From Local Sub Prime Crisis To Global Economic Crisis : An Impact On Indian Economy

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Abstract

The financial crisis that originated in US spread its tremors in different parts of the world. Culminating into a global economic crisis, its effect could be seen not just in nearby countries but far off places and Indian economy was not an exception to it as it is much more integrated with the world economy through current and capital accounts. Though being insulated by strong financial system, the slowdown in the economy was observed in low GDP, less FDI, withdrawal of FIIs, and the adverse effect on the export of software and IT services. The stimulus package introduced by the government for stimulating the demand of the economy was not that sufficient so as to fight the crisis. Depending more on the monetary policy by injecting liquidity in the market rather than focusing on effective fiscal policy, the government needs an orientation to bring a revival of the Indian economy. The need is to improve the livelihood of the people and bring about a growth in all the sectors of the economy. The present paper is an attempt to analyze the impact of the global recession on the Indian economy and to what extent it has been adversely affected by it.

The paper is divided into three sections. The first section is an introductory section which discusses the genesis of the global financial meltdown, its features and effects on the US financial system. The second section deals with the impact of the crisis on the Indian economy, and the slowdown in the economy. The third section deals with how far the Indian economy has been insulated to avoid the adverse effect of the crisis and the measures that the government need to undertake so as to bring a revival of the economy.

Section -I

Current economic recession better known as global recession, has engulfed the world economy. The Great Depression 1930s which had its origin in US and spread the world over was characterized by dwindling business and massive unemployment. The main cause of this depression was the crashing of stock markets that took all the nations in its web. This leads to vast downfall in global trade as each country started following protectionist measures.

Today the picture is quite different. The US economy had a stock market and real estate bubble that has gone beyond its own during the 1920s. Thus during the 1930s, only the US suffered from gross financial imbalances while today the imbalances has engulfed the whole world. The tremors of this crisis are being felt in various parts of the world, including India. The worst ever financial crisis to have adversely affected the US since the Great depression of 1930s has taken into grip almost every country. The prime explanation being, global economy does not function in isolation. Falling share-markets, declining industrial growth and the overall pessimistic environment of the economy became the most talked about news. It stands to reason that the unwinding of these global imbalances is likely to be more painful today than it was during the Great Depression due to both size and scope.

The global economic situation looks increasingly worse as we face a certain global recession primarily *due to the insane monetary policies of the central bankers.*

Causes of major economic upheaval in the world

Questions may arise as to what is the cause of the falling share market the world over and the bankruptcy of the major banks, to what extent and how has it affected India.

The main factor behind all such economic upheaval has been the *Housing sector of America*. The US economy was economically sound since 2001 to 2006 and the interest rates that were prevalent were quite low due to which the prices of houses were continuously increasing. With the belief that the housing prices would never fall, the financial institutions took the risk of giving loans to sub-prime lenders for purchasing the houses.

"No boom lasts forever". The housing bubble bursted eventually. The housing prices had declined after 15-16 years. Overbuilding of houses finally led to surplus inventories of homes, causing home prices to decline beginning from the summer of 2006. Housing prices started depreciating in parts of USA. Refinancing became difficult for the homeowners, and they began to default on loans as their loans were reset to higher interest rates and payment amount. The crisis became global in nature with the failure merger of several large US based financial firms and spread with the insolvency of additional companies, governments in Europe, recession and declining stock market prices around the globe.

Effects of the Crisis

The effects of the current crisis seems to be more perception driven rather than based on real structural flaws in the financial system and therefore India is expected to bounce back more strongly during an economic turn around. As home prices started declining, sub-prime borrowers found themselves in a precarious situation as the loan interest was soaring. Not able to manage 2nd mortgage on their home, it became difficult for them to pay it. Many of them defaulted on their home-loans and vacated their house.

In America, around 25 private banks had been closed so far due to global economic crisis. The lending companies could not draw the entire amount of loan from the cost of the house. Thus they

were left with no option than to bear those losses. Many of the global banks and brokerages had to write off an estimated $512 billion in subprime losses

One of the world's largest investment banks and securities trading firm, *Bear Sterns* collapsed in spite of the retrieval efforts in the form of financial assistance by the US Federal Reserve. It was finally bought by *J P Morgan Chase*. Next in turn was the *Lehman Brothers*, the 4th largest investment bank in the USA. Bank of America bought the *Merrill Lynch*. The collapse of Lehman Brothers was a symbol of global financial crisis. Two of the giant mortgage companies, *Freddie Mac and Fannie Mac* were nationalized to maintain its existence. A major Insurance group American Insurance Group (AIG) somehow tried to survive by taking around $82.9 billion. Several industrialized nations could be seen sliding into recession.

When the problem is not nip in the bud, it follows a chain reaction. Panic pervaded in the entire economic atmosphere. Banks became alert in lending to the corporate sector. Companies became deficit in cash and had to think twice before expanding their business plans. Measures were tried to overcome this cash crunch or money crisis. The very disastrous effect could be seen in the employment sector. The new recruitments were given a setback. The existing ones were retrenched to balance the money markets. The global investment companies started pulling out of assets.

Catastrophe fell in the stock markets. They became poor victims of the whole currency crisis. The inter bank market became inactive in the world all over. The whole world was going to be affected by this crisis as the major international banks running heavy losses, have their investment interest in almost all the countries. The bail-out package by the Bush administration for the US financial system is just like a trickle-down economics as argued by *Nobel Prize winner Joseph Stiglitz* which is seen as a bail-out for the culprits while the ordinary person has to pay for their folly.

Section-II

Impact on India

The intensity of the present economic crisis was so high that it is being compared with the global economic recession of 1873, great depression of 1930s and East Asian crisis of 1990s. With the advent of 2010, economists started debating the extent of the impact of global meltdown on the Indian economy in the present year. The process still continues. The predictions range between somewhat optimistic to fairly pessimistic. But the common thread running is that 2010 was challenging indeed, the effects yet to be coped up with.

Many economists believe that several sectors of Indian economy have already faced and will continue to severe jolts as an effect of the global recession. The front runners among them are the ***real estate industry, the construction industry and the financial services sector***. The experts opine that one of the prime reasons for the slumping of GDP growth in the third quarter of the 2008-09 was the poor performance of these three sectors which accounts for almost one third of the service GDP. Now the fear is that the slow down of industrial growth is expected to deliver a severe blow to the ***transport industry*** in turn.

India faced heat on three grounds:

- Falling share market everyday
- Weakening of rupee against dollar
- Shortage of liquidity in the market

Though the public sector including the nationalized banks in India could somehow insulate effects of globalization yet global recession touched significant channels herein too. The financial sector, export sector and the exchange rates got a severe jolt.

After a long period of growth, a downturn was seen in Indian economy. The table 1.1 depicts the GDP growth rate which was 9.6 percent in 2006-07, came down to 9.3 percent in 2007-08 and due to impact of global recession, the growth rate kept on declining to 6.8 percent in 2008-09, though it improved marginally to 8.6 percent in 2009-10 and 8.6 percent in 2010-11. The economy faced a slowdown as the growth rate declined to 6.7 percent in 2011-12 and subsequently to 4.9 in 2012-13. A gradual revival was somehow noticed in 2013-14 when the growth rate became 6.6 percent.

Table1.1 Annual Growth Rates of Real Gross Value Added at Factor Cost by Industry of Origin (Per cent) (at 2004-05 prices)

Year	*GDP growth rate (%)*
2005-06	*9.5*
2006-07	*9,.6*
2007-08	*9.3*
2008-09	*6.8*
2009-10	*8.6*
2010-11	*8.9*
2011-12	*6.7*
2012-13	*4.9*
2013-14	*6.6*

Source: Economic Survey , Government of India

This declining trend adversely affected the industrial production, specifically the manufacturing and infrastructure and in the services sector, construction, transport, and communication, trade, hotels experienced a slow growth. The table1.2 given below shows that while the index of industrial production was 108 in 2005-06 and increased to 152.9 in 2009-10, and 165.5 in 2010-11 showed mild increase to 170.3 in 2011-12 and to 172.2 in 2012-13. The following year faced a decline when the index became 172.0 in 2013-14.

Table 1.2 Index of Industrial Production (Base 2004-05 =100)

Year	IIP
2005-06	108.0
2009-10	152.9
2010-11	165.5
2011-12	170.3
2012-13	172.2
2013-14	172.0

Source: Economic Survey of India, Government of India

The most immediate effect of that crisis on India has been an outflow of foreign institutional investment from the equity market. FIIs being the main buyers of Indian stocks had to withdraw their money from the stock market to meet their liabilities at home. Initially they were on a buying spree and now they wanted to sell it off, quitting from the market. So our markets were touching a low phase day by day. The table 1.3 below shows the net investment of FIIs which was $2590 million in 2000-01 and but declined drastically to $-14030 million in 2008-09. This was in fact the gruesome situation which came as a consequence of the global crisis in India. After a gentle revival to 32396 million in 2009-10, the fall was noticed in 2011-12 when it declined to 17170 million and then increased slightly to 26891 million but again decreased to 4822 million in 2013-14. The Indian economy underwent a slowdown with the low level of foreign investment.

Table1.3 : Net FDIs, FIIs and Foreign Investment (in US $million)

Year	Net FDI	Net FII	Net Foreign investment
2000-01	3272	2590	5862
2008-09	22372	-14030	8342
2009-10	17966	32396	50362
2010-11	11834	30293	42127
2011-12	22061	17170	39231
2012-13	19819	26891	46711
2013-14	21564	4822	26386

Source : Securities and Exchange Board of India (SEBI), Government of India

As FIIs pull out their money from the stock market, the large corporate no doubt were affected, the worst affected was likely to be the exports and small and marginal enterprises that contribute significantly to employment generation. The BSE Sensex showed a vast difference in that particular period itself. While it was as high as 20873 in January 2008, it fell severely to nearly 8000 in the same year in November 2008. The table below shows the trend of import and export growth rate during the period 2005-06 to 2010-11. While the import growth rate was 33.8 percent in 2005-06 and export growth rate was 23.4 percent, it reduced to 20.7 and 13.3 percent in 2008-09 respectively, while in the next year i.e. 2009-10, it became negative and was estimated to be -3.5 percent and -5.0 percent respectively. This was the utter consequence of the crisis that the nation faced.

Table 1.4: Trends of India's Import and Export (Growth %)

Year	*Import Growth rate (%)*	*Export Growth rate (%)*
2005-06	*33.8*	*23.4*
2006-07	*24.5*	*22.6*
2007-08	*35.5*	*29.0*
2008-09	*20.7*	*13.3*
2009-10	*-3.5*	*-5.0*
2010-11	*40.5*	*28.2*
2011-12	*21.8*	*32.3*
2012-13	*-1.8*	*0.3*
2013-14	*4.7*	*-8.3*
2014-15 Apr-Dec	*4.0*	*3.6*

Source: Economic Survey of India 2014-15, Government of India

India's balance of payments in 2008-09 captured the spread of the global crisis to India. The **current account deficit** during 2008-09 shot up to 2.6 percent of GDP from 1.5 percent of GDP in 2007-08 and this is the highest level of current account deficit for India since 1990-91. The **capital account surplus dropped** from a record high of 9.3 percent of GDP in 2007-08 to 0.9 percent of GDP in 2008-09. And this is lowest level of capital account surplus since 1981-82. The year ended with a decline in reserves of US$ 20.1 billion (inclusive of valuation changes) against a record rise in reserves of US$ 92.2 billion for 2007-08.

India has been accumulating reserves in 2007. With the outflow of FIIs and depreciation of the Rupee, RBI tried to defend the Rupee by selling dollars. This has resulted in a depletion of foreign exchange reserves. Rupee started losing its strength as demand of dollars increased on account of the conversion of money after selling stocks.

Table 1.5 FOREIGN EXCHANGE RATE

Month	*Rupees per unit of Dollar*	*Appreciation/ Depreciation*
March 2008	40.36	-
April 2008	40.02	+0.85
May 2008	42.13	-4.2
June 2008	42.82	-5.74
July 2008	42.84	-5.79
Aug 2008	42.91	-5.95
Sep 2008	45.56	-11.42
Oct 2008	48.66	-17.05
Nov 2008	49.00	-17.64
Dec 2008	48.63	-17.01
2011-12	47.92	
2012-13	54.41	
2013-14	60.5	
Dec 2014-15	62.75	

Source: Monthly Economic Report, Ministry of Finance, Government of India

Figures in the above table 1.5 shows that during a year itself, the value of rupee with respect to dollar declined sharply from 40.02 in April 2008 to 48.63 rupees to a dollar in Dec 2008. This was record fall of 17.02 in the exchange value of rupee. Since then the exchange value has been depreciating, it reached 54.41 in 2012-13 and then Rs. 62.75 to a US dollar in Dec 2014-15.

The Indian industries were directly affected as sources of raising the money via stock-markets and external borrowing were dwindling. Not only this, the external demand got a severe blow. The cumulative effect fell on the India's financial market and real economy.

Section -III

Indian Economy being insulated to some extent

But again a question arises whether India would be devastated by the crisis. Many economists, however, have contrasting viewpoint. According to them, the global crisis has less impact on India as the Indian financial structure is less exposed to foreign assets and their derived products than other countries. India's exports account for only 15% of their GDP. The factors determining economic growth are more of local in nature. The growth aspect of the Indian economy is moved forward by strong growth in domestic consumption and noteworthy spending on building infrastructure. Though projections indicate that in financial year 2008, India's economic growth is affected by the economic crisis, ***yet the Asian Development Bank predicted India to recover from weakening momentum in 4-6 quarters.*** At the G-20 summit, India called for coordinately global fiscal stimulus to mitigate the severity of global credit crunch. Analysts pointed out that India's trade with other Asian countries will help to reduce the negative impact of the crisis.

The roots of the current banking crisis stem largely from the irrational excitement of the financial services industry during the boom times which has impacted the real estates, and investment banking. The country was protected from much of the negative impact, by preventing "risky" financial instruments such as collaterised debt obligations (CDOs). *The root cause of the current global recession has been the sub-prime mess and Indian banks are quite insulated from it*. The exposure of Indian banks to CDOs is zero. Extreme caution is taken in disbursing loans by the banks to companies and needy ones. Though there is the presence of European /US banks in India and also that some Indian banks have their subsidiaries in foreign countries having some stake in sub-prime losses, their presence is minimal as compared to the overall size of the Indian banks.

Though there has been fall in the demand of consumer goods as a result of global depression (13.5 % of goods sold by India in 2007-08 to foreign buyers is likely to decline), Indian Banking has emerged as a strong and stable system. The three distinct characteristics of the contemporary banking scenario acts like a strong shield for the Indian economy:

- *soundness of the banking system,*
- *the need for further capital augmentation, and*
- *remaining uncontaminated by the recent global financial contagion resulting from sub-prime turbulence,*

On closely scrutinizing the Indian economy, we find that India is capable of handling the scenario and has not been drastically affected by the recession. World economic forum and Confederation of Indian Industry are of the opinion that Indian economy may get affected but not devastated because India is in high production and high consumption phase of development. We are still in a position to pay for our imports as the foreign reserves are adequate for it.

To say that employment will get a major jolt may not be fully accepted. The nationalized banks generated more than 20,000 jobs during March 2009. Likewise, the insurance companies are also not behind. Many private insurance companies have given job opportunities to many dynamic youth. *Larsen and Tubro* have announced around 10,000 jobs before the beginning of the new financial year. *NASSCOM* has announced that software and *BPO sector* jobs will remain unaffected which is good indicator of strong economic citadel.

India has made a strong fort to stop the attack of global recession in its economy. Our big population has become a boon for us due to the high quality human resource for the developed countries. Indians were targeted for outsourcing by the developed countries like America, Germany, France, Britain, Spain etc, and the positive response from us has proved to be an asset for our economy. Good quality work at reasonable rate strengthened our position. FIIs still find higher opportunities in India as the middle class in India has a steady rising purchasing power and which constitute a huge section of the Indian market. The foreign investors had no option but to go for institutional investments in India.

Our banks have strong balance sheets. They are well capitalized. The capital adequacy ratio of each of our banks is well above Basel norms and above the norms stipulated by the RBI. Being well regulated, they have shown resilience and continue to provide credit to all sectors of the economy.

Merely pumping the liquidity into the economy is not a long term solution but it is the need of the hour to create demand which is possible through the expansionary fiscal policy of the government. For an inclusive and balanced growth, the government is required to orient its expenditure on agriculture, rural infrastructure, social infrastructure like health and education. The Indian economy has a challenging situation where *it has to focus on fiscal consolidation, ensure that the monetary and fiscal policies get stimulated*, and are managed in this globalized world. ***A thriving manufacturing sector and recovering agriculture sector would make the economy return to a speedy pace of growth***. The growth should not be based on any speculative bubble but on the improved production of food crops where the peasants are given due consideration so that the livelihoods of the people is improved.

Thinking deeply and with a cool mind, it is very much evident that the greed of Americans failed to anticipate the consequence of their actions. Hence, broad global regulatory framework needs to be evolved to avoid the repeat of such act, where it is known that the greed of some can affect the billions.

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