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RETREAT OR ADVANCE OPTION FOR INDIA AFTER THE
GLOBAL FINANCIAL CRISIS



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Short Profile

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ABSTRACT:

Financial deepening (opening up and further globalizing) is seen as an angel and demon at the same time. There has been a decline in the cross border capital flows as the after math of the crisis, which has definitely affected the growth momentum of the Indian Economy. The crisis has stressed the need for greater caution and stability, but unless current regulatory reform initiatives succeed in restoring confidence, there is a possibility of

excessive caution. This will risk creating a financial system that fails in its primary purpose that is of providing a healthy flow of credit to the real economy.

Decisions have to be taken on the front of whether the Indian financial markets should retreat from further globalizing and integrating or whether it should globalize further. One path leads to a structure that relies primarily on domestic capital formation and concentrates risks within local banking systems, while another points toward a healthier model of financial globalization that corrects the pre-crisis excesses while supporting more robust economic growth. Achieving this second outcome will require rigorous actions by the Indian policy makers. This study tries to analyze the factors in favour of and against further globalization of the financial markets and tries to figure out the way forward.

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KEYWORDS

Financial Crisis, Retreat, Advance, India, Globalization.

INTRODUCTION:

Developed capital markets are favorable to the long-term development of a more stable financial system. Especially for India which has an economy of ~\$1.6 trillion and a savings rate of approximately 33.7% and at the same time requires approximately \$500 billion of capital for infrastructure development, a well developed and efficient capital market is the need of the hour. Investors in India prefer investments that are risk-averse. Only less than 1% of a total population of more than 1.2 billion, are active participants, with a mere approximate 10% of their investments in the capital market. Because of this, retail equity ownership amounts to approximately 10% of total equity ownership due to which trading volumes are relatively lower than other countries (Sikka 2012). The corporate debt market is also under-developed. An under-developed capital market system eventually results into financial inefficiency. Consequently, investor awareness & penetration of retail markets has become inevitable for the optimum growth of the capital market. Financial deepening (opening up and further globalizing) is seen as an angel and demon at the same time. Decisions have to be taken on the front of whether the Indian financial markets should retreat from further globalizing and integrating or whether it should globalize further to become more developed and efficient.

One path leads to a structure that relies primarily on domestic capital formation and concentrates risks within local banking systems, while another points toward a healthier model of financial globalization that corrects the pre-crisis excesses while supporting more robust economic growth. Achieving this second outcome will require rigorous actions by the Indian policy makers.

The Affects of the Global financial Crisis: Slowing Growth

Regulatory measures and developments in the international financial markets have an impact on the Indian financial market. The financial shock was also transferred to the Indian Capital market through a variety of means which include credit squeeze, sudden stop in financial flows and reduction in export earnings. The global financial crisis had its affects mostly on the developed economies, which were at the heart of the crisis, but the developing economies were also affected. The loss of momentum in financial depth was not only confined to the advanced economies. Developing markets weathered the crisis well, but their financial depth is on an average less than half that of advanced economies as of 2012 (157 percent of GDP compared with 408 percent of GDP). This gap was narrowing before the crisis, but it is no longer closing. (McKinsey, 2013)

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Table 1: Top 5 contributors to Global Financial Depth
(in percent of all countries' GDP)

	1989		2009
World	4.25		6.71
Advanced countries	3.93		5.50
US	1.38	US	1.96
Japan	1.20	Japan	0.88
UK	0.24	UK	0.52
Germany	0.23	Germany	0.41
France	0.19	France	0.36
Emerging Markets	0.32		1.21
Brazil	0.08	China	0.48
China	0.04	Brazil	0.11
Hong Kong SAR	0.03	Hong Kong SAR	0.10
Korea	0.03	Korea	0.08
India	0.02	India	0.08

Source: BIS, World Bank, updated and extended Lane and Milesi-Feretti (2007) dataset, IMF staff calculations.

Financial deepening is widely believed to confer important stability benefits, it helps to limit fluctuations in asset prices, find alternative sources of funding, and reduces the need for reserve accumulation.

The world's financial assets—or the value of equity market capitalization, corporate and government bonds, and loans—grew from around \$12 trillion in 1980 to \$206 trillion in 2007. Financial depth, which measures those assets relative to GDP, rose from 120 percent to 355 percent of global GDP over the same period. (McKinsey, 2013)

Table 2: GDP Growth Rates (Percent change)

Country	Year 2007	Year 2008	Year 2009
US	1.790	-0.291	-2.802
United Kingdom	3.427	-0.769	-5.170
Germany	3.389	0.807	-5.085
Japan	2.192	-1.042	-5.527
France	2.285	-0.081	-3.147
China	14.146	9.635	9.214
India	9.081	3.891	8.480

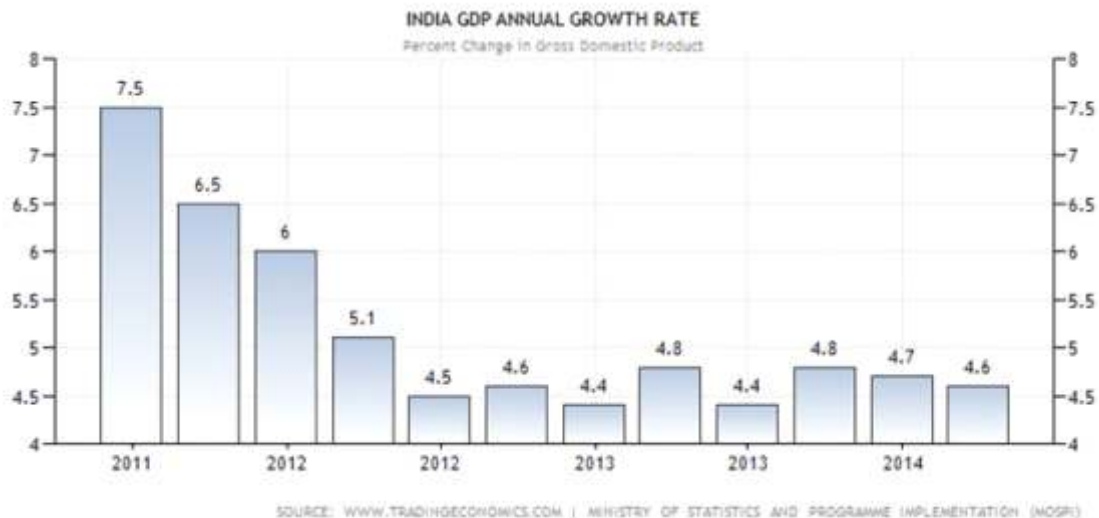
Source: International Monetary fund Database

As can be seen from the table, the status of growth before and after the financial crisis struck. Although India did seem to be insulated from the crisis, but the real effect could be felt when the crisis intensified. There is a positive correlation between financing for the Government and corporate sectors and subsequent GDP growth. A decline in financial deepening could therefore slow down the economic growth of India. The risk being that continued slow growth in financial assets may hinder the economic growth, depress business investment, as well as decelerate investment in innovation and infrastructure. The grim economic outlook may force many countries to return to protectionism of their domestic industry and to prevent such incidents where unemployment is an option as there certainly has been a severe decline in the cross border capital flows as the aftermath of the crisis.

IMPACT OF THE CRISIS ON THE INDIAN ECONOMY:

Although India did not have direct exposure to the subprime crisis and with limited dependence on exports which account for less than 15% of the GDP and growth mostly dependent on domestic investments and demand, the Indian Economy was still impacted by the crisis and the GDP fell from a 9% growth to 6%. The financial crisis has impacted India through three channels: financial markets, trade flows, and exchange rates. The initial effect of the crisis was, in fact, positive, as the country received accelerated Foreign Institutional Investment (FII) flows during September 2007 to January 2008. But as the crisis increased it spread to the emerging economies through capital and current account of the balance of payments. The net portfolio flows to India eventually turned negative. The stock market and the exchange rates were affected through the supply demand imbalance in the foreign exchange market. The current account was mainly affected mainly after September 2008 through slowdown in exports. This reversal in capital inflows, which created a credit crunch in domestic markets along with export demand severely being reduced, contributed to the decline of gross domestic product by around 3% in the fiscal year 2008–09.

India has been rigorously integrating in the world economy. The sum of merchandise exports and imports as a proportion of GDP grew from 21.2% in 1997-98, the year of the Asian crisis, to 34.7% in 2007-08. From 2003-08, the share of investment in India's GDP rose by 11%. (ASSOCHAM,) For the corporates, while the funds were available domestically, they were quite expensive, therefore a significant proportion of funding came from foreign sources. Also, looking at India's promising growth potential, foreign investors were willing to provide the funds. This became the main reason for deeper financial integration in India. The negative effects of the crisis began in early 2008 with the withdrawal of capital from the Indian financial markets. This is shown in India's balance of payments as a substantial decline in net capital inflows in the first half of 2008-09 to US\$ 19 billion from US\$ 51.4 billion in the first half of 2007-08, a 63 percent decline (Bajpai, 2011). This is seen from a large outflow of portfolio investment (as equity disinvestment by foreign institutional investors); and lower external commercial borrowings, short-term trade credit, and short-term bank borrowings.



When compared to countries across the world, India stands out as one of the best performing economies. Although there was a clear moderation in growth from 9 percent levels to 7+ percent soon after the crisis hit, in 2010-11, at 8.6 percent, GDP growth is far from the pre-crisis levels and if India can attain and sustain growth rates of 9+ percent that it had achieved prior to the crisis, this will give a hike to domestic savings. Stronger growth should attract more foreign savings, especially foreign direct investment, and thus raise the investment rate. In 2007 - 08, India received capital inflows amounting to over 9 % of GDP as against a current account deficit in the balance of payments of just 1.5 % of GDP. These capital flows, in excess of the current account deficit, prove the importance of external financing and the depth of India's financial integration.

As compared to the previous robust five years of growth, moderation started in the second half of 2008-09. There was a negative growth in Industrial output, for the first time since 1990s, which was because of the decelerating external demand which affected performance. Something that can be attributed to the increasing integration of India to the outside world.

The Two Pathways: Retreat or Advance

After the shock of the global financial crisis, emerging as well as developed economies are trying to figure out whether openness is necessary for a healthy financial sector. India has a choice between the two pathways, as to how to progress in the future. The two pathways are, either to "retreat" from the current position of further liberalizing the financial sector. This would eventually result in lower growth. Or on the other hand, to "advance" forward with gradually liberalizing but at the same time controlling and regulating the cross border capital flows.

Emerging economies have long worried that a large financial sector is a potential hazard, and if fully liberalized, they curtail further financial market development. But at the same time, as predicted in a report, (McKinsey, 2013) by 2020 as emerging economies account for a larger share of global GDP, their lack of further financial deepening would reduce the global ratio by around 25 percentage points. A more conservative market can hold back the access of the local economy to much needed expansion capital. Also, a study by Ranciere et al. 2008, found that countries with occasional financial crises grow

faster on an average than those with completely stable conditions. Greater integration of the Indian capital market offers four principal, and inter-related, benefits: Better allocation of capital, more efficient risk sharing, enhanced portfolio diversification and lower cost of capital (Merton, 1987).

The “retreat” scenario is one which is shaped by a high degree of risk aversion—one that may squeeze the financing needed for investment in innovation and R&D, business expansion, infrastructure, housing, education, and human capital development. As a consequence of the crisis a reduction in long-term lending to corporations is already apparent in Europe. In such a scenario, the Indian economy may face massive investment needs as it gets urbanized and industrialized, but at the same time may encounter a shortage of capital. If other developed Countries follow the same trend they would find themselves with surplus capital but with too few good investment opportunities; savers and investors in these countries could face lower returns.

If the trend of retreat is to be chosen, the value of global financial assets relative to GDP would remain flat or even decline by 2020. Based on an analysis (McKinsey, 2013) of the relationship between financing to households and non-financial corporations and economic growth, it is estimated that the lack of financial deepening could potentially reduce GDP growth by roughly 0.45 percentage points.

On the contrary, with completely unrestrained capital flows, it is no longer possible to control the amount of capital inflow or outflow, and both movements can create consequences which are undesirable. It is increasingly recognized that liberalization can dismantle the very financial structures that are crucial for economic growth. A better outcome would involve more sustainable growth and development of the financial system.

The Way Forward:

The crisis has stressed the need for greater caution and stability, but unless current regulatory reform initiatives succeed in restoring confidence, there is a possibility of excessive caution. This will risk creating a financial system that fails in its primary purpose that is of providing a healthy flow of credit to the economy. India has huge domestic demand, which needs to be tapped.

Greater participation from Global Institutional Investors assures greater liquidity and enhanced reputation of the market, leading to better valuations of companies listed on Indian Exchanges. In addition, such reforms would also have additional benefits like job creation in financial cities of India and exposure to global corporate securities laws. India has to move towards a healthier model of financial globalization that corrects the pre-crisis excesses while supporting more robust economic growth. Achieving this outcome will require rigorous actions by the Indian policy makers. There should be quick and consistent policy making which can transmit positive signals to the private sector for boosting the investment levels in the economy. Retreating even though can insulate the economy from the crisis situations but is not a feasible option, as it will weaken the growth trajectory that India is dreaming of to be reaching by 2020.

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