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Global Financial Crises: Bindings on India

AUTHORS

Dr. Anshul Sharma
Mangalmay Institute of Management Studies, Greater Noida.

Dr. Amit Gupta
Mangalmay Institute of Management Studies, Greater Noida.

ABSTRACT

The intensification of the global financial crisis, following the bankruptcy of Lehman Brothers in September 2008, has made the current economic and financial environment a very difficult time for the world economy, the global financial system and for central banks .The global financial crisis originated in United States of America. Investment banks have collapsed, rescue packages are drawn up involv-ing more than a trillion US dollars, and interest rates have been cut around the world in what looks like a coordinated response. Leading indicators of global economic activity, such as shipping rates, are declin-ing at alarming rates. The current financial crises in the U.S. have originated in the indiscriminate lending of housing loans in that country's sub-prime mortgage market. Among the clients were the investors with poor credit histories or insufficient financial resources. Sub-prime lending has resulted in high levels of defaults. The banks were laying huge bets with each other over loans and assets. Different views on the reasons of the crisis include boom in the housing market, speculation, high-risk mortgage loans and lending practices, securitization practices, inaccurate credit ratings and poor regulation of the financial institutions. The financial crisis has not only affected United States of America, but also European Union, U.K and Asia. The global crisis has hit India through a "sudden stop" of capital inflows and a collapse of both external and domestic demand. The growth of the economy dropped to 6.7 per cent in 2008-09 (April-March) from 9.0 per cent in the previous year and is projected to decline further in 2009-10 to about 5.0 per cent. In this study I will attempt to provide my interpretation of the unfolding of the present global financial crisis; how it is affecting us; why the Indian financial sector has been able to weather the crisis relatively well; the analytics of our policy response; and, finally, some implications of its longer lasting effects.

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1. INTRODUCTION

The existence of financial crises does not change our assessment that, on balance, financial development and globalization are good for poverty reduction in the longer-term. However, this positive long-run relationship can coexist with a negative short-run relationship through financial fragility. This can reflect fundamental distortions that build up for a long time, largely hidden from view, before a macro shock reveals the underlying vulnerabilities. But financial crises can also strike economies with relatively sound institutions and generally good policies. Arguably, greater openness in areas such as trade and migration helps countries deal with domestic shocks, but may well increase vulnerability to external shocks. Globalization has probably facilitated contagion of the 2008 financial crisis, although some economies and some people are likely to be more vulnerable than others. A financial crisis refers to a loss of confidence in a country's currency or other financial assets causing international investors to withdraw their funds from the country. Financial crisis is applied broadly to a variety of situations in which some financial institutions or assets suddenly lose a large part of their value. The proximate cause of the current financial turbulence is attributed to the sub-prime mortgage sector in the USA. Surplus inventory of houses and increase in interest rates led to a decline in housing prices in 2006-2007 resulting in an increased defaults and foreclosure activity that collapsed the housing market (Sengupta 2008)

At a fundamental level, however, the crisis could be ascribed to the persistence of large global imbalances, which, in turn, were the outcome of long periods of excessively loose monetary policy in the major advanced

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economies during the early part of this decade (Mohan, 2007, Taylor, 2008). Due to globalization, the Indian economy cannot be insulated from the present financial crisis in the developed economies. The investments in Indian firms by these U.S. investment bankers are a major worry for Indian investors. Indian stock market has seen its worst time with the global financial crises. Mostly all the industrial sectors experienced a consistent low in their stock prices. Despite all this, Indian policy makers still seem to be caught in some complacent time-warp, whereby they proudly point to the GDP growth rate (now spluttering, but still high by international standards) and to the supposed "resilience" of the domestic financial sector. The current slowdown in GDP is sharper than the government would like to admit, and more significantly it has been accompanied by a much steeper than expected reduction in employment, especially in export sectors.

2. CRISES REFLECT SYSTEMIC RISK

An economy-wide crisis strains coping strategies for dealing with variability and risk at firm, household and community levels given that the more covariate nature of the shock limits the scope for co-insurance; mutual insurance arrangements may even break down when faced with a large external shock. Research on the impact of the 1995 "Peso crisis" in Mexico (resulting in a 9% decline in GDP in that year) revealed that many of the normal strategies of poor households (such as seeking credit, extra work or private transfers) failed during the crisis. However, connections and support networks still play a role. For example, there is evidence that firms had a lower probability of filing for bankruptcy when they had ownership links to banks and families. The tightening of formal credit also limits the scope for households and firms to buffer themselves.Credit growth slow substantially, and recovers more slowly than output. Banks, including healthier ones, reallocate their asset portfolio away from loans. Other sources of credit are also affected. We have studied the effect of financial crises on trade credit. The empirical findings indicate that, although provision of trade credit increases right after the crisis, it subsequently collapsed in the following months and years. Firms in a weak financial position—for example, those with a high pre-crisis level of short-term debt and low cash stocks and cash flows—are more likely to reduce trade credit provided to their customers. This suggests that the decline in aggregate credit provision is driven by the reduction in the supply of trade credit, which follows the bank credit crunch.

Methodology: The present study focuses on

- The origin and causes of global financial crisis.
- The impact of the crisis on the Indian economy.
- The data for the study has been collected from secondary sources.

Causes of Financial Crisis: The first hint of the trouble came from the collapse of two Bear Stearns hedge funds early 2007. Subsequently a number of other banks and financial institutions also began to show signs of distress. Matters came to the fore with the bankruptcy of Lehman Brothers, a big investment bank, in September 2008. The main causes of financial crises are:

i) Boom in the Housing Market.
ii) Inaccurate Credit Ratings.
iii) High- Risk Mortgage Loans and Lending practice.
iv) Poor Regulation.
v) Securitization Practices.
vi) Speculation.

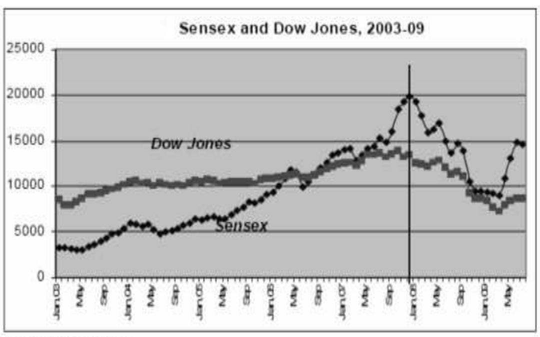
3. EFFECT OF FINANCIAL CRISES ON INDIA

India's engagement with the global economy became deeper from the 1990s. Total merchandise trade which was hardly 15 per cent of India's GDP in 1990-91 (April-March) rose by nearly two and half times to

36 per cent of GDP in 2007-08; invisibles trade rose about fourfold from just 5 per cent of GDP to 19 per cent in the same period; and capital flows increased even faster at more than fivefold from 12 per cent of GDP to 65 per cent of GDP over the same period. Indian economy began to slow down in 2007-08 (April-March) after reaching a GDP growth of 9.8 per cent in the last quarter of 2006-07. In fact, Indian economy grew at an annual average rate of 8.8 per cent during the five years ending 2007-08. In the first half of the financial year 2008-09, the growth rate dropped to 7.8 per cent

***Indian Stock Market*:** The first impact of the global crisis on India was felt in the stock market in January 2008. An eventful week of great turbulence has begun in the global financial scenario as stock prices dipped across much of the globe on news that investment bankers, Lehman Brothers Holdings filed for bankruptcy and Merrill Lynch & Co's forced sale to Bank of America. Mostly all the industrial sectors experienced a consistent low in their stock prices. Stock prices have fallen by 60 per cent. Fig.1 indicates that India's stock market index—Sensex— touched above 21,000 mark in the month of January,2008 and has plunged below 10,000 during October 2008 (Kundu 2008)

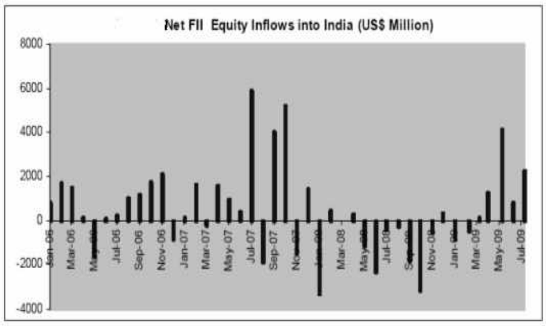
Fig. 1



Source: Yahoo Finance.

Foreign Institutional Investment: The movement of Sensex shows a positive and significant relation with Foreign Institutional Investment flows into the market. This also has an effect on the Primary Market. This came through the reversal of inflows from foreign institutional investors (FIIs) into the country. Fig.2 shows India had received about US$ 17.7 billion as net equity investment inflows from FIIs during 2007. This turned into a net disinvestment of US$ 13.3 billion during the period from January 2008 to February 2009. This was the direct result of the massive de-leveraging of US banks after the financial meltdown. The combination of a rapid sell off by financial institutions and the prospect of economic slowdown have pulled down the stocks and commodities market. Foreign institutional investors pulled out close to $ 11 billion from India, dragging the capital market down with it (Lakshman 2008).

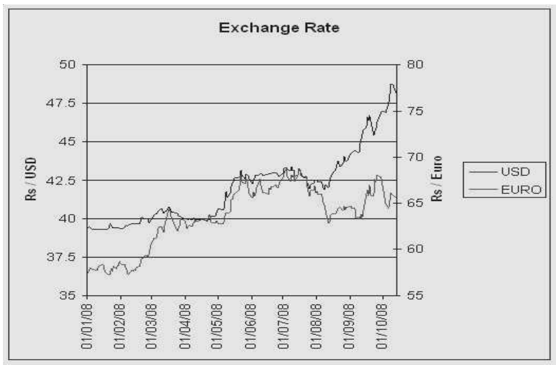
Fig. 2



Source: Securities Exchange Board of India.

Exchange Rate: Exchange rate volatility in India has increased in the year 2008-09 compared to previous years. Rupee value against the US dollar has weakened dramatically. One reason might be the foreign fund inflow into India that was so prominent in the last couple of years, has turned negative. Between January 1 and October 16, 2008, the Reserve Bank of India (RBI) reference rate for the rupee fell by nearly 25 per cent, from Rs.39.20 per dollar to Rs.48.86 (Chandrasekhar and Gosh 2008). The Reserve Bank of India intervened by selling dollars to smoothen the fall of the rupee. The heavy selling led to a massive depletion of the stock of reserves. The Dollar has also strengthened against most currencies globally, not due to any strength of the US economy, but due to a 'flight to safety' of global capital. The US Dollar has been the world's reserve currency for several decades now. The Rupee's fall against other major currencies has been less pronounced, as seen in the Figure 3 below.

Fig. 3

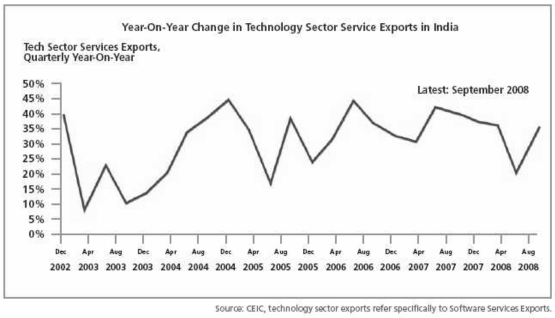


***Banks*:** The ongoing crisis has an adverse impact on Indian banks. The large investment

Banks originally from the US, had invested substantially in the stocks of Indian banks. Some of the Indian banks have invested in derivatives which might have exposure to investment bankers in U.S.A. However, Indian banks in general, have very little exposure to the asset markets of the developed world. Indian banks have very few branches abroad. Our Indian banks are slightly better protected from the financial meltdown, largely because of the greater role of the nationalized banks even today and other controls on domestic finance. Strict regulation and conservative policies adopted by the Reserve Bank of India have ensured that banks in India are relatively insulated from the travails of their western counterparts (Kundu 2008).

Information Technology: With the global financial system getting trapped in the quicksand, there is uncertainty across the Indian Software industry. Accounting for over 25% of total exports, the IT outsourcing sector growing at around 30% a year for almost a decade but now it will be impacted by Global crisis. Approximately 61 per cent of the Indian IT Sector revenues are from U.S financial corporations like Goldman Sachs, Washington Mutual, Citigroup, Bank of America, Morgan Stanley and Lehman Brothers. The top five Indian players account for 46 per cent of the IT industry revenues. The revenue contribution from U.S clients is approximately 58 per cent. About 30 per cent of the industry revenues are estimated to be from financial services (Atreya 2008) Fig.4 shows that service export of IT sector in India fall tremendously in 2008.

Fig. 4



According to National Association of Software service Companies (NASSCOM), the sector growth for the year ending in March 2009 is likely to around 17%, compared with 21% in the previous fiscal year. For the coming fiscal year of 2009-2010, growth is expected to decline further, and may fall as low as into single digit territory.

Exports: The crisis will sharply contract the demand for exports adversely affecting the country's growth prospects. The worldwide financial crisis has caused up to 70 percent fall in India's exports. Handicrafts exports fell by 70 percent. Other sectors like tea and carpets were also down by 20 percent and 32 percent, respectively. Overall export growth went down to just over 10 percent from 26.9 percent. Two of India's largest markers, European Union and the US, are both in the throes of financial crisis. Bulk cargo shipping rates have also come down by nearly 50 percent.

According to the provisional data available from DGCI&S up to March 2009, India's Export percentage change in March

Export Performance Monitor

Export Performance of Principal Commodities : for March - 2009

(Figures in USD million)

Principal Commodity	Cumulative Exports - 2008-09	% change over 2007-08	% change in March-09 over February- 09	% change in March 09 over March 08
Transport equipment	11159.91	58.78	-13.02	-2.54
Machinery & instruments	10970.48	20.12	22.64	-10.51
Manufactures of metals	7562.84	7.20	-7.92	-31.15
Primary & semi-finished iron & steel	4741.54	14.09	12.42	-59.84
Non-ferrous metals	2016.18	-33.92	17.11	-77.58
Ferro alloys	1497.89	34.39	-5.24	-62.86
Iron & steel bar/rods	1090.26	-15.70	5.64	-65.90
Aluminium other than products	506.62	8.12	-43.23	-48.91
Machine tools	373.55	11.32	-43.76	-58.62
Residual engineering items	145.11	57.20	8.51	2.91
Mica	29.64	36.21	-14.34	-17.72
Grand Total	40094.02	18.80	0.47	-32.46

Source: DGCI&S Provisional Data

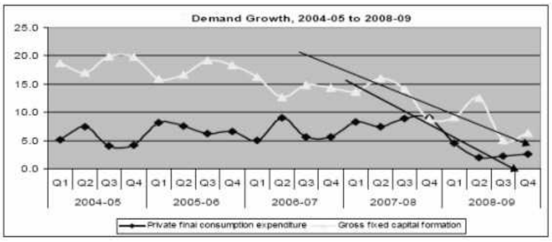
09 over March 08 is negative. Exports of all Principal commodities are decline in 2008-2009 and decline in export growth may sharply affect some segments of the Indian Economy that are export oriented. Rising unemployment and reduced spending by the Americans have forced some of the leading brands in the U.S to close down their outlets, which in turn has affected the apparel industry here in India. The U.S accounts for 55 per cent of all global apparel imports (Bageshree and Srivatsa 2008).

Impact on GDP**:** The growth in GDP moved down to 5.8 per cent (year-on-year) during the second half of 2008-09 from 7.8 per cent in the first half, shown in Fig.5. This can be attributed partly to the decline in private consumption growth to just 2.5 percent in the second half from and an already low growth of 3.3 per cent in the first half and an average consumption growth of 8.5 per cent in the whole of 2007-08 . Also, the growth in fixed investment declined to 5.7 per cent in the second half of 2008-09 from 10.9 per cent in the first half and an average of 12.9 per cent in 2007-08. The government consumption growth, on the other hand, rose steeply at 35.9 percent from just 0.9 per cent in the first half and 7.4 per cent in 2007-08 shown in Fig.6. The sharp rise in government consumption growth cushioned the sharp drop in aggregate demand and prevented a much sharper fall in GDP growth in the second half of 2008-09.

4. STEPS FOR RECOVERY

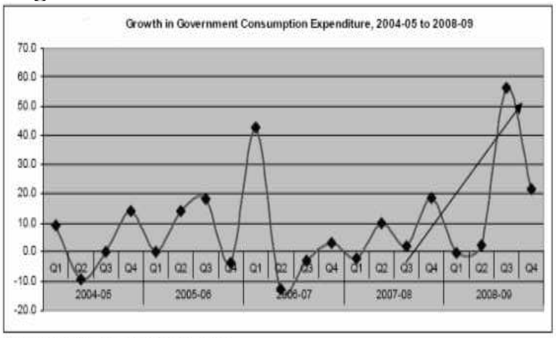
On October 20, 2008, Prime Minister Manmohan Singh in the Lok Sabha stated that Indian banking system is not directly exposed to the sub-prime mortgage assets. Their exposure to other problem assets is also minimal. The major policy response to the crisis came in the form of loosening of the monetary policy and administering fiscal stimulus packages. There were a few other measures like relaxation of

Fig. 5



Source: Central Statistical Organization.

Fig. 6



Source: Central Statistical Organization.

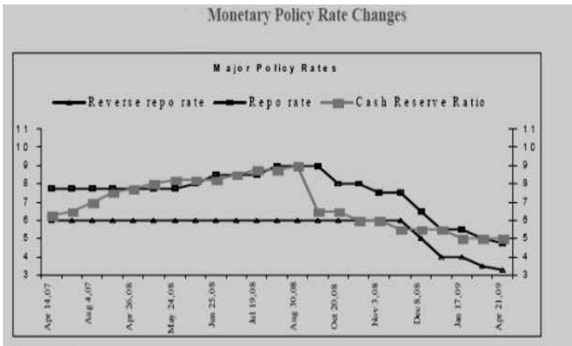
the cap of FII investment in debt and permission given to India Infrastructure Financing Company Limited (IIFCL) in floating tax-free bonds for infrastructure funding, etc. A number of steps have been taken to address this problem:

- Between October 6, 2008 to October 15, 2008, the RBI cut the Cash Reserve Ratio by a total of 250 basis points.
- The SLR (statutory liquidity ratio) requirements were relaxed initially by one percentage point and subsequently an additional window of 0.5 percentage points was introduced specifically to enable banks to draw funds to provide liquidity to mutual funds.
- As a result of these steps, the liquidity position in the financial system has improved considerably

In mid-September, the central bank started relaxing liquidity but no cuts were made yet in policy rates. Inflation measured in terms of wholesale price index (WPI) peaked at 12.9 per cent in early August 2008 and remained high for some time. From mid-September to till end-October 2008 the economy was in the grip of a serious liquidity crisis and credit crunch as detailed earlier. The Reserve Bank of India (RBI) acted aggressively from mid-October to ease the situation by a series of rate cutting and liquidity injecting measures till April 2009.

Through successive steps, the RBI brought down cash reserve ratio (CRR) from 9 to 5 per cent, statutory liquidity ratio (SLR) from 25 to 24 per cent, the repo rate from 9 to 4.75 per cent and reverse repo rate from 6 to 3.25 per cent as shown in fig.7.

Fig. 7



Source: Reserve Bank of India.

RBI announced a 100 basis points cut in the repo rate, which is the rate at which banks can borrow against surplus SLR securities. It will have a beneficial effect on the interest rate structure, and, in combination with the other steps to increase liquidity, will help to support economic activity and investment. Reserve bank of India and the government are carefully monitoring the flow of credit and will ensure that the additional liquidity infused into the system translates into actual credit. The RBI opened a special window for banks to lend to mutual funds, non-banking financial companies (NBFCs) and housing finance companies. The central bank also opened refinance facilities for banks, the Small Industrial Development Bank of India (SIDBI), the National Housing Bank (NHB), and the EXIM Bank. To maintain the adequate liquidity level, suitable advisories have been issued by the RBI and the Ministry of Finance to the banks to ensure that borrowers are provided adequate credit, including export credit and working capital. The RBI also introduced a liquidity facility for NBFCs through a special purpose vehicle (SPV), and increased export credit refinance. The actual/ potential release of primary liquidity by the central bank since mid-September 2008 has been massive at about Rs. 5617 billion amounting to about 9.5 per cent of GDP . The RBI also made dollar swap arrangements for branches of Indian banks in the US and Europe facing shortage of dollar funds with the seizing up of the inter-bank markets there.

5. CONCLUSION

While the developed worlds, including the U.S, the Euro Zone and Japan, have plunged into recession, the Indian Economy is being affected by the spillover effects of the global financial crisis (Chidambaram 2008).

There are broadly five areas in which fresh reforms are needed:

1. Infrastructure
2. Education
3. Agriculture
4. Investment climate
5. Delivery of public services

The Indian economy can recover fast if can get a big boost in domestic business and consumer sentiments which are badly shaken by the global crisis. This is very well possible by undertaking structural and procedural reforms as has happened in the early 1990s. Great savings habit among people, strong fundamentals, strong conservative and regulatory regime have saved Indian economy from going out of gear, though significant parts of the economy have slowed down and there is a wide variance of opinion about how long it will continue. Currently, India is facing a challenge. It is not a new phenomenon as India has faced challenges in the past and has overcome them. Our nation has strength to overcome the current challenges

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