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RESEARCH ARTICLE

GLOBAL FINANCIAL CRISIS AND ITS IMPACT ON INDIAN ECONOMY-AN ANALYSIS AND PERCEPTION

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ABSTRACT

The global financial crisis is an outcome of deep economic recession which generally refers to business cycle contraction and slowdown activity over a long period of time. It is a situation where macro indicator like gross domestic product, employment, capital utilization, household incomes and business profit fall and bankruptcies and unemployment rates are rise. Global Financial Crisis is among the greatest financial challenges to the world economy which is originated in United States of America. The global economic slowdown is unprecedented in scale and has severe implications on policy formulation among emerging market. Currently India has one of the largest Developing countries in the world. Strong economic growth in the last decade combined with a population of over a billion makes it one of the potentially largest markets in the future. This paper provides an overview of global financial crisis (GFC) and its impact on the Indian Economy.

INTRODUCTION

The current global economic slowdown has its epicenter in the United States (US) but the contagion is being witnessed in all major economies of the world. Several countries are experiencing rapid contraction in their Global Domestic Product, rising unemployment levels and an overall slowdown in the pace of investment activity. What started as a shock in the financial markets has spread to all sectors of the world economy and the exact depth and breadth of the impact is still unclear. India's economy has been fuelled by the growth in the technology sector in the recent past. A large part of this growth is dependent on the "outsourcing" or "off shoring" of key business processes and software development activity (and related services) by large global corporations and other organizations. Hence, the global slowdown has also affected the business climate within India and the growth rate of the all industries. With the increasing integration of the Indian economy and its financial markets with rest of the world, there is recognition that the country does face some downside risks from these international developments. The risks arise mainly from the potential reversal of capital flows on a sustained medium term basis from the projected slow down of the global economy, particularly in advanced economies, and from some elements of potential financial contagion. In India, the adverse effects have so far 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 so far been muted due to the overall strength of domestic demand, the healthy balance sheets of the Indian corporate sector, and the predominant domestic financing of investment. What stands out glaringly in the current regulatory failure. The regulatory failure was twofold. First, some parts of the financial system were either loosely regulated or were not regulated at all, a factor which led to "regulatory arbitrage" with funds moving more towards the unregulated segment.

The second failure lies in the imperfect understanding of the implications of various derivative products. In one sense, derivative products are a natural corollary of financial development. They meet a felt need. However, if the derivative products become too complex to discern where the risk lies, they become a major source of concern. Rating agencies in the present episode were irresponsible in creating a booming market in suspect derivative products. Quite clearly, there was a mismatch between financial innovation and the ability of the regulators to monitor them. It is ironic that such a regulatory failure should have occurred at a time when intense discussions were being held in Basle and elsewhere to put in place a sound regulatory framework. The objective was the present study, 1)Analysis the reasons for the financial crisis, 2) Financial crisis and its impact of the Indian economy with reference to (a) information technology (b) impact on the Indian banking system (c) impact on stock and forex market (d) impact on industrial sector and export prospect (e) impact on employment.

Statement of the problem

The international financial crisis originated in the sub-prime mortgage crisis which surfaced nearly two years ago in the

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U.S. With interest rates rising and home prices falling, there was a sharp jump in defaults and foreclosures. However, this would have remained as a purely mortgage market crisis but for the fact that these sub-prime mortgages were securitized and packaged into products that were rated as investment grade. Once doubts about these assets arose they turned illiquid; it also became very hard to price them. As a result, it started affecting a host of institutions which had invested in these products. These institutions were not confined to U.S. alone. Financial institutions in Europe and to a much lesser extent in East Asia had such assets on their books. With the failure of a few leading institutions and most notably Lehman Brothers, the entire 3 financial system was enveloped into an acute crisis. There was mutual distrust among the financial institutions which led to freezing up of several markets including the overnight inter-bank market. Many think today that letting the Lehman Brothers to fail was a great mistake. The crisis in the financial system has now moved to affect the real sector in a significant way. Hence the researcher decided to take up the study on "*Global financial crisis and its impact on Indian economy-An analysis and perception*".

Economic analysts have attributed that the stimulus for booms in contemporary capitalism has increasingly come from asset bubbles. They have shown that the likelihood of crises increases with the strength and duration of economic booms and that banking crises are occasioned by shocks in asset prices, output, terms of trade and interest rates. Experts have held that the derivatives have the potential to benefit the investors, provided there is thorough understanding of the varied facets of the derivative products including transparent dealings with the borrowers. If the derivate products become too complex to discern, where risk lies, they become sources of concern. Banks lent money on the assumption that housing prices would continue to rise. Also the real estate bubble encouraged the demand for houses as financial assets. Banks and financial institutions later repackaged these debts with other high-risk debts and sold them to world- wide investors creating financial instruments called CDOs or Collateralized Debt Obligations (Sadhu, 2008).

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). Since the collateral debt instruments had been globally distributed, many banks and other financial institutions around the world were affected. Major Banks and other financial institutions around the world have reported losses of approximately US $ 435 billion as on 17th July, 2008 (Onaran, 2008). Policy-makers, regulators and supervisors, in some advanced countries, did not adequately appreciate and address the risks building up in financial markets, keep pace with financial innovation, or take into account the systemic ramifications of domestic regulatory actions. Major underlying factors to the current situation were, among others, inconsistent and insufficiently coordinated macroeconomic policies, inadequate structural reforms, which led to unsustainable global macroeconomic outcomes. These developments, together, contributed to excesses and ultimately resulted in severe market disruption. According to a report by the International Monetary Fund (IMF), many of the factors that led to the financial crisis in the United States created a similar crisis in Europe.51 A host of factors, such as the low interest rates, complex mortgage securitization process, leveraged debt of banks and financial institutions, rise of perverse incentives and complexity for credit rating agencies, expanded linkages between national financial centers that stimulated expansion in credit and spurred economic growth. Credit rating process was faulty. High ratings given by credit rating agencies encouraged the flow of investor funds into mortgage-backed securities helping finance the housing boom. Risk rating agencies were unable to give proper ratings to complex instruments (Gregorio, 2008). Chile, as other open emerging market economies with highly integrated financial systems and capital markets, has been affected by developments in global financial markets. (Banco Central de Chile, 2008). While the financial system has remained resilient to the significant shocks experienced since September 2008, the Chilean authorities took several measures to minimize domestic disruptions and preserve stable conditions in the domestic financial system. The evidence suggests that the greatest gains are obtained from the opening to foreign direct investment, followed by portfolio equity investment. The benefits emanating from external debt flows have been found to be more questionable until greater domestic financial market development has taken place (Henry, 2007; Prasad, Rajan and Subramanian, 2007).

METHODS AND MATERIALS

The present study focuses on the global financial crisis and its impact on Indian economy. The data for this study has been collected from secondary sources of information are mainly from the web sites and News dailies (news papers) besides from the research publications which are mentioned in the reference section.

Analysis the impact of economic crisis in India

(a) Information technology

With the global financial system getting trapped in the quicksand, there is uncertainty across the Indian Software industry. The U.S. banks have huge running relations with Indian Software Companies. A rough estimate suggests that at least a minimum of 30,000 Indian jobs could be impacted immediately in the wake of happenings in the U.S. financial system. 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). The software companies may face hard days ahead.

(b) Impact on the Indian banking system

One of the key features of the current financial turmoil has been the lack of perceived contagion being felt by banking systems in emerging economies, particularly in Asia. The Indian banking system also has not experienced any contagion, similar to its peers in the rest of Asia. The Indian banking system is not directly exposed to the sub-prime mortgage assets. It has very limited indirect exposure to the

US mortgage market, or to the failed institutions or stressed assets. Indian banks, both in the public sector and in the private sector, are financially sound, well capitalized and well regulated. The average capital to risk-weighted assets ratio (CRAR) for the Indian banking system, as at end-March 2008, was 12.6 per cent, as against the regulatory minimum of nine per cent and the Basel norm of eight per cent. A detailed study undertaken by the RBI in September 2007 on the impact of the sub-prime episode on the Indian banks had revealed that none of the Indian banks or the foreign banks, with whom the discussions had been held, had any direct exposure to the sub-prime markets in the USA or other markets. However, a few Indian banks had invested in the collateralized debt obligations (CDOs)/ bonds which had a few underlying entities with sub-prime exposures. Thus, no direct impact on account of direct exposure to the sub-prime market was in evidence. Consequent upon filling of bankruptcy by Lehman Brothers, all banks were advised to report the details of their exposures to Lehman Brothers and related entities both in India and abroad. Out of 77 reporting banks, 14 reported exposures to Lehman Brothers and its related entities either in India or abroad. An analysis of the information reported by these banks revealed that majority of the exposures reported by the banks pertained to subsidiaries of Lehman Brothers Holdings Inc., which are not covered by the bankruptcy proceedings. Overall, these banks' exposure especially to Lehman Brothers Holdings Inc. which has filed for bankruptcy is not significant and banks are reported to have made adequate provisions. In the aftermath of the turmoil caused by bankruptcy, the Reserve Bank has announced a series of measures to facilitate orderly operation of financial markets and to ensure financial stability which predominantly includes extension of additional liquidity support to banks.

(c) Impact on stock and forex market.

With the volatility in portfolio flows having been large during 2007 and 2008, the impact of global financial turmoil has been felt particularly in the equity market. Indian stock prices have been severely affected by foreign institutional investors' (FIIs') withdrawals. FIIs had invested over Rs 10,00,000 crore between January 2006 and January 2008, driving the Sensex 20,000 over the period. But from January, 2008 to January, 2009 this year, FIIs pulled out from the equity market partly as a flight to safety and partly to meet their redemption obligations at home. These withdrawals drove the Sensex down from over 20,000 to less than 9,000 in a year. It has seriously crippled the liquidity in the stock market. The stock prices have tanked to more than 70 per cent from their peaks in January 2008 and some have even lost to around 90 per cent of their value. This has left with no safe haven for the investors both retail or institutional. The primary market got derailed and secondary market is in the deep abyss. Equity values are now at very low levels and many established companies are unable to complete their rights issues even after fixing offer prices below related market quotations at the time of announcement. Subsequently, market rates went down below issue prices and shareholders are considering purchases from the cheaper open market or deferring fresh investments. This situation naturally has upset the plans of corporate to raise resources in various forms for their ambitious projects involving heavy outlays In India, there is serious concern about the likely impact on the economy of the heavy foreign exchange outflows in the wake of sustained selling by FIIs on the bourses and withdrawal of funds will put additional pressure on dollar demand. The availability of dollars is affected by the difficulties faced by Indian firms in raising funds abroad. This, in turn, will put pressure on the domestic financial system for additional credit. Though the initial impact of the financial crisis has been limited to the stock market and the foreign exchange market, it is spreading to the rest of the financial system, and all of these are bound to affect the real sector. Some slowdown in real growth is inevitable. Dollar purchases by FIIs and Indian corporations, to meet their obligations abroad, have also driven the rupee down to its lowest value in many years. Within the country also there has been a flight to safety. Investors have shifted from stocks and mutual funds to bank deposits and from private to public sector banks. Highly leveraged mutual funds and non-banking finance companies (NBFCs) have been the worst affected.

(d) Impact on industrial sector and export prospect.

The financial crisis has clearly spilled over to the real world. It has slowed down industrial sector, with from 8.1 per cent from last year to 4.82 per cent this year. The service sector, which contributes more than 50 per cent share in the GDP and is the prime growth engine, is slowing down, besides the transport, communication, trade and hotels & restaurants sub-sectors. In manufacturing sector, the growth has come down to 4.0 per cent in April-November, 2008 as compared to 9.8 per cent in the corresponding period last year. Sluggish export markets have also very adversely affected export-driven sectors like gems and jewellery, fabrics and leather, to name a few. For the first time in seven years, exports have declined in absolute terms for five months in a row during October 2008-February 2009 In a globalised economy, recession in the developed countries would invariably impact the export sector of the emerging economies. Export growth is critical to the growth of Indian economy. Export as a percentage of GDP in India is closer to 20 per cent. Therefore, the adverse impact of the global crisis on our export sector should have been marginal. But, the reality is that export is being and will continue to be adversely affected by the recession in the developed world. Indian merchandise exporters are under extraordinary pressure as global demand is set to slump alarmingly. Export growth has been negative in recent months and the government has scaled down the export target for the current year to $175 billion from $200 billion. For 2009-10, the target has been set at $200 billion.

(e) Impact on employment

Industry is a large employment intensive sector. Once, industrial sector is adversely affected, it has cascading effect on employment scenario. The services sector has been affected because hotel and tourism have significant dependency on high-value foreign tourists. Real estate, construction and transport are also adversely affected. Apart from GDP, the bigger concern is the employment implications A survey conducted by the Ministry of Labour and Employment states that in the last quarter of 2008, five lakh workers lost jobs. The survey was based on a fairly large sample size across sectors such as Textiles, Automobiles, Gems & Jewelers, Metals, Mining, Construction, Transport and BPO/ IT sectors. Employment in these sectors went down from 16.2 million during September 2008 to 15.7 million during December 2008 Further, in the manual contract category of workers, the employment has declined in all the sectors/ industries covered in the survey. The most prominent decrease in the manual contract category has been in the Automobiles and Transport sectors where employment has declined by 12.45 per cent and 10.18 per cent respectively. The overall decline in the manual contract category works out to be 5.83 per cent. In the direct category of manual workers, the major employment loss, i.e, 9.97 per cent is reported in the Gems & Jewellery, followed by 1.33 per cent in Metals Continuing job losses in exports and manufacturing, particularly the engineering sector and even the services sector are increasingly worrying. Protecting jobs and ensuring minimum addition to the employment backlog is central for social cohesiveness.

Conclusion

While there are growth-related challenges in the short to-medium term, there seem to be some opportunities for managing the bottom line for the rest of the year. The macroeconomic environment is depressing and has impacted the overall confidence in the sector from a market perspective. A US recession, in all probability, will last through 2009 and more, in making this period a challenging one for growth. Despite the foreboding financial crisis, the opportunities are massive. Making the growth vs. profitability trade-off early on during the slowdown is just one of them. Profitability levers are still available if growth is sacrificed where required, and managed well. All in all, the environment looks weakest in a long while, and yet there remain pockets of opportunity. These areas, if tapped intelligently, would enable the Indian industries firms to ease the blow of this financial crisis and help them tide through the tough times. The crisis has now spread globally, and further reduces room to maneuver. To conclude, we are tempted to use a popular aphorism; the Chinese character for “Crisis” represents two symbols “Danger” and “Opportunity“ but the choice is ours.

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