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International Journal of Current Research
Vol. 6, Issue, 02, pp.5115-5118, February, 2014

INTERNATIONAL JOURNAL OF CURRENT RESEARCH

ISSN: 0975-833X

REVIEW ARTICLE

GLOBAL FINANCIAL CRISIS AND ITS IMPACT ON INDIAN ECONOMY

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ARTICLE INFO

Article History:
Received 29th November, 2013
Received in revised form
14th December, 2013
Accepted 19th January, 2014
Published online 21st February, 2014

Key words:
Financial Crises, Subprime crisis, Speculation, Securitization.

ABSTRACT

The Indian economy looked to be relatively insulated from the global financial crisis that started in August 2007 when the sub-prime mortgage crisis first surfaced in the United States (US). In fact, the Reserve Bank of India (RBI) was raising interest rates until August 2008 with the explicit objective of cooling the economy and bringing down the gross domestic product (GDP) growth rate, which visibly had moved above the rate of potential output growth and was contributing to the buildup of inflationary pressures in the economy. This paper attempts an analysis of the origin and causes of global financial crisis and the impact of the crisis on the Indian economy.

INTRODUCTION

The global Financial Crisis of 2008 is the most severe financial crisis that the world has ever faced since the Great Depression of the 1930s. The ‘Financial Crisis of 2008’, also called the US Meltdown, has its origin in the United States housing sector back in 2001-02, but gradually extended over a period of time and eventually brought the entire world under its grip. The financial crisis is characterized by contracted liquidity in the global credit and housing market, triggered by the failure of mortgage companies, investment banks, and government institutions which had heavily invested in subprime loans. Though the crisis started in 2005-06, but has become more visible during 2007-08, when many of the renowned Wall Street firms collapsed. According to IMF officials, the losses due to real estate crisis is amounted to $945 billion in USA alone, but may run into trillions of dollars, the losses of all the countries considered together. Initially, the crisis caused mass foreclosure and default in subprime loans but the crisis accelerated during the month of September 2008, and ultimately developed into a global financial crisis. The impact of this crisis was so severe that it led to the collapse of top investment firm’s viz. Lehman Brothers, Bears Sterns. Merill Lynch and others such as Citi Group, JP Morgan were rescued by the government and AIG (American Investment Group). The impact of this crisis was so severe that the United States Government had to intervene in the free market economy and had to come with $700 billion bailout package to revive the investment banks/firms and reinstate the investor’s faith in the stock market. Since January 1, 2008 owners of stocks in U.S. stock market have suffered about $12 trillion dollar in losses, as their value declined from $20 trillion to $12 trillion. The subprime lending is the practice of providing loans to borrowers who do not qualify at the market rate of interest owing to various risk factors such as low income level; size of down payments made, credit history, employment status etc. The subprime loans (also called Ninja or Liar loans) are provided to those who do not qualify at the market rate of interest. The value of U.S. subprime mortgages was estimated at $1.3 trillion till March 2007. An agonizing fact of these subprime loans was that the delinquent rate was as high as 25 per cent till March 2008.

India, is a largest economy, has been facing major challenges owing to the global financial crisis. The immediate effects were plummeting stock prices, a net outflow of foreign capital, a large reduction in foreign reserves and a sharp tightening of domestic liquidity. These caused a rapid depreciation of the exchange rate and a surge in short-term interest rates. The second round effects emerged from a slowdown in domestic demand and exports. Demand effects have been particularly severe in housing, construction, consumer durables and the IT sector. As a result, manufacturing production has taken a hit and activities in the organized services sector (housing, construction, IT) are down sharply. Exports declined for two consecutive months in October and November 2008. A recent government study estimates job losses to the tune of five hundred thousand between October and December 2008. GDP growth rate is now estimated at around 7 percent for 2008, down from 9 percent in 2007, and is projected to decline to around 5 percent in 2009. The monetary and fiscal stimulus package is expected to contain the downward slide in demand in 2009 while providing a good basis for recovery in 2010.

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Causes of the Subprime crisis

It is difficult to pin down the exact cause of the financial crisis, but majority of the experts and economists are of the view that subprime loans in the housing sector was one of the most important cause of the financial crisis of 2008. The different causes of the crisis are specified below:

Boom and bust in the housing market

The current crisis actually started with the bursting of housing "bubble" that began in 2001 and started growing at a rapid rate until it reached its peak in 2005. The housing bubble occurred due to rapid increase in the rate of the valuation of real property until the prices of the property reached the unsustainable level. The factors that led to the rapid increase in the demand for house price are-- low interest rate and the huge inflow of foreign capital from countries such as China, Japan U.K. Also, subprime loans added fuel to the fire, further increasing the demand for houses. Also, the Federal Reserve Board cut the short-term interest rate from 6.5 percent in 2000-01 to 1 percent in 2003-04. A Greenspan, the Governor of Federal Reserve, accepted in 2007, the fact that housing bubble was "fundamentally endangered by the decline in real long-term interest rate" (Bianco, 2008). Because of above mentioned fact, the home ownership rate increased from 64 per cent in 1994 to an all time high peak of 69 per cent in 2004 (Wikipedia) This rise in demand pushed the prices of house by leaps and bounds. Between 1997 and 2006, American home prices increased by 124 per cent. (Wikipedia) Further, U.S. consumers lured by the increasing value of their homes went on borrowing spree. They started borrowing money for consumption by mortgaging their property.

Also, Americans spent $800 billion per year more than they earned. Household debt grew from $680 billion in 1974 to $14 trillion in 2008. During 2008, the average U.S. household owned 13 credit cards, and 40 percent of them carried a balance up from 6 percent in 1970. (Wikipedia) But overbuilding during the boom period and rise in interest rate led to the bursting of the bubble. Between 2004 and 2006 the Federal Reserve Board raised the interest rate by 17 times, up from 1 percent to 5.25 percent. Also, overbuilding during the boom eventually led to a surplus inventory of houses, causing home prices to decline, beginning in summer, 2006.(Bianco, 2008). As a result foreclosure and default rate increased. About 8.8 million homeowners (10.8 per cent of total homeowners) had zero or negative equity as of March, 2008, (Wikipedia) meaning their houses are worth less than their mortgage. Sales of houses decreased by 26.4 per cent in 2007 compared with the previous year.

Speculation

Another important cause of housing crisis is speculation in real estate. It was observed that investment in housing sector yield high return compared to other traditional investment avenues. As a result investment in housing sector increased. During 2006, 22 per cent of homes purchased (1.65 million units) were for investment purposes, with an additional 14 per cent (1.07 million units) purchased as vacation homes. Nearly 40 per cent of home purchases were not for primary residences. A hoping 85 percent of the houses purchased in Miami were for investment purposes.(Wikipedia)

High risk loans and lending practices

The subprime loans were highly risky, as these loans were offered to the high risk borrowers-- illegal immigrants, person without any job, any assets and any income. The repayment from these borrowers was hardly expected. The share of subprime mortgages to total originations increased from 5 per cent ($35 billions) in 1994 to 20 per cent ($600 billions) in 2006. Again the difference between the prime loan and subprime loan declined from 2.8 per cent in 2001 to 1.3 per cent in 2007. This resulted in the increase in demand for subprime loans. (Wikipedia) Another example of high risk loans is the Adjustable Rate Mortgages (ARM). Under ARMs borrowers had to pay the only the interest (not principal) during the initial period. An estimated one-third of ARMs originated between 2004 and 2006 had 'teaser' rates below 4 percent.(Wikipedia)

Securitization

Securitization is a structured finance process in which assets, receivables or financial instruments are acquired, pooled together as collateral for the third party investments (Investment banks). Due to securitization, Mortgage Backed Securities (MBS) is created/ originated and distributed by the investment firms/banks. Initially Freddie Mae and Fannie Mac (quasi government agency) use to issue MBS but later private agencies also started issuing MBS on subprime loans. During 2003 to 2006, the agencies share of MBS fell from 76 per cent to 43 per cent while Wall Street's share climbed up from 24 per cent to 57 per cent during the same period. The securitized share of subprime mortgages (MBs on subprime) increased from 54 per cent in 2001 to 75 per cent in 2006.(Bianco, 2008)

Inaccurate credit rating

Under new system of securitization, investment firms/banks repackaged mortgages securities (MBS) into innovative financial products called CDOs (Collateral Debt Obligation), that promised to boost the return for investors. These CDOs were further divided into small financial units called 'tranches'. These tranches were rated on the basis of risk involved. The safest portion of the tranches received the highest rating of AAA/aaa, while riskier tranches received the medium quality BBB/bbb rating, just above the junk bonds. It has been observed that MBS and CDOs originated from subprime mortgages were distributed by the investment firms. Credit rating agencies are under scanner for giving investment-grade rating to securitization transactions based on subprime loans.

Government Policies

To provide house at affordable price to all the people was the priority of both the Clinton and Bush administration. In 1974, President Carter passed the Community Reinvestment Act. This Act made mandatory for all the banks and saving institution to provide home loans to the lower income people in broad outlying areas where they had branch.

The U.S. Department of Housing and Urban Development's Mortgage policies fueled the trend towards issuing risky loans. Housing and Urban Development directed Freddie and Fannie to provide at least 42 per cent of their mortgage financing to borrowers with income below the median in their area. This target was increased to 52 per cent in 2005. The only way to achieve income loan target while dramatically increasing lending was to erode underwriting lending standards. Fannie Mae aggressively bought Alt-A loans, where these loans may require little or no documentation of a borrower's finances. Till November 2007 Fannie Mae held a total of $55.9 billion of subprime securities and $324.7 billion of Alt-A securities in their portfolios

Central bank policies

The Federal Reserve's primarily concern was to manage the monetary policy and was least bothered about the housing bubble and dot-com bubble. Once the bubble burst, the Central Bank tried to control the spread of the crisis on other sectors.
A contributing factor to the rise in home prices was the lowering of the interest rate earlier in the decade by the Federal Reserve lowered by the funds rate target from 6.5 per cent to 1 per cent. Further Greenspan has been criticized for flourishing subprime loans.(Bianco, 2008)

Impacts of the US Financial Crisis on India

Though in the beginning Indian official denied the impact of US meltdown affecting the Indian economy but later the government had to acknowledge the fact that US financial crisis will have some impact on the Indian economy. The US meltdown which shook the world had little impact on India, because of India's strong fundamental and less exposure of Indian financial sector with the global financial market. Perhaps this has saved Indian economy from being swayed over instantly. Unlike in US where capitalism rules, in India, market is closely regulated by the government.

Impact on stock market

The immediate impact of the US financial crisis has been felt when India's stock market started falling. On 10 October, Rs. 250,000 crores was wiped out on a single day bourses of the India's share market. The Sensex lost 1000 points on that day before regaining 200 points, an intraday loss of 200 points. This huge withdrawal from the India's stock market was mainly by Foreign Institutional Investors (FIIs), and participatory-notes.

Impact on India's trade

The trade deficit is reaching at alarming proportions. Because of worker's remittances, NRI deposits, FII investment and so on, the current deficit is at around $10 billion. But if the remittances dry up and FII takes flight, then we may head for another 1991 crisis like situation, if our foreign exchange reserves depletes and trade deficit keeps increasing at the present rate. Further, the foreign exchange reserves of the country has depleted by around $57 billion to $253 billion for the week ended October 31.(Sivaraman, 2008)

Impact on India's export

With the US and several European countries slipping under the full blown recession, Indian exports have run into difficult times, since October. Manufacturing sectors like leather, textile, gems and jewellery have been hit hard because of the slump in the demand in the US and Europe**.** Further India enjoys trade surplus with USA and about 15 per cent of its total export in 2006-07 was directed toward USA. Indian exports fell by 9.9 per cent in November 2008, when the impact of declining consumer demand in the US and other major global market, with negative growth for the second month, running and widening monthly trade deficit over $10 billions. Official statistics released on the first day of the New Year, showed that exports had dropped to $1.5 billion in November this fiscal year, (Sivaraman, 2008) from $12.7 billion a year ago, while imports grew by $6.1billion to $21.5 billion.

Impact on India's handloom sector, jewelry export and tourism

Again reduction in demand in the OECD countries affected the Indian gems and jewellery industry, handloom and tourism sectors. Around 50,000 artisans employed in jewellery industry have lost their jobs as a result of the global economic meltdown. Further, the crisis had affected the Rs. 3000 crores handloom industry and volume of handloom exports dropped by 4.6 per cent in 2007-08, creating widespread unemployment in this sector. With the global economy still experiencing the meltdown, Indian tourism sector is badly affected as the number of tourist flowing from Europe and USA has decreased sharply.

Exchange rate depreciation

With the outflow of FIIs, India's rupee depreciated approximately by 20 per cent against US dollar and stood at Rs. 49 per dollar at some point, creating panic among the importers.

IT-BPO sector

The overall Indian IT-BPO revenue aggregate is expected to grow by over 33 per cent and reach $64 billion by the end of current fiscal year (FY200). Over the same period, direct employment to reach nearly 2 million, an increase of about 375000 professionals over the previous year. IT sectors derives about 75 per cent of their revenues from US and IT-ITES (Information Technology Enabled Services) contributes about 5.5 per cent towards India's total export. So the meltdown in the US will definitely impact IT sector. Further, if Fortune 500 hundred companies slash their IT budgets, Indian firms could adversely be affected.

FII and FDI

The contagious financial meltdown eroded a large chunk of money from the Indian stock market, which will definitely impact the Indian corporate sector. However, the money eroded will hardly influence the performance real sector in India. Due to global recession, FIIs made withdrawal of $5.5 billion, whereas the inflow of foreign direct investment (FDI) doubled from $7.5biilion in 2007-08 to $19.3 billion in 2008 (April-September).

Conclusion

From the above argument it can be noted down that the 'Financial or Subprime Crisis' was the shear consequences of 'greed' and to make 'too much profit' on the part of Wall Street Firms and Investment Banks. This crisis also shows the failure of capitalist market economy. Though the Indian economy would be able to withstand the crisis without any major difficulty, but the crisis is still causing mayhem all over the world.

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