Indian Streams Research Journal
Vol -1 , ISSUE –1, Feb - 2011
ISSN:- 2230-7850
Available online at www.isrj.org

GLOBAL FINANCIAL CRISIS AND IT'S IMPACT ON INDIAN ECONOMY

Mr. Ambanna Bhavimani

Assistant Professor, Government First Grade College Sulepeth,
Tq. Chincholi, Dist. Gulbarga.

ABSTRACT

The turmoil in the international financial markets of Developed economies, that started around mid-2007, has exacerbated substantially since August 2008. The financial market crisis has led to the collapse of major financial institutions and is now beginning to impact to real economy in the advanced economies. As this crisis is unfolding, credit market appear to be drying up in the developed world. With the substantive increase in financial globalisation, how much will these developments affect on Indian emerging market economy (EME)?

In view this the present paper makes an attempt to study the Global financial Crisis, to emphasis its impact on the Indian economy in the wake of the global financial crisis and measures taken by the Government and RBI to overcome the already set in Financial crisis, and offer some measures to adders the crisis.

Key words: international financial markets , financial market crisis , Indian emerging market economy (EME).

INTRODUCTION:

The developing countries which today are closely integrated with overseas markets have the impact of the development of the other country also. India at the moment faces a considerable risk of a sever downturn as a consequence of the global financial crisis. Despite the large size of the nation, both in terms of the geographical spread and population which provides the potential for a large home market, India's reliance on overseas markets have recently rised considerably. The reasons include at least four factors Viz. The free play of FII investors since 1993 when India's stock markets were thrown open to such short term investments. Speculatory flows have been responsible for phenomenal expansions in the country's stock markets, with capitalization as well as P/E ratios moving up to unprecedented levels. Second, there has been an extensive use of derivatives, on a legal basis in security exchanges and as OTCs. This has led to rapid increases in their use, especially after 1992 when much of these were legalised. Derivative trading in the future market has been at least 6 times the turnovers in spot trading at the National Stock Exchange till the meltdown started in these

Indian Streams Research Journal
Vol -1 , ISSUE –1, Feb - 2011
ISSN:- 2230-7850 Available online at www.isrj.org

markets. Third foreign presence in the capital market has been prominent, especially with FII inflows in the secondary markets for stocks, which not only contributed to the rising turnovers but also to vulnerability in terms of sudden flight of capital. The rising level of official reserves, to the extent propped up by these inflows, are already facing depletion. These have also affected the exchange rate of the rupee, currently heading a downward spin, despite efforts on the part of monetary authorities to manage the rate. Fifth, with both banks and corporates having a considerable exposure in the global equity market it remains one of the imponderables as to how much the balance sheet of these financial and industrial units would be damaged by the global financial melt-down. As recently estimated by the author, for corporate units as a whole 40% of their portfolio consists of short term assets. Finally, with the onset of recessionary forces in the real sector of the advanced nations, export markets will be generally hard hit for countries like India.

OBJECTIVES

The present paper makes an attempt to study the global financial crisis, to emphasis the impact of global financial crisis on Indian economy, to focus on the challenges before Indian economy in the wake of the global financial crisis and measures taken by the Government and Reserve Bank of India to overcome financial crisis and finally to offer some suggestion to address the crisis.

Impact of the Global Financial crisis on the Indian Economy:

Economic Growth:

Has the present global crisis affected India's domestic economy? To answer this it is necessary to look at our current microeconomic fundamentals. Latest RBI estimate place India's growth rate during 2008-09 at 7.7 percent. Most other estimates also place GDP growth for the year in the range of 7-8%. During the first quarter of 2008-09 (April – June) Indian economy grew at 7.9% though growth is expected to slow down in the subsequent quarters as the slowdown. Started effetely all the sector of the economy. The first indication has already come from the index of Industrial production (IIP). According to latest data, the IIP grew by 4.8% in September 2008 as against 7% in the corresponding period last year. The cumulative growth during April – September 2008 was only 4.9% as against 9.5% during the corresponding period in previous year. While the September figure is an improvement over the dismal growth of 1.3% recorded for August 2008, it is too early to see it as a recovery from the previous low.

Price Situation:

The rate of inflation, as measured by the wholesale price index (WPI) has gone down during recent few weeks and more encouragingly declined sharply during the week ended 1st November to 8.98% down from the previous week's level of 10.68% and the peak level of 12.9 percent in first week of August 2008. However, food inflation remains high. Moreover, inflation as measured by the consumer price index (CPI IW) has not shown a decline. On the contrary, there is a steady rise in CPI IW inflation from 7.7 percent in June 2008 to 9.8 in September, 08.

The Combination of rising prices of consumer goods coupled with declining growth does not bode well for the economy.

Banking Sector:

The banking Sector in India is largely (70%) dominated by the public sector. Parly as a result, India has not been witness to the kind of crisis of confidence seen in advanced countries. Additionally, strict regulation and conservative policies adopted by the reserve Bank of India have ensured that Banks in India are relatively insulated from the travails of their Western counterparts. However, this cannot be advanced as a reason either for continuance of public sector dominance or for resistance to further financial sector reform. The example of Canada where the private sector plays a major role in the banking sector and is, by and large, less affected by the present financial crisis is a case in point.

Indian banks are well capitalized with a low level of non performing assets (NPAs), the level of NPAs may go up due to the recession set in the economy which is being felt all the sectors.

The reserve Bank of India has initiated a series of steps to ease the liquidity problems being faced by banks. It has cut the cash reserve ratio to 5.5% and the repo rate at which the central bank pumps liquidity into the system to 7.5%. It has also reduced the statutory liquidity ratio to 24%, down from 25% earlier.

Capital Market:

After the macro-economic reforms in 1991, Indian economy has been increasingly integrated into the global economy. The financial institutions in India are exposed to the world financial market. Foreign institutional investment (FII) is largely open to the India's equity, debt market and market for mutual funds. The present crisis has significant impact on FII investment in India as investors all over world lack confidence in the market. The crisis in confidence resulted in net outflow of $10.1 billion from both the equity and debt market in India in the year 2008, till 22nd Oct. This has made significant impact on India's stock Market and exchange rate. As higher FII outflows have a down pressure on the value of rupee at the same time a weaker rupee makes it costlier for FIIs and hedge funds to pull out of the market but decline in stock prices only adds to their woes. India's stock market index Sensex which touched above 21,000 in the month of January, 2008 has plunged below 10,000 during October. Date on sensex at the weekend closing point and net FII in equity on the same day taken since 1st of August, 2008 till 17th Oct. Figures a positive correlation of 0.66. The positive correlation establishes the fact that market capitalization of most of the companies including banking, finance and real estate sector has been depend on FII.

Impact of capital outflows on domestic Currency:

Exchange rate volatility in India has increased in the year 2008-09 compared to previous years. The exchange rate of rupee vis-à-vis the dollar which stood at Rs.39.9/$ on 1 April 2008 has fallen steadily on account of net dollar out flows, driven predominantly by portfolio investors pulling out of the country. It breached the Rs.50 to the dollar mark, falling to Rs.50.29

to the dollar on 27 October 2008 before recovering to Rs.48-49 to the dollar in subsequent trading.

Exchange rate Volatility and India's external trade:

After registering an export growth of 29.02 percent and import growth of 35.4 percent during 2007-08, growth merchandise export growth fell by 15% in dollar terms in October 2008. This is the first time in five years that exports have actually shown a dip, reflecting the growing adverse impact of the global slowdown. If the present trend continues there is a danger that India will not achieve the export target of $ 200 bn for the current fiscal.

Credit squeeze for care Sectors:

Project financing for infrastructure development such as roads, highways, port, power Plants, Steel, Cement, airports etc are going to be hit as finance has started to slow down because of the credit squeeze in the Market. The Reserve Bank has tried to inject liquidity into the market by dropping lending rates, relaxing the cash reserve ratio (CRR) and statutory liquidity ratio (SLR) to make more money available to the Indian Corporate sector to borrow money and complete project in time.

Impact on Software exports:

With regard to software exports, the larger companies are yet to feel any severe adverse effect of the financial crisis. To the extent that the IT and ITES industries at the national level expect almost 50 percent reduction in growth rate. The limited exposure to crisis thus for could perhaps be seen in the context of relatively lower engagement of India based companies with financial services. It can be understand that, there is a greater orientation of India based firms towards the Japanese market while at the national level share of Japan is only about 3 percent.

Impact on Tourism Industry:

Tourism industry is already adversely affected by the crisis. Recent terror attacks have aggravated the situation. Given that there exist linkages between tourism and retail trade, any decrease in the number of tourists is likely to have a negative effect on retail trade. Given the weight of trade, hotels, transport and storage in the service sector of the country, any adverse effect on the tourism sector could have its impact on the overall growth of the country's domestic product.

The Challenges Ahead:

Let's now turn to the major challenges being faced by the banking sector in the country, particularly in the wake of the global financial crisis.

- **Maintaining the Credit Flow:**

There is a noticeable decline in the credit demand in the month of November, 2008 but it is not yet clear if it was a one off episode or it reflects a trend. If it is indicative of slowing

Indian Streams Research Journal
Vol -1 , ISSUE –1, Feb - 2011
ISSN:- 2230-7850 Available online at www.isrj.org

economic activity, it would be a major challenge for the banks to ensure healthy flow of credit to the productive sectors of the economy.

- **Reform Financial Sector Regulations Reforms:**

By far, the most contentious and most valuable debate triggered by the crisis has been about the flaws in the regulatory architecture of the financial sector. Several issues have come to the fore, like, how complex derivative products are? Which transmitted risks across the system, be made more transparent? What are the financial stability implications of structured product like credit derivatives? Are exchange traded derivatives better than over-the-counter (OTC) derivatives? Is universal banking, the model that the United States has now turned to, appropriate? Can we apply the same regulatory regime for both wholesale and retail banks?

- **Regulatory Forbearance and Relaxing Regulatory Norms:**

There has been a demand to relax the asset classification norms by increasing the period of delinquency beyond the current norm of 90 days after which the loan asset is required to be classified as non-performing. The objective underlying the demand is to permit the banks to avoid recognizing non-performing loans (NPLs) for a longer period. Is it desirable to change the NPL norm by relaxing the 90 day rule?

- **Effective Implementation of Basel II Framework:**

The Indian banking system has already migrated to the Basel II Framework effective March 31, 2008 and the remaining commercial banks are slated to do so by March 31, 2009. The RBI is yet to announced the timeframe for adoption of the Advanced Approaches in the Indian Banking System but the migration to these approaches is the eventual goal for which the banking system will need to start its preparations in all earnestness. The migration to the advanced approaches poses several significant challenges to the bankers and as the banking regulator and supervisor, also to the RBI.

Measures taken by RBI:

1) The RBI has taken several measures aimed at infusing rupee as well as foreign exchange liquidity and to maintain credit flow to productive sectors of the economy. Measures aimed at expanding the rupee liquidity included significant reduction in the Cash Reserve Ratio (CRR), reduction of the Statutory Liquidity Ratio (SLR), opening a special repo window under the liquidity adjustment facility (LAF) for banks for on-lending to the non-banking financial companies (NBFCs), housing finance companies (HFCs) and mutual funds (MFs), and extending a special refinance facility, which banks can access without any collateral. The RBI is also unwinding the market stabilization scheme (MSS) securities, roughly synchronized with the government borrowing programme, in order to manage liquidity.
2) Measures aimed at managing forex liquidity include upward adjustment of the interest rate ceilings on the foreign currency non-resident (banks) [FCNR(B)] and non-resident (external) rupee account [NR(E)RA] deposits, substantially relaxing the external commercial

borrowings (ECB) regime, allowing the NBFCs and HFCs access to foreign borrowing and allowing corporate to buy back foreign currency convertible bonds (FCCBs) to take advantage of the discount in the prevailing depressed global markets. RBI has also instituted a rupee-dollar, swap facility for banks with overseas branches to give them comfort in managing their short-term funding requirements.

3) Measures to encourage flow of credit to sectors which are coming under pressure include extending the period of pre-shipment and post-shipment credit exports, expanding the refinance facility for exports, counter-cyclical adjustment of provisioning norms for all types of standard assets (except in case of direct advances to agriculture and small and medium enterprises which continue to be at 0.25 percent) and risk weight on banks, exposure to certain sectors which had been increased earlier counter-cyclically, and expanding the lendable resources available to the SIDBI, the National Housing Bank (NHB) and Exim Bank.
4) To improve the flow of credit to productive sectors at viable costs so as to sustain the growth momentum, the RBI signaled a lowering of the interest rate structure by reducing its key policy rate viz., the repo rate by 250 basis points from 9.0 percent as on October 19 to 6.5 percent by December 8, 2008.
5) Although, remain vulnerable to global financial and economic developments, the measures taken so far have eased the liquidity and credit flow situations considerably. Also add that in managing the impact of the global crisis.
6) The mechanism of Special Market Operations (SMO) for public sector oil marketing companies instituted in July-2008 taking into account the extraordinary situation then prevailing in the money and forex markets will be instituted when oil bonds become available.
7) For fin-tuning the management of bank reserves on the last day of the maintenance period, a second LAF (SLAF) on reporting Fridays, was introduced with effect from August 1, 2008. It was decided to conduct the SLAF on a daily basis till further notice.

MEASURES TO ADDRESS THE IMMEDIATE CRISIS:

1) In the context of credit crisis, the Government has to monitor the credit availability through the mechanisms such as state level bankers committee They may also consider using the co-operative banking network to extend credit to small and medium enterprises and exporters especially those dealing with the products of traditional industries. This depends on the viability of co-operative banking system in the country, and its ability to meet future challenges.
2) Since the construction and real estate sectors-sectors having high multiplier effects in terms of both employment and income are highly vulnerable to credit crisis more pro-active measures need to be taken. Here the mitigation measures include rationalization of stamp duty and lessening the cascading effect of present tax structure.
3) The Government should to take steps to enhance the ability of commercial crop growers to withstand the instability in export market. Crop insurance and other mechanisms that limit the cost / price fluctuations need to be re-evaluated, based on recent assessment that such insurance is indeed viable for pepper.

4) Considering the negative impact in tourism sector, Government should change those policies that work against the competitive advantage of tourism operators and service providers in the country. This requires rationalization of taxes charged on tourist services like hotels, license regulations of bars / beer parlours aimed at foreign tourists, to make the India comparable with other tourist destinations outside the country.
5) One area where (deficit financed) public spending can be beneficial during the crisis, either to provide fall back employment, or to serve as a long term support to economic activities, is that of infrastructure. Moreover, India has crucial gaps in quality infrastructure. The country may need more resources for such infrastructure oriented public spending. However, the greater constraint in this regard seems to be the inability of the Government in project planning and implementation and also the slow pace of decision-making in general. This prevents the effective use of external resources available (like those from multilateral agencies).
6) The crisis provides an opportunity to make more investments in infrastructure though the reduction of cost of intermediate inputs. The prices of oil, steel, cement and many others have come down due to the tapering (or slackening) of demand all over the world. Thus the real cost of construction of physical infrastructure like roads, ports, bridges, railway lines, etc. is likely to come down. Thus if public spending can be directed to infrastructure, the value enhancement could be much higher during the crisis compared to the earlier situation.

CONCLUSION:

The Indian economy has shown considerable resilience in the face of the present global financial crisis. The financial sector has emerged without much damage thanks in part to our strong regulatory framework and in part on account of state ownership of most of the banking sector. However, it would be naïve to expect the real economy to be completely unaffected by the global slowdown. The immediate impact of the crisis is the drying up of dollar liquidity as FIIs pull out their money from the stock market and sources of overseas credit and trade credit dry up. While large corporate will no doubt be affected, the worst affected are likely to be they exports and SMEs (Small and Marginal Enterprises) that contribute significantly to employment generation. RBI's efforts to ease the downward pressure on the rupee (by selling dollars) have added to the domestic liquidity crunch in a scenario where corporate are increasingly turning to the domestic banking sector to make up for the drying up of external sources of finance and the IPO (Initial Public Offering) market. Despite robust growth of 30% in bank credit (year-on-year), corporate are complaining of a credit crunch. The only silver lining is the decline in inflation latest number show inflation at 8.98% for the week ended 1st November 2008.

REFERENCES:

1) Henry, Peter Blair (2007), "Capital Account Liberalization: Theory, Evidence and Speculation", Journal of Economic Literature, Vol. XLV, December.
2) Mohan, Rakesh (2006), "Coping with liquidity management in India: A Practitioner's View", Reserve Bank of India Bulletin, April.

3) Prasad, Eswar S., Raghuram G, Rajan and Arvind Subramanian (2007), "Foreign Capital and Economic Growth", Brookings Papers on Economic Activity, 1.
4) Rakesh Mohan (2008) Deputy Governor, RBI "Global Financial Crisis and Key Risks: Impact on India and Asia", Remarks Prepared for IMF-FSF high-level meeting on the Recent Financial Turmoil and Policy Responses at Washington D.C. October 9, (Down loaded through Internet).
5) Reserve Bank of India (2008), Annual policy statement for the year 2008-09 April, (Down loaded through Internet).
6) Dr.D.Subbarao, (2008) Governor, RBI "The Global Financial Turmoil and Challenges for the Indian Economy", Speech at the Bankers' Club, Kolkata on December 10.
7) www.google.com

Mr. Ambanna Bhavimani
Assistant Professor, Government First Grade College Sulepeth,
Tq. Chincholi, Dist. Gulbarga.