The Impact of Financial Crisis on Indian Economy

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The Global Financial Crisis and its Impact on India's External Sector

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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. The financial crisis and associated recession originated in the US in early 2008 and then spread to Europe has by now engulfed most of the economies in both developed and developing world. 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 present study makes an attempt to identify the immediate impact of the financial crisis on major world economies especially Indian economy in terms of selected economic indicators. The study examines the trends in export, import, foreign remittances, earnings from business services, overall Balance of Payment position, 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. The study shows that 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.

Key Words:

Financial crisis, Great Depression, Emerging Market Economies, Foreign Direct Investment, Foreign Institutional Investment, Balance off Payments, GDP

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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. The financial crisis and associated recession originated in the US in early 2008 and then spread to Europe has by now engulfed most of the economies in both developed and developing world. The crisis, of course, being an unavoidable phase in the path of market economy, injures almost all sectors of an affected economy. 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. The speed and magnitude of the spread of the crisis from one corner of the world to the other is simply oiled by the globalisation process.

Historically the world economy has witnessed several financial crises in the past few decades. The most severe among them was the Great Depression of the 1930s which had very dangerous and protracted effect on the world economy compared to the current economic upheaval. Later on the world witnessed the OPEC oil crises of the 1970s, the United States Savings and Loan crisis of the 1980s, the prolonged economic downturn in the Japanese economy in the 1990s and the Asian financial crisis in the latter part of the 1990s. All these recessionary trends had been accompanied by shocks to the economies of one or more markets or regions 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; it nevertheless results in economic losses for the countries involved and for the people, businesses and institutions in those countries.

The beginning of the crisis

The Global Financial Crisis, which started in 2008, is considered to be the latest in the series of economic crises to adversely affect world economies. Unlike the past few crises, the current crisis has not spared any of the countries or market sectors, and has devastated economies that were traditionally strong. 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)[1].

The economic world heard about the recent crisis with the striking news of the collapse of an American bank, Leman Brothers, which was traditionally well experienced and financially very strong. The crisis in the financial sector had already started in the latter half of 2007 and finally burst out on 23rd September 2008 in the form of the collapse of the bank. 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 defaults on the one side, the banks, in order to regain confidence, continued to give fresh loans. The banks gradually wanted to take over loans and assets. Since the investors, realizing the situation, somehow wanted to avoid heavy risk started complex transactions in spite of sliding value of assets. All these led to severe credit crunch in United States especially in the banking sector. Finally the collapse of Lehman Brothers and the about to collapse news of Merrilinch affected the investing world losing confidence. The impact that followed was very deep throughout the world that was closely integrated during the globalization process.

Attempts are made by scholars and economists to find out the impact that the current crisis has brought about and the possible dangers that are about to occur. There is every possibility of direct as well as indirect implications of the crisis on all the economies of the world. Though the advanced western countries are more severely hit, the developing economies including India are not left free. Viswanathan (2010)[2] states that the problems that were first noticed in the U S sub-prime mortgage market quickly spilled over into the real estate and banking sector. From the financial sector, it moved on to the real sector in the U S market and then into the international markets. The contagion effect impacted both the advanced economies and the Emerging Market Economies (EMEs). (*Emerging market economy is defined as an* *economy with low to middle per capita income. Such economies constitute approximately 80% of the global population. The term EMEs was coined by Antoine W. Van Agtmael in 1981*).

In this context the present study focuses attention on the following objectives.

- *To identify and compare the immediate impact of financial crisis on the major global economies in terms of selected economic indicators*
- *To examine the impact of financial crisis on India's external sector and growth rate*

Financial crisis and the world economies

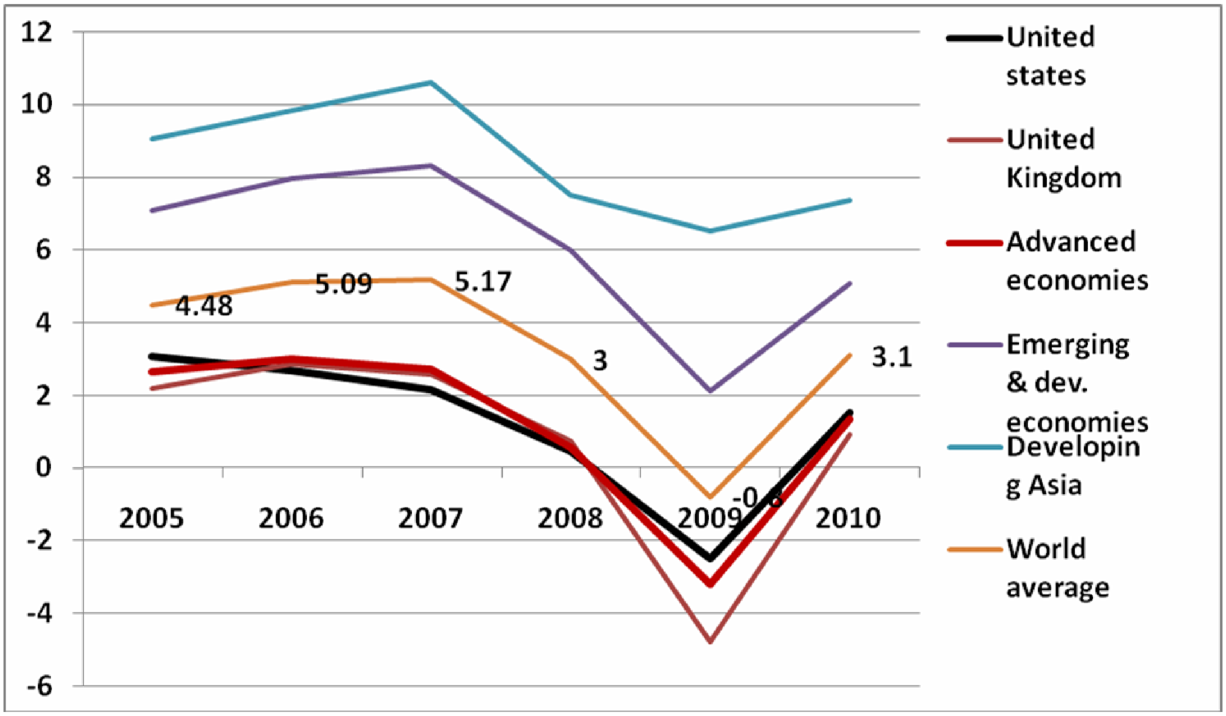
The financial crisis of 2008 affected almost all economies of the world. However, the impact on the financial and real sectors was not uniform across the countries. While some economies that were structurally strong were able to better withstand the crisis, others had to be bailed out with extensive and multiple stimulus packages to overcome the adverse effects on the domestic economies[3]. The impact on the world economies in terms of indicators like GDP growth rate, volume of trade, unemployment rate etc have been analysed using IMF data from 2005 to 2010.

Table 1: GDP growth rates in major world economies

Economies	2005	2006	2007	2008	2009	2010
United states	3.05	2.67	2.14	0.44	-2.5	1.5
United Kingdom	2.17	2.85	2.56	0.74	-4.8	0.91
Advanced economies	2.63	2.99	2.72	0.56	-3.2	1.32
Emerging & dev. economies	7.09	7.94	8.31	5.99	2.1	5.08
Developing Asia	9.03	9.83	10.59	7.5	6.5	7.35
World average	**4.48**	**5.09**	**5.17**	**3.0**	**-0.8**	**3.1**

Source: International Monetary Fund – World Economic Outlook Database

Figure 1: GDP growth rates in major world economies



The table 1 shows the GDP growth rates of major world economies during 2005 -2010. The deterioration in the economic conditions is well evident from the data. The average GDP growth rate of the world economy which was around 5 percent during 2005-2007, was seriously affected during the crisis period. In the year 2008, when the financial crisis started the world economies grew by 3 per cent. In 2009, when the crisis was in its peak, the world economic growth rate was negative i.e., -0.8 per cent. However, the economies started regaining confidence showed positive growth of 3.1 per cent in the year 2010. The very similar trends are witnessed in all categories of economies as shown in the table. The advanced economies including the United States and United Kingdom were all growing steadily prior to the crisis, but deteriorated severely during 2008-09. These economies gradually started gaining momentum in 2010. Though the very similar trend was found in the emerging and developing economies and developing Asian economies, the severity and the magnitude of the deterioration was light.

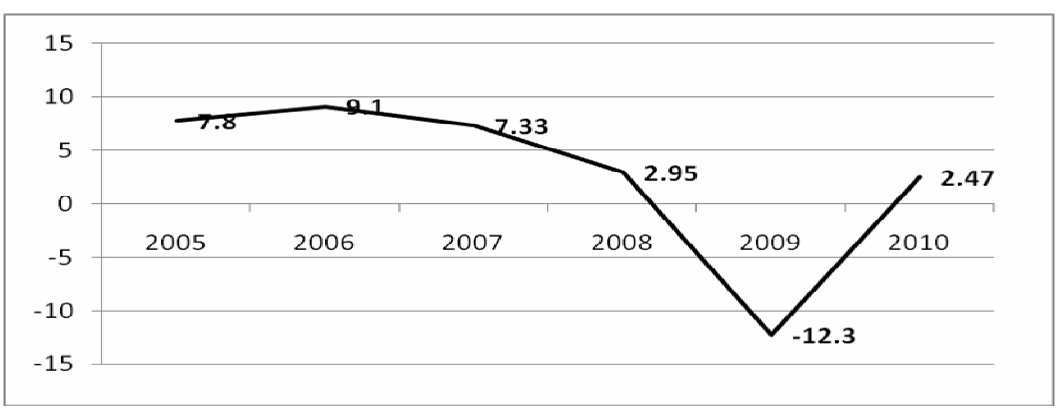
Table 2: Volume of world trade in goods and services (annual % change)

Year	% change in volume of trade
2005	7.8
2006	9.1
2007	7.33
2008	2.95
2009	-12.3
2010	2.47

Source: International Monetary Fund – World Economic Outlook Database

The trade in goods and services is an important indicator showing the strength of market integration and volume of business in the present day globalised world. The table 2 shows that the volume of trade in goods and services was significantly affected by the crisis. The trade which was growing at a rate of 7.8 % in 2005, 9.1% in 2006 and 7.33 % in 2007 was immediately slowed down to 2.95% in 2008. The volume of trade was further shrunk by 12.3% in 2009. This shows complete deterioration of confidence in the business world. However, there are symptoms of relief from the crisis in the trade performance as it started moving, though at a gradual speed, in the positive path in 2010.

Figure 2: Volume of world trade in goods and services (annual % change)



The poor performance in the trade also affected the level of employment throughout the countries. It could be observed that the unemployment rate for the advance countries was projected to rise from 5.8 % in 2007 to 8.2% in 2009 and 9.29% in 2010[4]. The unemployment among the EMEs, though deteriorated during the period of crisis, was lesser in its extent compared to advanced economies.

Indian economy during financial crisis

The global financial crisis which originated in the advanced economies spread rapidly to India and other Emerging Market Economies through various channels. Indian economy could withstand the adverse effects of the financial crisis and thereby avoid the long term consequences with the help of the strength it already achieved. However, it is wrong to say that it is free of adverse impacts. India's increasing dependence on bilateral trade with other countries and its financial relationship with the advanced economies somehow transferred the economic shocks to the national economy. 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[5]

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 2000s. The overall foreign investment in India met serious setback during the crisis. 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 balances[6]. 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 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	15.24	210047	41.15
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: Reserve bank of India Data, www.rbi.org

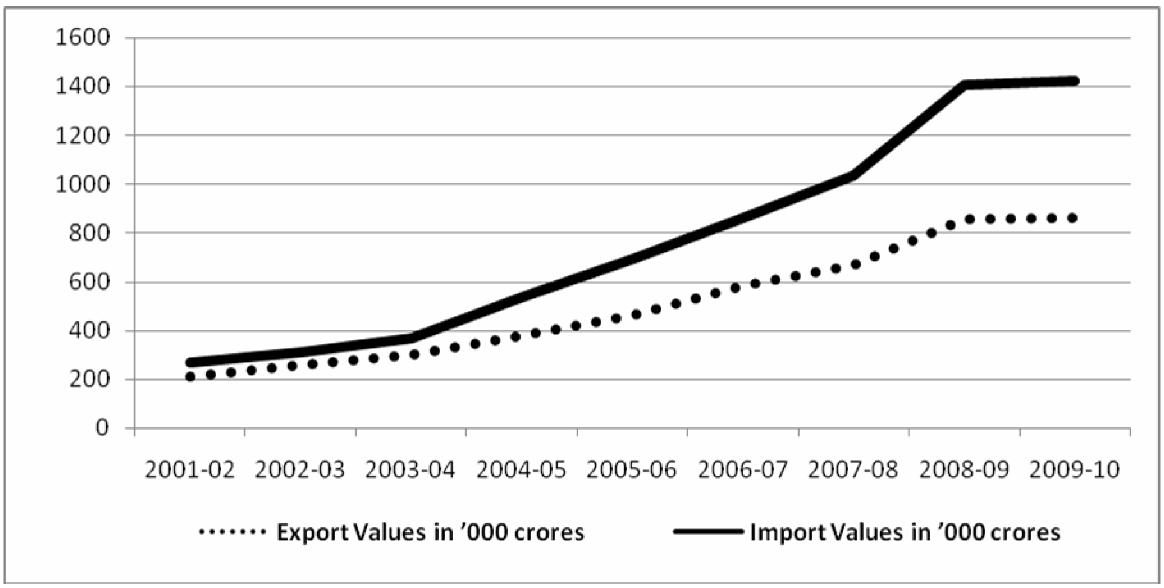
The worldwide financial crisis has caused fall in India's merchandise exports and imports. Handicrafts exports fell by 70 percent. Other sectors like tea and carpets were also down by 20 percent and 32 percent, respectively. Overall merchandise export and import have been significantly improving since 2001-02. The growth momentum continued till 2008-09. But the merchandise trade of India was severely attacked by the crisis as due to the fact that our major 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 meagre 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.

Table 4: Merchandise export and import

year	Export		Import	
	Values in '000 crores	% change	Values 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	25.1	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: Reserve bank of India Data, www.rbi.org

Figure 3: Merchandise export and import



An important sector severely affected during the financial crisis was India's business services. The earning from business services was treated to be an important source of income flow to the national economy during the globalisation era. The data shown in table 5 depicts increased earnings of business services during 2000s especially up to 2008-09. The picture all on a sudden changed because the earning from business services declined from 85544 crores during 2008-09 to 53749 during 2009-10 i.e., a decline of 37.17 per cent

Table 5: Earnings from business services

year	Earnings from business services	
	Values in crores	% change
2004-05	23067	----
2005-06	41356	79.29
2006-07	65738	58.92
2007-08	67430	2.57
2008-09	85544	26.86
2009-10	53749	-37.17

Source: Reserve bank of India, www.rbi.org

The summary effect of the crisis on country's external sector can be well analysed with the aid of the Balance of Payments data. Balance of Payments (BoP) refers to the summary statement of overall economic transactions of a country with the rest of the world. BoP comprises current account, capital account, errors and omissions and changes in foreign exchange reserves. Under current account of the BoP, transactions are classified into merchandise (exports and imports) and invisibles. Under capital account, capital inflows can be classified by instrument (debt or equity) and maturity (short or long-term). The main components of capital account include foreign investment, loans and banking capital. Thus, the BoP summary gives a clear picture of the overall performance of the economy especially the external sector.

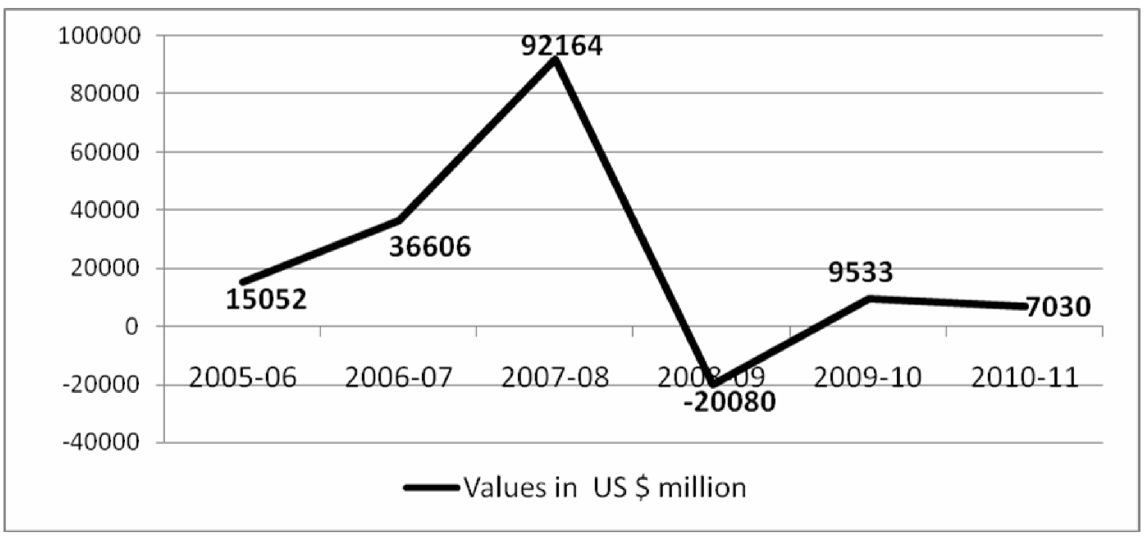
Table 6: Balance of payment position-overall balance

year	Values in US $ million
2005-06	15052
2006-07	36606
2007-08	92164
2008-09	-20080
2009-10	9533
2010-11	7030

Source: Reserve Bank of India (RBI). www.rbi.org

As the RBI data indicates, the overall balance of BoP has been improving since 2005-06. But it was shocking that during the year 2008-09, the overall BoP balance turned negative i.e., -20080 US $ million showing that global financial crisis severely hit the flow of capital into the country. It was noted that right from the beginning of 2008-09 and then subsequently the current account transactions (both trade and invisibles) in the second half of the year. This has led to one of the highest current account deficits and one of the lowest capital account surpluses for the country. The impact of the crisis on both capital flows and current receipts has been much larger than what economists initially thought. However, the economy could recover from the sudden shock of the crisis thereby making positive balance in country's BoP account.

Figure 4: Balance of payment position-overall balance



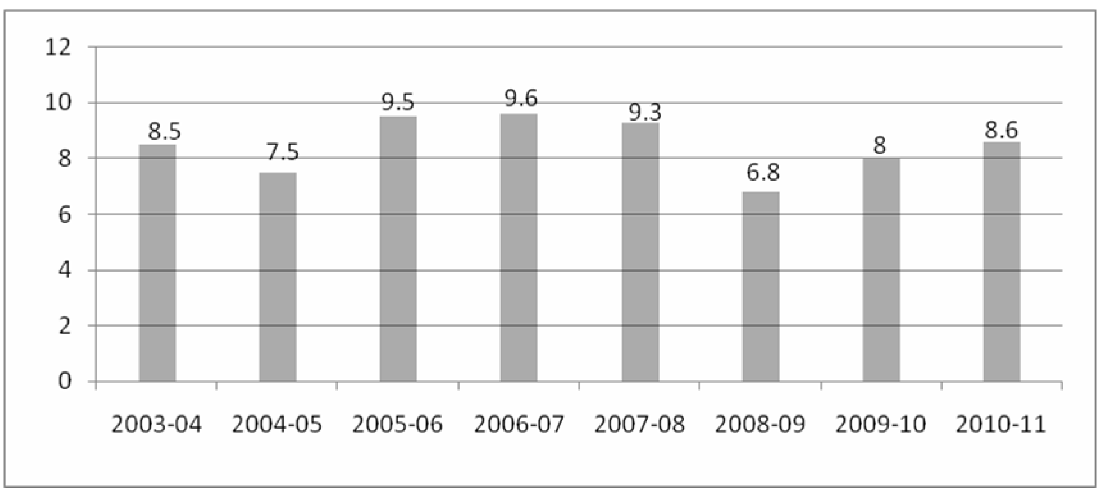
The macroeconomic and financial indicators predominantly pointed to a strong and vibrant Indian economy prior to the financial crisis. Table 7 presents the Gross Domestic Product (*GDP- stands for the money value of all final goods and services produced within the domestic territory of a country during a fiscal year*) growth rate of Indian economy for the fiscal years from 2003-04 to 2010-11. (*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. It can be noted from the recent GDP figures that the Indian economy has emerged with remarkable rapidity from the slow down caused by the financial crisis of 2007-09. During the last two fiscal years, the economy registered a growth of 8% and 8.6% showing a quick recovery from the symptoms of financial crisis

Table 7: GDP growth rate of Indian economy

Year	Growth rate
2003-04	8.5
2004-05	7.5
2005-06	9.5
2006-07	9.6
2007-08	9.3
2008-09	6.8
2009-10	8.0
2010-11	8.6

Source: Reserve Bank of India (RBI). www.rbi.org

Figure 5: GDP growth rate of Indian economy



Concluding remarks

From the above discussion, we could learn that the entire world economies are affected in one way or other by the financial crisis. The strength and duration of the impact do vary among the economies on the basis of the nature of their domestic economy. It was noticed that the advanced economies are more badly affected by the crisis when compared with the developing and Emerging Market Economies. Indian economy too was not free from the hit of the current crisis. The external sector of our economy was severely affected and that the overall BoP position turned negative. 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.[7]

In order to counter the negative fallout of the global slowdown on the Indian economy, the federal Government responded by providing certain fiscal stimulus packages in the form of tax relief to boost demand and increased expenditure on public projects to create employment and public assets. 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 world economy is also exhibiting signs of recovery, driven largely by the robust growth in emerging economies. Advanced countries however, continue to face uncertainty with large fiscal deficit, high public debt and large scale unemployment. Indian economy also shows the symptoms of rapid recovery from the sudden set back it had to undergo during 2008-09. This is significantly due to the strong and focused steps taken by country's central bank and the government. 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.

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