Global Financial Crunch And India's Economic Growth: A Deep Insight

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INTRODUCTION

The whole world was again reminded of the Great Depression of 1929 when on 15th September 2008; the world famous investment bank, Lehman Brothers filed their claim for bankruptcy.15th September 2008 was the day when the extent of the catastrophe of the financial market was made known to the entire world. It was just like a "financial tsunami". Infact, whether it was the Great Economic Depression of 1929 or the Financial Crisis of 2008, all these are genesis of the heedless race of interminable gain (capital).

AMERICAN FINANCIAL CRISIS

The Root Cause

The last one decade of American economy was the decade of consumption and loan rather than that of production and saving; ignoring the law of Glass-Steagal[1] formed in 1929 to avoid a replay of the Great Depression of 1929 and encourage saving . The law was followed till 1980.After that, a careless attitude was inspired by the American Federal Reserve. Americans lived in the illusion that the whole world is investing in the world's largest economy to enable them to be a part of the global economy.

Glass-Steagal Law[1]: Law of Glass-Steagal came into existence to avoid the replay of the Great Depression of 1929.The law created a boarder for every activity of the banking sector by analyzing the activities say retail, investment and commercial banking etc. and its prime objective was to make the banking sector more responsible. The law was formed to encourage saving among public.

THE ERA OF COST FREE LOANS

The present crisis was seeded in the period of Greenspun, the President of Federal Reserve who remained in power for 19 years. Attack on World Trade Center and the downfall of dotcom companies' shares created the danger of depression in the American economy. Greenspun (as a precautionary measure to avoid depression) followed the policy of cheap money (at low rate of interest).The interest rates were reduced to such a low level that it seemed to people that the loans were available free of cost, without any down payment and without any inspection of financial capability. This continued for about 3-4 years. It ultimately caused consumer loan to cross 80% of the GDP of America's economy that led to inflation in the American Economy. More over, rising prizes of crude oil added fuel to the fire.

After Greenspun, the next president of the Federal Reserve was Dr. Ben Barnake. As a control weapon, he intensified the level of interest that could not decrease the inflation, but this action depressed the home loan payers that caused the decrease in prices of American real estate. When loan payers proved to be defaulters, the banks started selling their risk by converting them into stocks but by then, it was too late and it resulted in the downfall of Merrill Lynch and Lehman Brothers.

TREND OF OUTSOURCING BY AMERICAN COMPANIES

American companies follow the rules of a capitalist economy and they established their production units outside the country and have been out sourcing work to gain cheap and technical labor force mostly from developing economies like India. It led to lack of jobs for Americans that caused reduced purchasing power of Americans.

IMMEDIATE CAUSE

How the crisis turned on: - However, the immediate cause was the rise of the sub prime crisis in the American economy.

Big investment banks like Lehman Brothers (besides consulting) provide loans and take positions in security transactions with other banks. Lehman Brothers bought mortgaged loans from other banks and sold them in the form of bonds, thereby making profit form the spread. For example, if there was 8 percent rate of interest on

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mortgaged loans and Lehman Brothers spread them at the interest rate of 6 percent, the difference of 2 percent was the profit for the Lehman. But when loan takers proved defaulters, the bonds (mortgaged loans) lost their value. As a result, there was a Domino effect[2] that caused Lehman Brothers and Merrill Lynch to declare themselves as insolvent.

THE SUB PRIME CRISIS

In America, loan takers are categorized in two sections depending upon their repayment record of principle amount and interest their on:-

Prime: This is the category of customers who have good record of repayment of interest and principle amount of loan.

Sub prime: Those who have not good record of repayment of interest and principle amount of loans. Usually, banks don't want to spread such risky loans that might turn into bad debts.

But during the period 2002-2007, American banks distributed loans in bulk to reap into the booming American real estate that began in 1998 in expectation that customers would be sure to repay the home loans. More over, big investors like mutual funds and head funds invested in sub prime loans; as a result, there was further money with banks that led to a boom in the sub prime loan market. Being a sub prime, loan banks distributed them at higher rate of interest and at higher installment to customers. In the year 2007,the real estate boom came to an end that caused rapid fall in the real estate sector and the sub prime loans started turning bad debt and since the loans were in the form of home loans, the homes were captured in case of non-payment of loans that led to further decrease in American real estate sector, that finally proved fatal for the American banks.

DOMINO EFFECT[2]: WHAT HAPPENED WITH LEHMAN BROTHERS AND MERRILL LYNCH?

The domino effect is a chain reaction that occurs when a small change causes a similar change nearby, which in turn leads to another similar change, and so on in linear sequence. The term is best known as a mechanical effect, and can be explained by using the analogy of a falling row of dominoes. It typically refers to a linked sequence of events where the time between successive events is relatively small. It can be used literally or metaphorically (complex systems such as global finance, or in politics, where linkage is only a hypothesis).It is just like the falling of a row of playing cards when one card is pulled out.

To escape from the impact of the American crisis, Britain, Japan, Switzerland, Canada and Russia European Union and India spend about 600 billion dollars. Is it not absurd that the American Government came forward to rescue the private companies? The same Government was ready to hand over the whole economic system to the market. The Bailout Package of Rs. 700 billion dollars is not enough to create any impression against the crisis.

IMPACT OF GLOBAL FINANCIAL CRISIS ON INDIA

The current financial crisis has affected India in two ways.

- ***First,*** there has been financial contagion and spillovers of stock markets in emerging markets. As an immediate impact, FII's pulled out about 7.8 billion dollars from the Indian market that caused a two way effect. One of them is rapid fall of sensex and nifty. The rapid fall of sensex halted the IPO's of many companies this year. The IPO market dropped down to 62% since last year. Experts believe that it would take about 2-3 years to reach its earlier peak. The second one is increase in the level of exchange rate of rupee in terms of American dollar.

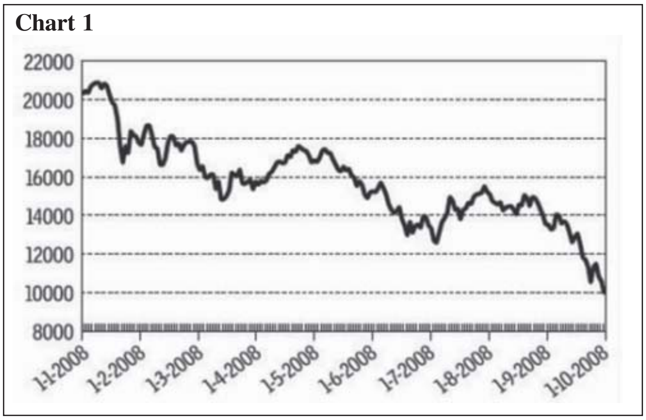
Table 1: TOP 10 SINGLE DAY FALL OF THE SENSEX

DAY	POINTS
October 24,2008	1131.82
October 10,2008	800.10
March 17,2008	951.03
March 13,2008	770.63
February 11,2008	833.98
January 22,2008	857
January 21,2008	1408.35
December 17,2007	769.48
March 31,2007	726.85
May 18,2006	826

(Source: www.bseindia.com)

The figure depicts the worst hit share market that caused it to fall below 10000 points as shown by the chart- 1 below.

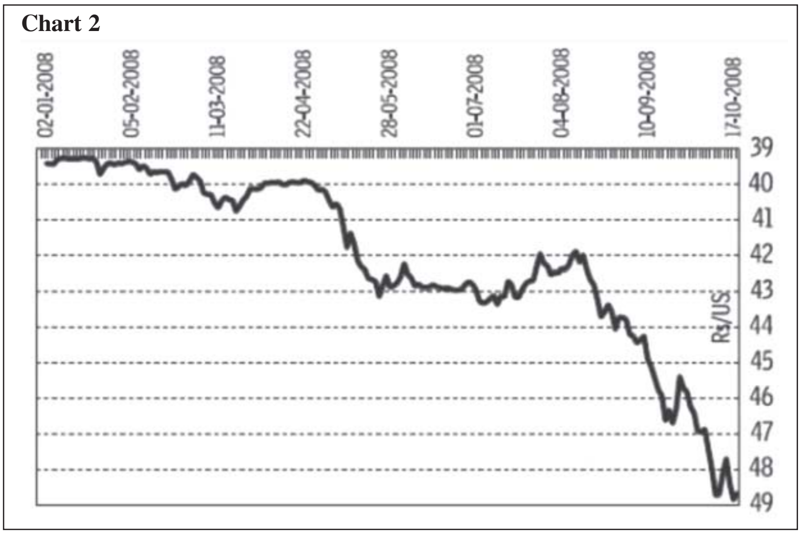
DAILY MOVEMENT OF SENSEX IN 2008



(Source: Business Line, the Hindu, Tuesday 21, Oct, 08)

The withdrawal of funds by FII's has also resulted in increased exchange rate of rupee in terms of American dollar. The exchange rate increased from Rs. 40.34 per dollar (US $ 1= Rs. 40.34) in September, 2007 to Rs. 48.74 per dollar (US $ 1= Rs.48.74) in October, 2008. The chart-2 depicts the fluctuation style of the exchange rate.

EXCHANGE RATE OF RUPEE VERSUS DOLLAR (RBI REFFERENCE RATE)



(Source: Business Line, the Hindu Oct. 21, 08)

In India, the immediate and direct effect have been mainly in the equity markets because of reversal of portfolio equity flows, and the concomitant effects on the domestic forex market and liquidity conditions. The macro effects have been muted due to the overall strength of the domestic demand, the healthy balance sheets of the Indian corporate sector, and the predominant domestic financing of investment.

The main impact of the global financial turmoil in India has emanated from the significant change experienced in the capital account in 2008-09, relative to the previous year as indicated in the table below. Total net capital flows fell from US$17.3 billion in April-June 2007 to US$13.2 billion in April-June 2008. While Foreign Direct Investment (FDI) inflows continued to exhibit accelerated growth (US$ 16.7 billion during April-August 2008 as compared with US$ 8.5 billion in the corresponding period of 2007), portfolio investments by foreign institutional investors (FIIs) witnessed a net outflow of about US$ 6.4 billion in April-September 2008 as compared with a net inflow of US$ 15.5 billion in the corresponding period in 2007.

Similarly, external commercial borrowings of the corporate sector declined from US$ 7.0 billion in April-June

2007 to US$ 1.6 billion in April-June 2008, partially in response to policy measures in the face of excess flows in 2007-08, but also due to the turmoil in advanced economies. With the existence of a merchandise trade deficit of 7.7 per cent of GDP in 2007-08, and a current account deficit of 1.5 per cent, and change in perceptions with respect to capital flows; there has been significant pressure on the Indian exchange rate in recent months. Whereas, the real exchange rate appreciated from an index of 104.9 (base 1993-94=100) (US$1 = Rs. 46.12) in September 2006 to 115.0 (US$ 1 = Rs. 40.34) in September 2007, it depreciated to a level of 101.5 (US $ 1 = Rs. 48.74) as on October 8, 2008.

Table 2: Trends in Capital Flows (US $ million)

Component	Period	2007-08	2008-09
FDI to India	April-August	8,536	16733
FII'S(net)	April-Sept	15,508	-6,421
External Commercial Borrowings (net)	April-June	6,990	1,559
Short term trade credit (net)	April-June	1,804	2,173
MEMO:			
ECB approvals	April-August	13,375	8,127
Foreign exchange reserve (variation)	April-Sept,26	48,583	-17,904
Foreign exchange reserve(end period)	Sept. 26, 2008	247,762	291,819

(Source: BIS review 122/2008)

- ***Second,*** the economic downturn in developed countries affects developing countries. The channels of impact have affected the following:-
- ***Export:*** America is among our largest importers, then it is obvious that Indian export would be hurt; especially software industry, because India's 40 percent software products are exported to the American and European banking industry that is likely to affect the revenue and employment status of the software industry of the nation. The BPO industry has been hit by the American companies as there has been downturn in their business activities due to the financial crisis.
- ***Remittances***: There have been fewer remittances and also lower volume of remittances per migrant due to recession.
- ***Foreign direct investment (FDI) and equity investment***: Both of these came under pressure. Year 2007 was fruitful from the point of view of FDI but it is in severe pressure due to recession. Corporate and project finance are in weak position.
- ***Commercial lending***: Banking sector of developed economies already facing liquidity crunch may not lend us as much as they have done in recent years. This would limit and change the growth pattern of a developing economy like India. Indian companies (which had access to cheap foreign currency funds for financing their export and import) have been worst hit.
- ***Aid*****:** Aid budgets are facing hurdle due to debt problem and weak fiscal positions. India wants to collect about 150 billion to develop its infrastructure sector from international funding agencies but to have the same target; India will have to collect 30 billion dollars per year for five years which seems to be very difficult in such a critical situation. In such situation, cement, real estate, steel and some other industries have been affected.
- ***Other financial flows***: Capital adequacy ratio of Development Financial Institutions has been under pressure.

The economy has been affected in the following way:

- Weaker export revenues.
- Further pressure on current account and balance of payment.
- Lower investment and growth rates.
- Volatile Stock Market.

Social effect Caused By Recession:

- Low growth rate leads to greater poverty.
- More crime, weaker health systems and also more difficulty in meeting the millennium development goals.
- Many people were laid off due to severe pressure on resources.

As far as the Indian banking industry is concerned, it has very little exposure to US mortgage market, therefore they do not have direct exposure to sub-prime crisis. However, few banks did suffer losses due to market to market losses caused by widening of credit spread arising from sub-prime on term liquidity in the market, even though the overnight market remained stable.

REACTION OF RBI

To calm the nervous Indian economy, RBI has undertaken following steps.:

As a response, RBI has reduced the repo rate (rate at which it lends to bank) by 1% from 7.5% to 6.5% and the reverse repo rate (rate at which banks lend to RBI) by 1% from 6% to 5% effective from December 8, 2008 to facilitate cheaper loans for trade.

- RBI reduced CRR by 100 bps to 6.5%. Rs. 400 billion was infused into the system.
- RBI raised interest rates ceiling on NRI deposits by 50 basis point, thereby providing additional liquidity.
- RBI also decided to resume special market operations for buying oil bonds from petroleum marketing companies.
- To help mutual funds, RBI has allowed banks to have additional liquidity upto 0.55 of their Net demand and Time liabilities (NDTL) in addition to reducing statutory liquidity ratio (SLR) to 24% of NDTL.
- RBI has also provided more headroom for banks to raise funds from their overseas branches up to 50% of their unimpaired tier-I capital or $ 10 million, whichever is higher.
- The Reserve Bank of India has raised the external commercial borrowing (ECB) limit for corporates to $500 million under the automatic route in a year, for rupee or dollar expenditure.

SEBI RESPONSE

- SEBI, as a response, decided to lift the curbs on the issuance of participatory notes (P notes).
- The limit on external commercial borrowing (ECB) by corporate sector has been increased to ensure the inflow of foreign capital in the market.

REACTION OF FINANCE MINISTRY

- Finance ministry raised oversees borrowings caps for infrastructure companies for rupee expenditure from $100 million to $ 500 million.
- Finance ministry expanded the definition of infrastructure companies to include mining, exploration and refining companies for ECB purpose.
- The Indian Government doubled the FII investment cap in corporate debt to $6 billion to encourage flow of foreign investment.

Further, Indian Government also announced a financial package of Rs. 200 billion in 2009. This was in addition to the package announced in the year 2008 (of Rs. 300 billion).

Moreover, the **Chamber of Industry and Commerce** issued an ****eleven point agenda*** for dealing with the impact of the Global Financial Crisis. The issues are explained below:

Key Issues to be addressed:

- Domestic liquidity shortage.
- Exchange rate volatility and reduction in access to foreign currency funds.
- Inadequate credit availability and slowdown in demand.
- Decline in business and investor confidence and optimism.

HIGHLIGHTS OF RECOMMENDATIONS

Domestic liquidity and interest rates:-

1. Further reduction in repo rate by at least 50 bps and in CRR by 150 bps to ensure adequate liquidity and reasonable cost of funding.
2. Provision of liquidity to mutual fund and NBFC sectors to enable orderly operation of financial markets.
3. Guarantee for all bank deposits for a two year period to maintain depositor confidence in the banking sector.

Foreign exchange management:-

4. Focused exchange rate management to prevent volatility without reducing rupee liquidity.
5. Permitting higher levels of FDI in order to attract foreign capital.
6. Utilization of foreign exchange reserves for meeting critical foreign currency needs.
7. Removal of the cap on NRE and FCNR (B) deposits.

Credit flow and impetus to growth:-

8. Establishment of a corpus for lending to SMEs.

* Source - CII

9. Speedy release of government funds for various projects to ensure timely implementation and generation of economic activity.
10. Fast tracking of all infrastructure projects to spur investments and growth through inter-sectoral linkages.

Communication:-

11. Comprehensive communication exercise by Government and regulators in consultation with industry to articulate the approach to mitigate risks arising out of the global financial crisis and strengthen confidence in the economy.

LONG TERM IMPACT OF THE CRISIS

Though India has been affected with the global financial crunch in short run, but in the long run, the impact would not be alarming. Though the recovery from financial turmoil would be slow, but India would be able to face the crunch with the help of domestic capital formation accompanied by high saving rates and highly functional capital markets.

Factors Behind India's Relative Immunity:-India being a liberalized economy is obviously facing financial crunch but the overall impact has been moderate due to the following reasons:-

- ***Firstly,*** India's dependency on export is rather low as a driver of economic growth. Out of the total deposits share, foreign deposit is only 1.5%. Further, following globalization, India has diversified its trade practices with East Asian countries during the last decade. We have only 17% share of export in our total domestic product and the software and BPO industry enjoy major share in India's total export.
- ***Secondly,*** Major impact of US slowdown was on FIIs inflows that primarily affected the stock market and put upward pressure on rupee's exchange rate. FDI inflows as a driver of growth were not much affected by the crisis because India's fast growing and large economy provides huge potential market for MNCs from all dimensions.
- ***Thirdly,*** Indian economy is still dependent upon its domestic demand. India's major growth drivers are domestic consumption and investment rather than export. Therefore, these two factors were not drastically affected by the financial crunch.
- ***Fourthly,*** Major Asian countries such as Japan, China, and South Korea etc. have large pools of foreign exchange reserve with India that is more than $3 trillion. These foreign exchange reserves can be deployed within the region for infrastructure investment.

CONCLUSION

In brief, the Indian economy has no direct relationship with the US financial crisis. Any such crisis in India is near impossible since only 3-5% of all home purchase/construction have been completed with mortgages. U.S. and other major European countries will continue to have Indian outsourcing services. However, the Indian economy has been interrupted and faced a slowdown due to global economic melancholy but the economy will win back the present enigma to regain its pace in the subsequent years.

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