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Abstract

There were arguments and counter arguments with regard to the impact on Indian economy of the global financial meltdown. The paper examines the economic scenario in India. The belief that Indian economy was adequately insulated from such global development has been found to be only partially correct. The crises affected the economy via dwindling foreign exchange reserves as significant amount of it had to be withdrawn from equity market by the foreign institutional investors. The phenomenon resulted in the adverse effect on various key macro variables which include balance of payments and employment. India's slow pace of lessening further controls, albeit because of political compulsions, came in handy for the economy.

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Global Financial Crises and its Effect on India

Introduction

When, the financial crisis erupted in a comprehensive manner in U.S and Europe in August, 2007. It was argued that India would be relatively immune to this crisis, because of the "strong fundamentals" of the economy and the supposedly well-regulated banking system. This argument was emphasized by the Finance Minister and others even when other developing countries in Asia clearly experienced significant negative impact, through transmission of stock market turbulence and domestic credit strictness. But now the crisis is entering into third year and many have termed it the 'worst financial crisis of the last century'.

The view that the Indian economy would be less adversely affected by the global economic crisis because of limited integration and other inherent strengths has proved to be wrong. The financial meltdown, morphed into a global economic downturn with the collapse of Lehman Brothers on 23 September 2008, the impact on the Indian economy was almost immediate. The economic boom in India that preceded the current downturn was dependent upon greater global integration in three ways: increased dependence on capital inflows, especially of the short-term variety, greater reliance on exports particularly of services; and the role these played in underpinning a domestic credit-fuelled consumption and investment boom.

Foreign Capital Flow

Capital flows could not have been an unmixed blessing for the economy as they have largely been associated with increased investment in stock market activity which in turn resulted in the build-up of inflationary pressures.

As soon as the first signs of the crisis became visible in Asia, foreign institution investors (FIIs) started withdrawing from the region on a noticeable

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scale. Credit flow suddenly dried-up reducing Indian companies' access to overseas finance, but also lowering domestic liquidity and causing stock price fall and, money market interest rate spiked to above 20 percent and remained high for the next month. The pressure was evident in the form of lower inflows and higher outflows, yielding net outflows in the last two quarters of 2008-09. It is important to note that net capital flows declined from US$ 108.0 billion in 2007-08 to US$ 9.1 billion in 2008-09 as shown in the table-1 below.

Table-1

Net Capital Flow

US$ billion

Items	April-March		2007-2008 PR Jan-Mar	2008-2009 P			
	2007-2008 PR	2008-2009 P		Apr-Jun	Jul-Sep.	Oct-Dec.	Jan-Mar
FDI	15.4	17.5	8.5	9.0	4.9	0.4	3.2
Inward FDI	34.2	35.0	14.2	11.9	8.8	6.3	8.0
Outward FDI	18.8	17.5	5.7	2.9	3.9	5.9	4.8
FIIs	20.3	-15.0	-4.1	-5.2	-1.4	-5.8	-2.6
Net Capital Flow	108.0	9.1	26.0	11.1	7.6	-4.3	-5.3

P: Preliminary, PR: Partially Revised.
Source: External Economy July 27, 2009, RBI Publication III

Notwithstanding increased risk aversion on the part of international investors and tightness in the overseas credit markets, which affected other types of capital flows, inflows in the form of foreign direct investment (FDI) and non-resident Indian (NRI) deposits displayed resilience, reflecting continued attractiveness of India as a long-term investment destination and also the positive impact of various policy measures undertaken for improving certain types of inflows in response to the global financial crisis.

FDI to India was channeled mainly into manufacturing sector (21.1 per cent) followed by financial services (19.4 per cent) and construction sector (9.9 per cent) during 2008-09.[1]

Foreign Exchange Reserves

During 2008-09, India's foreign exchange reserves declined by US$ 58.0 billion, down from US$ 309.7 billion as at the end of March 2008 to US$ 251.7 billion on the same date in March 2009. Of this decline of US$ 58.0 billion, US$ 37.9 billion was on account of valuation changes, and the balance of US $ 20.1 billion decline reflected the financing needs of the BoP.

Table- 2

Foreign Exchange Reserves

US$ Million

End of Month	Gold	SDR	Foreign Currency Assets*	Reserve Position in the IMF	Total (2+3+4+5)	*Memo*: Outstanding Net Forward Sales (-)/Purchases (+) of US dollar by the Reserve Bank at the end of the month
1	2	3	4	5	6	7
March 2007	6,784	2	191,924	469	199,179	-
March 2008	10,039	18	299,230	436	309,723	(+) 14,735
March 2009	9,577	1	241,176	981	251,735	(-) 2,042
April 2009	9,231	1	241,487	983	251,702	(-) 1,071
May 2009	9,604	1	251,456	1,245	262,306	(+) 131
June 2009	9,800	1	254,093	1,248	265,142	-
July 2009#	9,800	1	255,138	1,248	266,187	-

* : Exclude US $250 million invested in foreign currency denominated bonds issued by IIFC (UK) since March 20, 2009.

\# : As on July 17, 2009. – : Not Available.

Source: External Economy July 27, 2009, RBI Publication III

India’s foreign exchange reserves, however, increased subsequently to US$ 266.2 billion by July 17, 2009, with portfolio flows reversing the earlier trend and turning significantly positive during 2009-10 so far (Table -2).

[1] The External Economy, 27 July,2009, RBI,III, Publication.

Only one of the larger banks, ICICI, was partly affected but managed to prevent a crisis because of its strong balance sheet and timely action by the government, which virtually guaranteed its deposits. The equity markets have seen a near 60 percent decline in the index and a wiping off of about US$1.3 trillion in market capitalization since January 2008, when the sensex had peaked at about 21,000. This is primarily due to the withdrawal of about US$12 billion from the market by foreign portfolio investors between September and December 2008. The foreign investors withdrew these funds in order to strengthen the balance sheet of their parent companies. Commercial credit, both for trade finance and medium-term advances from foreign banks has virtually dried-up. Domestic exporters find it difficult to secure credit.

As the Rupee has come under pressure with the outflow of portfolio investments, higher foreign exchange demand by Indian entrepreneurs seeking to replace external commercial borrowing by domestic financing pushed the exchange rate up and consequently foreign exchange reserves declined. This is likely to continue because current account will remain in deficit and the capital account, which has been in deficit in the second and third quarters of 2008-09, will not generate the needed surplus to cover the current account deficit. This will imply further drawing down of foreign exchange reserves and continued downward pressure on the exchange rate. However, with foreign exchange reserves remaining at 110 percent of total external debt at the end of December 2008, investment sentiments should not be unduly affected in the near-term. The nearly 25 percent depreciation in the Rupee's exchange rate has partially nullified the benefits from the decline in global oil and gas prices and increased the cost of commercial borrowings. The weaker Rupee should encourage our exporters and it is possible that with imports declining as sharply as exports, the country's trade deficit may actually improve in the short-run and the external sector balance may remain stable and not pose any major policy issue. The severity and suddenness of the crisis can be judged from the IMF's forecast for the global economy. For the

first time in 60 years, the IMF is now forecasting a global recession with negative growth for world GDP in 2009-10. The IMF has revised its forecasts downwards thrice since July 2008, and it is not yet certain that this will be the last revision.

Export and Import

Credit crunch tended to have a greater impact on Indian exports than imports. The difficulty of importing components or raw materials directly required for producing exportable also has a negative impact on domestic demand. Indian economy has been through the steep decline in demand for India's exports in its major markets.

Table-3

Foreign Trade in India

Items		May* 2009	Fiscal Year So Far		Full Fiscal Year			
			2009-10*	2008-09	2008-09	2007-08	2006-07	2005-06
Exports	Rs crore	53435	107214(17.4)	129846(35.3)	766935(16.9)	655863(14.7)	571779(25.3)	456418(21.6)
	US $	11010	21753 (31.2)	31626(36.5)	168704(3.4)	163132(29.0)	126361(22.6)	103091(23.4)
Imports	Rs crore	78682	157514(25.6)	211752(37.8)	1305503(29.0)	1012312(20.4)	840506(27.3)	660409(31.8)
	US $	16212	31959 (38.0)	51507(38.9)	287759(14.3)	251654(35.5)	185749(24.5)	149166(33.8)
Balance of Trade	Rs crore	-25247	-50300	-81906	-538568	-356449	-268727	-203991
	US $	-5202	-10206	-19880	-119055	-88522	-59388	-46075

*: Provisional Figures
Source: Current Statistics from Economic & Political Weekly, August 1, 2009.

As presented in table-3 both exports and imports of India slowed down in the 2008-09, the decline in the growth of exports during this period was sharper than the decline in imports if measured in US $, which is 3.4 in 2008-09 and 29.0 in 2007-08 as the export demand was more severely affected by the sharp downturn in the advanced economies, which are key market for India's export.

The net exports of goods and services are conventionally regarded as external demand that supplements domestic aggregate demand in conditioning the growth process. In India, despite the dominant role of domestic demand in shaping the growth path, exports have become increasingly important in raising the country's GDP. During a global recession, when global trade contraction has been sharper than the rate of deceleration in global growth, the performance and prospects of Indian exports have also been affected adversely.

The first sector to be hit was the gems and jewelry which felt the impact in November itself and where more than 300,000 workers have lost their jobs.[2] The negative impact has since covered other export-oriented sectors such as garments and textiles, leather, handicrafts, and auto components. The 21 percent decline in exports in February 2009 is the steepest fall in exports for the last two decades. It is unlikely that exports will recover within this year. The WTO has predicted that world trade, which has virtually collapsed in the second half of 2008 is likely to decline by as much as nine percent in 2009-10. Yet the bad news does not stop. The worst downside scenario could be for the US economy being trapped in a Japan like "L" shaped recovery for the next few years. This will imply a further decline in world exports and softening of global commodity prices. In turn, it will result in sharp slowdown in world exports and result in widespread unemployment and social stress in major exporting economies. This could well generate irresistible protectionist sentiments and if governments do succumb to these, it will unleash the dreaded downward cycle which could see the global economy plunging over the precipice into a prolonged recession. It is, therefore, prudent not to underestimate the severity of the present crisis.

[2] Rajiv Kumar: Global Financial and Economic Crisis: Impact on India and Policy Response.

Unemployment in India

One of the serious problems of the global crises has been the rising unemployment and heightened uncertainty in the labour markets. In India, due to the dependence of a large section of the labour force on the agriculture sector for employment, the negative employment effect has been relatively moderate due to the resilient agricultural sector during 2008-09. Available scattered reports suggest that the employment intensive SMEs have been affected by the crisis and there is reverse migration from the urban to rural areas. The services sector, however, lost the momentum with weak external demand in the wake of the global downturn and its growth started slowing down from the beginning of 2008-09 following through the entire year. However, slowdown in services sector was more pronounced at the end of 2008-09. As the labour market recovery comes with considerable lags even after output picks up, a weak recovery of the global economy only in 2010 as projected by the IMF suggests grave implications for the employment scenario (ILO, April 2009).

According to the International Labour Office's (ILO) 'Global Employment Trends Report' released in May 2009, in all probabilities, there will be a sharp increase in the global unemployment in 2009, particularly in developing countries engaged in labour-intensive exports. Unemployment rate is estimated to rise up to 6.5 per cent in 2009 as compared with 5.7 per cent in 2007. In a worst case scenario it could rise up to 7.1 per cent (or 50 million people). The Report also noted that over 2009 and 2010, an estimated 20.3 million additional jobs would be needed to absorb India's growing labour force. Women and young labour force could be affected the most. In fact, Indian workers in sectors with high exposure to the global market and which employ millions of women workers have already faced job cuts, particularly in civil aviation, textiles, leather and gems and jewellery sectors.

In order to assess the unemployment situation in the context of the economic slowdown, the Ministry of Labour conducted two quick quarterly surveys for the period October-December 2008 and January-March, 2009 covering 21 centers (10 states/ UTs) and sectors such as mining, textiles, metals, gems and jewellery, automobiles, transport and IT/BPO covering more than 60 per cent of the GDP. The Reports observed that about half a million workers lost their jobs during October-December 2008 while employment increased by about half a quarter million during January-March 2009. The estimated employment in all the sectors declined from 16.2 million during September 2008 to 15.7 million in December 2008. The employment growth rate was placed at (-) 3.03 per cent during the third quarter of 2008-09 which improved somewhat during the quarter January-March 2009. Sector-wise, the decline in employment was observed in all the sectors, except for the IT/ BPO during October-December 2008 whereas sector like gems and jewellery, textiles, IT/ BPO, handloom/power-loom and automobiles posted rise in employment in January-March 2009.

Conclusion

After a long spell of growth, the Indian economy is experiencing a downturn. Industrial growth is faltering, inflation remains at double-digit levels, the current account deficit is widening, foreign exchange reserves are depleting and the rupee is depreciating. The last two features can also be directly related to the current international crisis. The most immediate effect of that crisis on India has been an outflow of foreign institutional investment from the equity market. Foreign institutional investors, who need to retrench assets in order to cover losses in their home countries and are seeking havens of safety in an uncertain environment, have become major sellers in Indian markets.

But India is not in the same position as the other countries which could be attributed to the virtual halt to the liberalization process probably because of the political compulsions. But even though we are slightly better protected from

financial meltdown, largely because of the still large role of the nationalised banks and other controls on domestic finance, there is certainly little room for self-satisfaction. The Government has undertaken several measures to promote growth in the sectors facing slowdown. Enhanced allocation of resources for national flagship schemes such as National Rural Employment Guarantee Scheme (NREGS) (rise by144 per cent), Bharat Nirman (rise by 45 per cent), National Highway Development Programme (rise by 23 per cent), Jawaharlal Nehru Urban Renewal Mission (JNNURM) (rise by 87 per cent) is also likely to generate additional employment, particularly in unorganised sectors, both in rural and urban areas during 2009-10.

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