisis has affected the entire global economies in one way or other. The current global financial crisis is the worst of its kind in the history of world economy since great depression of 1930s. The present study makes an attempt to identify the immediate impact of the financial crisis on indian economy in terms of selected economic indicators. The study examines the trends in export, import, gdp growth rates etc in the context of indian economy against the background of global financial crisis and subsequent global recession. India is considered to be highly vulnerable to a crisis like this because of its greater integration with the rest of the world. There are some reasons to believe that the financial crisis affected indian economy adversely by slowing foreign remittances, foreign investment, adverse bop position etc. However, indian economy shows the symptoms of rapid recovery from the sudden set back it had to undergo during 2008-09 and future trends also.*

Key words: *financial crisis, contagion, loss of confidence, inflation, balance of payments, fiscal deficit.*

Introduction

The term financial crisis refers to the loss of confidence in a country's currency or other financial assets causing international investors to withdraw their funds from the country. Financial crisis means a sudden change in the financial stability in the country, a situation where some of the huge financial institutions suddenly lose a large part of their assets. Some financial crisis may be due to the down turn of banking institutions, or may be due to stock market crashes or bubble, or huge inflation, or sovereign default, etc.the financial crisis and associated recession originated in the us in early 2008 and then spread to europe has by engulfed most of the economies in both developed and developing world. The various economic activities such as production, employment, saving, investment, consumption etc are being badly affected and thereby the economy of the country as well as an individual do undergo a downturn during the crisis. Historically, the world economy witnessed several financial crises in the past few decades .the most severe was the great depression of the 1930s .later on the world witnessed the opec oil crises of the 1970s ,the us saving and loan crisis of the 1980s ,has made an economic downturn in the japanese economy in the 1990s and the asian financial crisis in the latter part of 1990s all these recessionary trends had been accompanied by shocks to the economies of one or more markets and it took several years of concerted economic and regulatory policy adjustments for the affected markets to return to stability. It is quite natural for financial crises to occur frequently, and the affected economies to recover subsequently.

The Beginning Of The Crisis

Beginning with bankruptcy of lehman brothers in 23rd september 2008 entered an

acute phase marked by failures of prominent us and european banks and efforts by the american and european governments to rescue distressed financial institutions in the us by passage of the emergency economic stabilisation act of 2008 and in european countries by infusion of capital in to major banks. It is stated that an excessively loose monetary policy in the 1990s in major developed economies transformed into global imbalances and a full-blown financial and economic crisis for all the economies of the world (mohan, rakesh, 2009). As we learn, the current financial crisis in united states originated due to the indiscriminate lending of housing loans in the country's sub-prime mortgage market. The investment in real estate and the housing sector had started in the u s from the early 2000s and by 2007 there was a kind of housing boom in the us economy which led to mismatch between supply and demand. The clients were, of course, the investors with poor financial background and having insufficient financial resources. As there was inadequate demand for houses in the market, the investors in the housing sector could not sell them out profitably and failed to repay the bank loans. Thus, the sub- prime lending resulted in high level defaults. Though there was repayment of defaults on the one side ,the banks ,in to to maintain confidence ,continued to give fresh loans .the banks gradually takeover loans and assets .the investors try to avoid heavy risks started complex transactions inspite of sliding value of assets. All these led to severe credit crunch in us especially in the banking sector.

The five largest u.s. Investment banks, with combined liabilities or debts of $4 trillion, either went bankrupt lehman brothers, were taken over by other companies (bear stearns and merrill lynch), or were bailed-out by the u.s government (goldman sachs and morgan stanley) during 2008. Government-sponsored enterprises (gse) fannie mae and freddie mac either directly owed or guaranteed nearly $5 trillion in mortgage obligations, with a similarly weak capital base, when they were placed into receivership in september 2008. For scale, this $9 trillion in obligations concentrated in seven highly leveraged institutions can be compared to the $14 trillion size of the u.s. Economy (gdp) or to the total national debt of $10 trillion in september 2008. As a result of the financial crisis in 2008, twenty five u.s. Banks became insolvent and were taken over by the federal deposit insurance corporation (fdic). As of august 14, 2009, an additional 77 banks became insolvent. This seven month tally surpasses the 50 banks that were seized in all of 1993, but is still much smaller than the number of failed banking institutions in 1992, 1991, and 1990. The united states has lost over 6 million jobs since the recession began in december 2007. City bank, bank of china , banco de oro of philippines, bangkok bank , bank of nova scotia of singapore all these asian banks failed during crisis. Years of unrestrained spending, cheap lending and failure to implement financial reforms left greece badly exposed when the global economic downturn struck. National debt, put at €300 billion ($413.6 billion), is bigger than the country's economy, reached 120 percent of gross domestic product in 2010.

Indian Economy During Financial Crisis

The impact of financial crisis is already felt in terms of reduced export earning, drastic decline in industrial growth and employment, depreciation of rupee, reduction in foreign exchange reserves, down turn in stock markets and many other indicators. The stock of foreign exchange declined from $330 billion some six months before to 245 billion by the first week of december 2008 and the bse index declined from over 20000 during the early months of 2008 to 9000 during the last week of november 2008. The impact of the global crisis on india can broadly be divided into three different aspects: (1) the immediate direct impact on its financial sector; (2) an indirect impact on economic activities; and (3) potential long-term geopolitical implications.

Fortunately, india, like most of the emerging economies, was lucky to avoid the

first round of adverse affects because its banks were not overly exposed to subprime lending. Only one of the larger private sector banks, the icici, was partly exposed but it managed to counter the crisis through a strong balance sheet and timely government action. The banking sector as whole maintained a healthy balance sheet and, over the third quarter of 2008 –a nightmare for many big financial institutions around the world–, india's banks reported encouraging results and witnessed an impressive jump in their profitability.

However, the indirect –or second-round– impact of the crisis has affected india quite badly. The liquidity squeeze in the global market following lehman brothers' collapse had serious implications for india, as it not only led to massive outflows of foreign institutional investment (fii) but also compelled indian banks and companies to shift their credit demand from external sources to the domestic banking sector. It thereby exerted pressure on domestic market liquidity, thereby giving rise to a credit crunch. Coupled with the ensuing loss of confidence, this increased the risk aversion of indian banks, hurting credit expansion in the domestic market.

Additionally, given the recession in the developed world, the demand for indian exports in their major markets has almost collapsed. Merchandise exports shrank by more than 17% from october 2008 to may 2009. The decline in exports has accelerated, with a drop in may 2009 of 29.2% compared with may 2008. Likewise, exports of services are also facing a steep downturn. In the third quarter of 2008-09, growth in services exports declined to a mere 5.9%, compared with 34% in the same period a year back. Earnings from travel, transport, insurance and banking services have contracted, while the growth of software exports declined by more than 21 percentage points. The real shock came in the fourth quarter of 2008-09 when services exports contracted by 6.6% over the same period a year back.

India is not completely insulated against financial crisis. To some extent it is protected but still there is blow on our economy due to this crisis. The reasons why it was protected to some extent can be mentioned as below:

1. Our growth has been largely domestic demand driven with a comfortable level of foreign exchange reserves.
2. In our economy derivatives market is much regulated where it won't allow for immediate profit recognition.
3. The strength in balance sheets displayed by india inc due to domestic financing.
4. Lastly another reason for this is the proactive steps taken by government of india, of whom dr. Rangarajan has always been in forefront to take steps to keep us on safer side.

Challenges of Indian economic growth

The media and the official economists are going gaga over the high growth rate achieved in the indian economy in the last year. They are claiming that india has withstood the economic crisis; the growth rate has reached the pre-crisis level and india has reached a path of sustained high growth. This rosy picture has several black marks and exposes the vital flaws in the indian economic scenario. The potential rate of growth of an economy is the maximum sustainable rate at which an economy can grow without causing a rise in the rate of inflation. The potential growth rate is determined by the growth in the economy's productive capacity which, in turn, depends on the growth in inputs (labor, capital, land, etc.) And technology. An economy can grow above the potential rate for some time but that will trigger rising inflationary pressures. Growing below the potential rate will imply a rise in the rate of unemployment. The indian economy, which had grown at an average annual rate of close to 9 per cent during 2003-08, slowed down to 6.8 per cent in 2008-09 in the wake of the global crisis. The growth rate picked up to 8.0 per cent in 2009-10 and a robust 8.9 per cent in the first half of 2010-11.

The macroeconomic indicators affecting the indian economy are illustrated in succeeding paragraphs:

1. High inflation

Inflation rate refers to a general rise in prices measured against a standard level of purchasing power. The most well known measures of inflation are the cpi which measures consumer prices, and the gdp deflator, which measures inflation in the whole of the domestic economy.

Table: 1 Inflation Rate

2008	**8.349**
2009	**10.882**
2010	**11.989**
2011	**9.00**
2012	**6.50**

Source: morgan stanley

The inflation rate in 2008 stood at 8.349, and then there is a continuous increase up to 2010. In 2012 there is a marginal decrease and it is forecasted by morgan stanley that in 2013 the inflation rate will reach 5.90 and in 2014-18 the rate will reduce to 5.5.

2) Slow reform movement

The reformist movement started off well during the phase 1 of upa ruling. Though, the pace of reforms was mired by obstructive policies of left-coalition partners, the seeds were sown for a fast-paced reformist movement in the ensuing phase which bypassed the leftists altogether. Further, the 2nd phase started off with the big-bang reform initiatives such as the women's reservation bill, the gst structure which intends to swallow all sundry taxes and biggest ever indirect tax reform in the form of dtc.while dtc just managed to get the appointment of the finance minister by 2012, the gst reform got stuck in the mess of outstanding issues between the states and the centre.

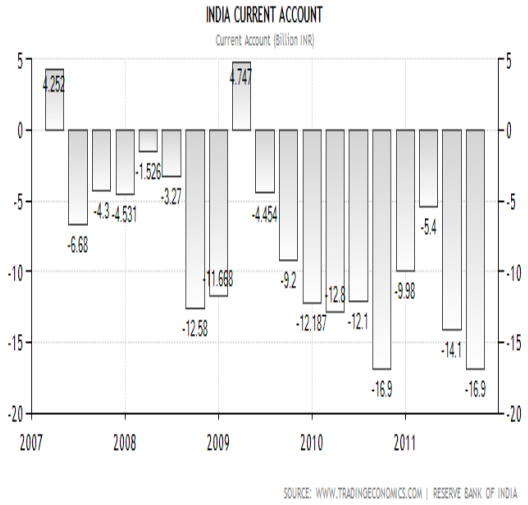
3) Earnings slowdown

High inflation and rising interest rates scenario does not impact individuals and tax-payers alone. It also affects corporate profitability. Higher input costs leads to squeeze in corporate margins at operating level or a spill-over to generalized inflation if the same is passed on to final consumers. While the pure commodity players are likely to benefit from the demand and supply mismatch, others involved in processing of raw-materials and turning them into finished goods might see an impact on the cost of goods sold and operating margins of the company. In such a scenario, companies that rely on high volume growth and master cost efficiency techniques, can weather the crisis through strategic planning or sometimes even by passing on the rising input burden to the final consumers.

4) Current account deficit

The current account deficit occurs when a country's total imports of goods, services and transfers are greater than the country's total export of goods, services and transfers. This situation makes a country a net debtor to the rest of the world. India reported a current account deficit equivalent to 16.9 billion usd in the third quarter of 2011. India is leading exporter of gems and jewelry, textiles, engineering goods, chemicals, leather manufactures and services. India is poor in oil resources and is currently heavily dependent on coal and foreign oil imports for its energy needs. Other imported products are: machinery, gems, fertilizers and chemicals. Main trading partners are European Union, the United States, china and uae. India's current account deficit has surged to 4.1% of gdp during second quarter of the fiscal as against

3.2% the previous year. Merchandise trade deficit widened to $35.4 billion during q2 fy11 as against $31.6 billion in previous quarter as growth in imports far outpaced the progress in exports. In its policy review, the rbi had warned that high current account deficit – 3.5% of gdp for the fiscal 2010-11 – is not sustainable. The central bank had also indicated that soaring oil prices could have negative impact on the trade balance going forward. The high current account deficit coupled with large fiscal deficit could play havoc for india in sustaining in its dream run amongst other emerging market economies. According to directorate general of foreign trade(dgft) , india's trade deficit for the year is likely to range between $115-125 billion.



Source: www.tradingeconomics.com

Finance minister pranab mukherjee on february7 2012 said that the main reason for decline in the gdp growth is slowdown in industrial growth, in particular in investment growth, but exuded confidence that the growth figures could be revised upwards when the full data for year 2011-12 becomes available. "no doubt these are challenging tasks, but national and international environment has thrust upon challenges. We shall have to face these challenges collectively,"

5) industrial growth

The volatility in the industrial output numbers announced over the last few months has left economists high-and-dry with regard to arriving at any type of conclusion on growth figures for the economy. In latest, the core growth (country's infrastructure sector output) registered a smart comeback in december 2010 with 6.6% growth. These core sectors – crude oil, petroleum refinery products, coal, cement and steel – accounts for almost a quarter of the country's iip. Thus, it raises hopes of robust december overall the index of industrial production (iip) data. The iip compares the growth in the general level of industrial activity in the economy with reference to a comparable base year. However, in november the slowdown in industrial production had hit an 18-month low of 2.7%, raising questions on the veracity of an index data. Further, lower growth in manufacturing and electricity has pulled down iip growth in august 2010.

6) rising interest rates

Rising interest rate scenario can directly impact the growth prospects of a nation as it sums up to costly working conditions and operating environment. In its mid quarter monetary policy review announced on, february 12 2012 rbi announced no change in key policy rates and reserve ratios. The key rates/ratios remain at the existing level as shown below;

Table: 2 Key Rates / Ratios

Rate	2009	2010	2011	2012
Repo	4.75	6.25	8.25	8.5
Reverse repo	3.25	5.25	7.25	7.5
Msf rate	9.25	9.25	9.25	9.5
Crr	6.00	6.00	6.00	5.5
Bank rate	6.00	6.00	6.00	9.50

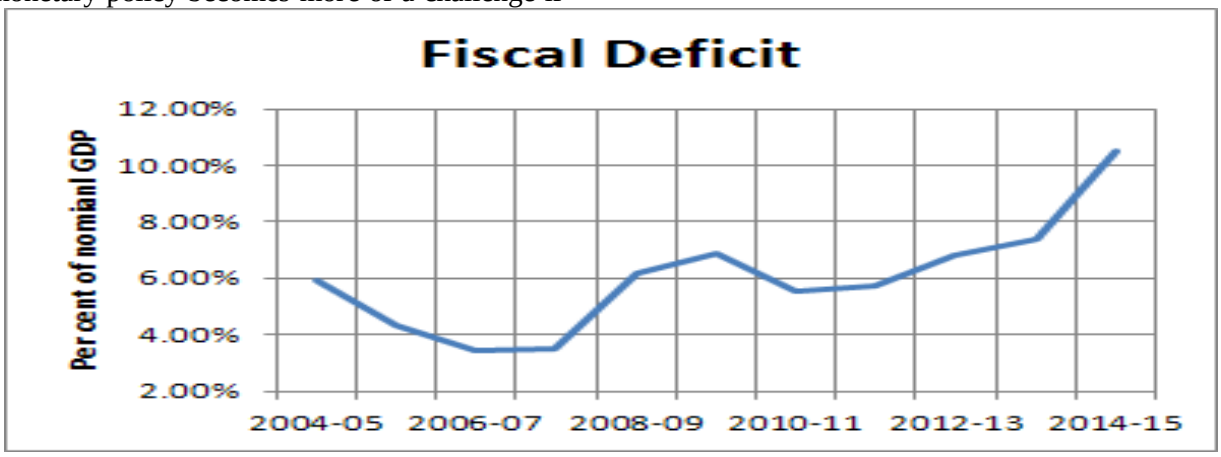
Source: RBI bulletin

Whenever there is an adjustment of the msf rate, rbi will consider and align the bank rate with the revised msf rate. All penal interest rates on shortfall in reserve requirements which are specifically linked to the bank rate. Msf, instituted at 100 basis points above the policy

repo rate, has been in operation, which more or less served the purpose of the bank rate. At present, the repo rate is 8.50 per cent, reserve repo 7.50 per cent and msf 9.50 per cent on april 2012 onwards . Repo rate is the rate at which banks borrow funds from the central bank and reverse repo rate is the rate at which banks park their funds with the central bank. Under the msf, banks are permitted to avail themselves of funds from the rbi on overnight basis.

7. Fiscal deficit

When a government's expenditures exceed the revenue that it generates, it is a case of fiscal deficit. Though, fiscal deficit is not necessarily a negative economic event, a controlled fiscal situation points towards a balanced budget policy of a country. More recently, rbi had indicated that managing inflation through monetary policy becomes more of a challenge if the fiscal deficit goes unguarded. The government has set a deficit target of 4.8% of gdp for fy12. Analysts are of the opinion that delay in reform rollover such as implementation of gst, adoption of food security bill, pass on of the oil subsidies to the final consumers could affect growth and delay fiscal consolidation.



Source: RBI bulletin

8. Fii selling

In the present global scenario, india has been considered as the most promising and fast growing economy in the world. Due to the liberalized rules for foreign direct investment (fdi) in india, the real estate, telecommunication, services, construction activities, power etc have become very attractive investment avenues for both the domestic as well as foreign investors. Similarly, due to the increased activities of foreign institutional investors (FIIS) like mutual funds, pension funds etc, the foreign portfolio investment in the country has witnessed tremendous upswing during 2008. The overall foreign investment in india met serious setback during the crisis.

Table 3: indicators of income flow and foreign investment

Year	Income flow to india		Foreign investment in india	
	Values in crores	% change	Values in crores	% change
2001-02	16080	-	73435	-
2002-03	17049	6.03	67401	-8.22
2003-04	17909	5.04	148811	107.84

2004-05	20638	15024	210047	41015
2005-06	28426	37.74	341818	62.73
2006-07	42016	47.81	597139	74.69
2007-08	57300	36.38	1082001	81.19
2008-09	65512	14.33	737696	-31.82
2009-10	62016	-5.44	Na	…….

Source: www.rbi.org

Table 3 shows that the foreign investment in india has been growing at a faster rate since 2003-04. However, during 2008-09, the very year hit by the crisis, the foreign investment declined significantly showing a negative growth rate of 31.82 per cent. It was seen that the net portfolio flows to india soon turned negative during the financial crisis as foreign institutional investors rushed to sell equity stakes in a bid to replenish overseas cash balances6. A similar trend of negative growth is found in case of income flow to india - including investment income and compensation of employees- during 2008-09 and 2009-10.

Table 4: merchandise export and import

Year	Export		Import	
	Value in 000' crores	% change	Value in 000' crores	% change
2001-02	213	-	268	-
2002-03	260	22.07	312	16.42
2003-04	304	16.92	367	17.63
2004-05	382	25.65	534	45.5
2005-06	466	21.99	695	30.15
2006-07	583	25.01	863	24.17
2007-08	668	14.58	1035	19.93
2008-09	857	28.29	1405	35.75
2009-10	862	0.06	1423	0.13

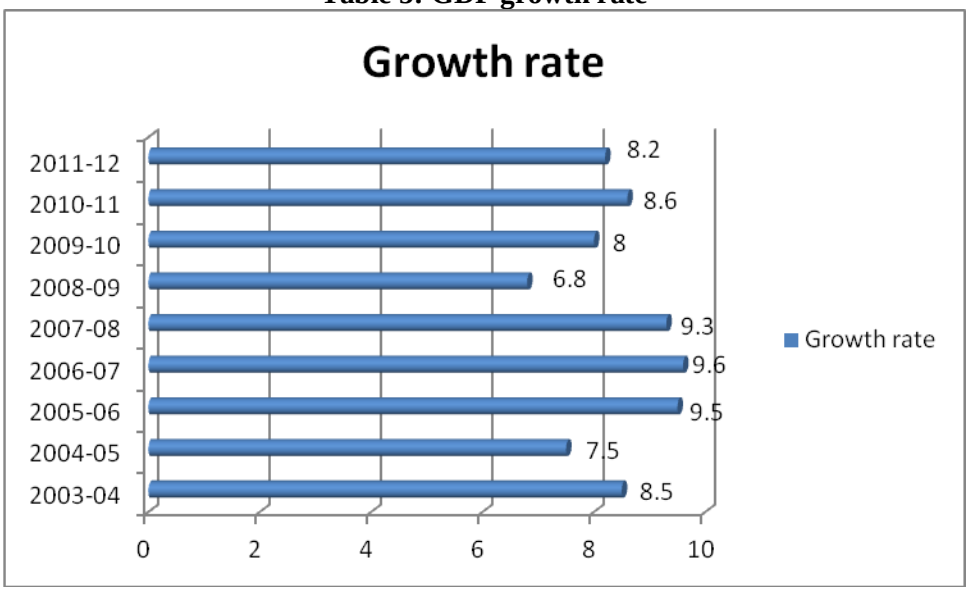
Source: www.rbi.org

The worldwide financial crisis has caused fall in india's merchandise exports and imports.. Other sectors like tea and carpets were also down by 20 percent and 32 percent, respectively. Overall merchandise export and import have been significantly improving since 2001-02. The growth momentum continued till 2008-09. But the trade partners, european union and the us, were both in the throes of financial crisis. The merchandise export which recorded a growth rate of 28.29 per cent during 2008-09, immediately turned down with major growth of only 0.06 per cent. The very similar trend is found in case of india's merchandise imports. It slid down from a growth rate of 35.75% during 2008-09 to 0.13 % during 2009-10.

9. Gdp growth rate of indian economy

Gross domestic product (gdp) refers to the market value of all final goods and services produced within a country in a given period. Gdp per capita is often considered an indicator of a country's standard of living.

Table 5: GDP growth rate



Source: RBI bulletin

The macroeconomic and financial indicators most importantly pointed to a strong and vibrant indian economy prior to the financial crisis. Table 5 presents the gross domestic product (gdp- stands for the money value of all final goods and services produced within the domestic territory of a country during a fiscal year) growth rate of indian economy for the fiscal years from 2003-04 to 2011-12. (*the fiscal year for india starts in april and ends in the following march*). The gdp was growing at the rate of 8.5%, 7.5%, 9.5%, 9.6% and 9.3%, respectively, for the five years leading up to the crisis. However, the crisis affected external as well as internal sectors of the national economy led to a reduced growth of the domestic economy. That is the gdp growth rate declined from 9.3 per cent to 6.8 per cent during 2008-09.in 2011-12, the growth rate is reduced to 8.2.morgan stanley opines that gdp growth is expected to decelerate next year to the lowest level since the financial crisis. During 2012-13, it may decline to 7.50and 2014-2018, it will reach 8.5 %.

10. Unforeseen events

The global warming is the biggest issue for the environmentalists today. Every few days we get to hear the news of either an earthquake or tsunami or a volcano erupting and damaging life and trade across the world. Nature has its own way of taking revenge against the man-made destruction of environment. In this new century, the magnitude of such natural occurrences is so huge that it can devastate the whole of village or district where it strikes. It severely affects the

logistics and trade in the area and alienates the location for days together which can hurt the economic activity for a prolonged period

Table 6: Prospects For Indian Economy

Challenges	Risks	Positives
Domestic weak supply response, high inflation deceleration of private consumption shoring up investments demand rebalancing - private and government consumption to private and public investment	twin deficits– fiscal and current account fiscal slippage revenue erosion rising input costs rise in cost of capital due to monetary tightening falling business confidence	productivity in farm sector string domestic demand due to rising incomes structural dimension to robust services sector growth sustainable baseline cad at threshold of 2.7-3.0% stable trade deficit
Global limitations of fiscal and monetary space for counter-cyclical stimulus against global uncertainty	global uncertainties, particularly post-downgrade of us debt difficulties in euro zone widening sovereign cds spreads elevated global commodity and oil prices near-zero rate policy of fed until mid-2013	robust export performance, led by services stability in incoming private transfers

www.careratings.com

There is potential for still higher growth on a sustained basis of 9+ per cent in the years ahead, but among other things, this would require the following:

(i) revival and a vigorous pursuit of economic reforms at the center and in the states;

(ii) a major effort at raising the rate of domestic savings, especially by reducing government dis savings at the central and state levels through cuts in, and refocusing of, explicit and implicit subsidies, stricter control over non-developmental expenditures, improvements in the tax ratio through stronger tax enforcement, and strengthening incentives for savings;

(iii) larger investments in, and better performance of, infrastructural services, both in the public

And private sectors; and
(iv) greater attention to, and larger resources for, agriculture, social sectors and rural development programs to increase employment, reduce poverty and for creating a mass base in Support of economic reforms.

Conclusion

The GDP growth rate of Indian economy was also met a slow down during the period of financial crisis. The contagion effects of the financial crisis spread from the advanced economies to the indian market in three distinct channels – the financial channel, the real or trade channel, and the confidence channel. India's central bank – the reserve bank of india (rbi) took a number of monetary easing and liquidity enhancing measures to facilitate flow of funds from the financial system to meet the needs of productive sectors. A number of steps like cutting down the cash reserve ratio (crr), relaxing statutory liquidity ratio (slr) by one per cent, have been taken to address this problem. Rbi also announced a 100 basis points cut in the repo rate, which is the rate at which banks can borrow against surplus slr securities. All these timely and strong steps taken by the monetary authorities helped indian economy show a rapid recovery from the Financial crisis. The economy remained on the path of rapid resurgence which began in 2009-10 and has virtually returned to the high growth path that it had achieved during 2005-08, before the Global financial crisis and economic meltdown. In January 2012, care ratings released its projections of various economic variables for 2012 and 2013.the report projects that India's GDP growth in FY 12 will be 7%, which is likely to rise to around 7.5 in FY 13 under certain assumptions made relating to the global economy and domestic policy responses. The fiscal deficit for FY 12 will not meet the budgets target of 4.6 % of GDP and would be higher on account of slippages and excess expenditure. Monetary indicators look to be weaker with growth in credit being 165 and deposits 18%. Therefore, while a gradual recovery is expected in the economy in fy 13, it is contingent on the policy action of the government.

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